

IFRS 16 Leases: Putting theory into practice

ALL IN THE PLANNING
PUTTING TOGETHER AN
IMPLEMENTATION PLAN
THAT WILL SUCCEED

AVAILABLE OPTIONS
CHOOSING THE BEST
WAY TO TRANSITION
TO IFRS 16

NUMBER CRUNCHING
ACCOUNTING FOR THE
RIGHT-OF-USE ASSET
AND LEASE LIABILITY



The route to success

Implementing the IASB's
new leases standard

Prepare for take off!



The former IASB chairman Sir David Tweedie once famously bemoaned the fact that he had never flown on a plane that was on the airline's balance sheet. The reason behind this apparent anomaly was that airlines typically leased their aircraft rather than buying them. And a little careful structuring of a lease arrangement or two meant that it was fairly easy for them to keep both the plane and the related lease

liability off-balance sheet.

Sir David declared, in his inimitable way, that the IASB's leasing standard was 'absolutely useless' and promised that all leases would be on-balance sheet within three years. That was way back in 2002. It has taken a lot longer than Sir David hoped but, after many a twist and turn, the IASB finally issued its long-awaited new leasing standard in January 2016. Its septuagenarian former chairman can finally sleep easy at night.

The publication of IFRS 16 Leases finally brought to a close a debate that had lasted for a generation. The age-old distinction in international standards between finance leases and operating leases is no more, meaning that, for the first time, almost all leases will appear on the balance sheet of the lessee. The new standard - which is effective for accounting periods beginning on or after 1 January 2019 - is intended to improve both comparability and transparency by providing users with a more complete and understandable picture of an entity's leasing obligations.

The effect of the new standard will, of course, vary between individual companies, sectors and even geographical regions. The impact is likely to be most pronounced in those business sectors - such as transportation, real estate, mining and construction - where there are currently a significant number of material off-balance sheet leases. Companies with significant leased premises - such as retailers - will be similarly affected. But whatever sector your business operates in, it is likely that implementing the new standard will present a formidable logistical challenge.

As IFRS 16's effective date draws ever nearer, this publication brings together the views of leading experts to help you plan for the change that lies ahead. We hope that it will provide a useful reference point during your journey towards implementation.

Dr Nigel Sleight-Johnson FCA
Head of Faculty

© ICAEW 2017. All rights reserved. The views expressed in this publication are those of the contributors; ICAEW does not necessarily share their views. ICAEW and the author(s) will not be liable for any reliance you place on information in this publication. If you want to reproduce or redistribute any of the material in this publication, you should first get ICAEW's permission in writing. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by ICAEW, the publishers or the author(s). Whilst every care is taken to ensure accuracy, ICAEW, the publishers and author(s) cannot accept liability for errors or omissions. Details correct at time of going to press. ISSN 2044-4508 TECPLM15678

Printed in the UK by Sterling Solutions
The paper used to produce this magazine is sourced from sustainable, managed forests.
To comment on your magazine, please email publishing@icaew.com



ICAEW

Financial
Reporting
Faculty

THE TEAM
Dr Nigel Sleight-Johnson FCA
Head of faculty and co-editor

Eddy James FCA
Manager and co-editor

Marianne Mau FCA
Manager

Sarah Dunn ACA
Manager

Henning Diederichs ACA
Manager

Alison Dundjerovic FCA
Manager

Lorraine Sinclair
Services manager

THE BOARD
Stephanie Henshaw FCA
(Chair) Technical partner,
Francis Clark LLP

Kathryn Cearns FCA
(Vice-chair)
Corporate reporting
and governance consultant

David Blair FCA
CEO, DBA Group

Steven Brice FCA
Partner, Mazars

Donna Caira FCA
Partner, Saffery Champness

Vanessa Gough FCA
Group reporting controller,
Johnson Matthey plc

Neil Harris FCA
Chief financial officer,
EA Technology Limited

Peter Nicol FCA
Audit & technical partner,
Horsfield & Smith

Andrew Spooner FCA
Partner, Deloitte

Danielle Stewart FCA
Partner, RSM

**FINANCIAL REPORTING
FACULTY**

Chartered Accountants' Hall
Moorgate Place
London EC2R 6EA UK
☎ +44 (0)20 7920 8533
☎ +44 (0)20 7920 8780
✉ frfac@icaew.com
icaew.com/frf

By All Accounts is produced
by Progressive Content
71-73 Carter Lane
London EC4V 5EQ

Advertising enquiries:
advertising@progressivecontent.com



IFRS 16 Leases

4

IN ESSENCE

IASB technical manager Kathryn Donkersley provides an outline of the key elements of IFRS 16 *Leases*



8

TAKING INTO ACCOUNT

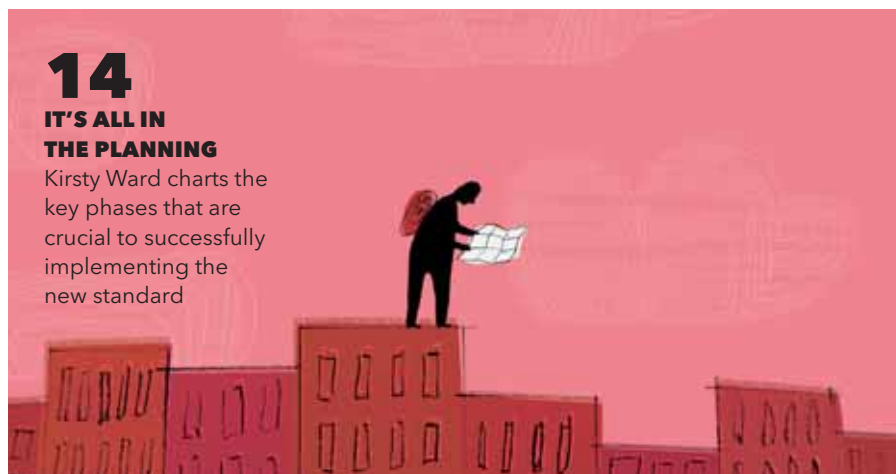
Eddy James examines the new standard's effect on lease liabilities and right-of-use assets



14

IT'S ALL IN THE PLANNING

Kirsty Ward charts the key phases that are crucial to successfully implementing the new standard



06 Leases redefined

Peter Westaway explores what constitutes a lease under the new standard

10 Discount decisions

Paul Sutcliffe on why determining an appropriate discount rate may be easier said than done

12 Remeasurement

Joseph Finn details what happens when things don't work out as expected

13 Different perspective

Sandra McGowan highlights what lessors need to know about IFRS 16

16 Seamless transfer

Steve Brice and Ben Levy consider the transition options available

18 Timely disclosures

Neil Parsons explains what the new disclosure requirements will mean for lessees

19 Tax changes ahead

Paul Martin reviews the options HMRC is considering in response to IFRS 16

20 Credit where credit's due

Sam Holland presents a rating agency's perspective on IFRS 16

21 Transatlantic debate

Fred Gill discusses the similarities and differences with the US leasing standard

22 ICAEW resources

Useful links and advice to help keep you up-to-date



THE BIG PICTURE

Kathryn Donkersley provides an overview of the new leasing standard and highlights the key changes it introduces

IFRS 16 *Leases* introduces significant changes to lessee accounting by requiring a lessee to recognise assets and liabilities on the balance sheet for almost all leases. The IASB decided to make these changes to address concerns raised by users of financial statements about off-balance sheet lease accounting.

For lessors, very little will change when IFRS 16 is applied. That's because users of financial statements are generally happy with how a lessor accounts for its leases today. The IASB therefore concluded that it would not pass the cost-benefit test to make any significant changes to lessor accounting at this time. Instead, IFRS 16 retains the lessor accounting model in IAS 17 *Leases*. It does, however, introduce some additional disclosure requirements for lessors, including information about residual asset risk.

SIGNIFICANT CHANGES TO LESSEE ACCOUNTING

Today, applying IAS 17, the majority of leases are classified as operating leases. Such leases do not appear on the lessee's balance sheet. That will change when lessees apply IFRS 16. The new standard eliminates the classification of leases by

lessees as either operating leases or finance leases. Instead, applying IFRS 16, a lessee accounts for almost all leases similarly to today's finance leases.

Most notably, this means that at commencement of each lease, a lessee will recognise both an asset and a liability on the balance sheet. The asset represents the lessee's right to use the asset underlying the lease for the duration of the lease term. IFRS 16 refers to this asset as a 'right-of-use' asset. The liability reflects the lessee's contractual obligation to make payments to the lessor throughout the lease term.

Once on the balance sheet, a lessee accounts for right-of-use assets and lease liabilities similarly to any other non-current assets and financial liabilities. For right-of-use assets, a lessee will recognise a depreciation charge in the income statement throughout the life of the lease, typically on a straight-line

When a lessee applies IFRS 16, there will be a reduction in operating costs and an increase in finance costs

The standard eliminates the classification of leases by lessees as either operating leases or financial leases

basis. This is similar to the accounting for owned property, plant and equipment.

For lease liabilities, a lessee will recognise interest expense in the income statement in a similar way to other similar financial liabilities. This means that lessee accounting applying IFRS 16 has a similar effect on a lessee's financial statements as the financed purchase of an asset with a similar value to the lessee's right-of-use asset.

RECOGNITION EXEMPTIONS

IFRS 16 contains two limited optional recognition exemptions for lessees.

The first category of exemption is for short-term leases - defined as leases with a lease term of 12 months or less. The second category relates to leases of low-value assets, such as telephones, personal computers or small office furniture. When thinking about the exemption for leases of low-value assets in 2015, the board had in mind leases of assets with a value, when new, in the order of magnitude of \$5,000 or less. The exemption applies on an absolute basis, irrespective of the size of the lessee or materiality. This means that a lessee does not have to 'prove' that leases captured by the exemption are immaterial.

The exemptions are designed to capture leases that a lessee often has in high volumes, but for which the numerical effect on the financial statements is expected to be low. For these leases, the board concluded that the cost of recognising right-of-use assets and lease liabilities is likely to outweigh the benefits. Instead, a lessee can choose to account for leases captured by the exemptions similarly to today's operating leases - by recognising lease payments as an expense over the lease term, typically on a straight-line basis. A lessee does not have to provide any balance sheet disclosures relating to leases captured by the exemptions. Consequently, when IFRS 16 is applied, lessees will not need to capture any additional information about leases to which the exemptions are applied beyond that captured for today's operating leases.

EFFECT ON THE FINANCIAL STATEMENTS

BALANCE SHEET

A lessee that enters into what today are operating leases will report higher non-current assets and financial liabilities on the balance sheet when IFRS 16 is applied. For any company with material operating leases, this effect will be significant. There will also be a relatively small decrease in overall equity or net assets - that's because right-of-use assets depreciate more quickly than lease liabilities decrease. Therefore, at any point between the beginning and end of a lease, the right-of-use asset will be slightly smaller than the lease liability.

There will also be a change to key financial ratios that are derived from a company's reported assets and liabilities - such as leverage ratios. Again, these changes are likely to be significant for lessees with lots of operating leases.

INCOME STATEMENT

The typically straight-line operating lease expense that a lessee recognised applying IAS 17 will be replaced by a depreciation charge on right-of-use assets and an interest expense on lease liabilities. Consequently, when a lessee applies IFRS 16, there will be a reduction in operating costs and an increase in finance costs. This means that profit measures - such as operating profit, EBIT and EBITDA - will be higher.

A lessee will typically recognise the depreciation charge on right-of-use assets on a straight-line basis, while the interest expense reduces over the life of a lease as lease payments are made. This means that, for an individual lease, the total lease expense will reduce each year as the lease matures. This is different from today's typically straight-line operating lease expense. However, this difference in expense profile is expected to be insignificant for the majority of lessees. That's because if a lessee has a portfolio of leases that start and end in different reporting periods, the effect on the income statement of newer leases with relatively higher interest expense will be balanced by leases towards the end of their life with relatively lower interest expense. Consequently, for most companies, profit measures that include finance costs, such as profit before tax, are expected to be largely unaffected when IFRS 16 is applied.

CASH FLOW STATEMENT

IFRS 16 requires a lessee to classify cash payments for the principal portion of a lease liability within financing activities and those for the interest portion of a lease liability similarly to other interest payments. Consequently, for a lessee with material operating leases, applying IFRS 16 will result in a reduction in operating cash outflows and an increase in financing cash outflows.

OVERALL EFFECT

When IFRS 16 is applied, the financial statements of lessees will become more comparable with those of similar companies that buy their assets and will provide greater transparency about a lessee's financial leverage and capital employed. Overall, this accounting will provide a more faithful representation of the financial position of a lessee than is reported today applying IAS 17. ●

Kathryn Donkersley is a technical manager at the IASB and leads its activities to support the implementation of IFRS 16

HOW WELL DO YOU KNOW YOUR LEASES?



Peter Westaway looks at the implications of the new definition of a lease

Am I leasing the servers that host my website? Am I leasing the trucks and ships that transport my goods? What about the solar panels I'm taking some power from that the provider installed on my land?

As IFRS 16's effective date draws ever closer, these are the sorts of questions that companies and their advisers are starting to grapple with as they realise that it's not just the arrangements traditionally regarded as leases which may be caught within the scope of the new standard.

With most leases coming on to lessees' balance sheets, the question as to whether or not an arrangement is a lease has now taken on far greater significance. It's no longer just considering whether payments due go into a commitment note; it's deciding whether they should go on the balance sheet.

IFRS 16 has 10 illustrative examples to help companies assess whether contracts are leases. Once leases have been identified, collecting all the data that is required for IFRS 16 is a significant undertaking too, given the fact that leases can often be scattered throughout an organisation.

DOES IFRS 16 CHANGE WHAT CONSTITUTES A LEASE?

IFRS 16 treats arrangements that convey a right to control the use of an identified asset as leases, with the assessment being undertaken at contract inception. The definition applies to both lessees and lessors, with the two key elements being:

1. the existence of an identified asset; and
2. customer control over use of that asset.

This is broadly similar to the existing guidance in IFRIC 4, although there are a few important changes. For example, in some circumstances IFRIC 4 would have avoided a lease treatment if the customer was paying a fixed or market price per unit of output from an asset. IFRS 16

Companies and their advisers are starting to realise it's not just the arrangements traditionally regarded as leases which may be caught within the scope of the new standard

contains no such pricing provisions. There are also some circumstances where a contract would be a lease per IFRIC 4 but not per IFRS 16.

When IFRIC 4 and IFRS 16 lead to different conclusions as to whether an arrangement is a lease, it's worth noting the transitional provision allowing any ongoing contracts to grandfather across the IFRIC 4 conclusion. However, this only relates to the conclusion as to whether an arrangement is a lease - it does not mean leases can stay off balance sheet for lessees.

PART 1 - IDENTIFYING THE ASSETS

For there to be a lease a specific asset must be identified. An asset is typically identified by being explicitly specified in a contract, for example by a specific serial number. However, the specificity can be implicit, if for example there is only one asset that can be used under the contract. Capacity portions are also regarded as identified assets if they are physically distinct or represent substantially all the capacity of a specific asset.

Even if an asset is specified as set out above, a customer will not be regarded as leasing it if the supplier has a substantive substitution right. For the substitution right to be substantive the supplier needs to have the practical ability to substitute alternative assets throughout the period of use and the supplier needs to benefit economically from substitution. Practically speaking, it may take time to identify such clauses and to assess whether they are substantive. IFRS 16 states that if one is unable to readily determine whether the right is substantive, it shall be presumed that it is not, ie there is a lease (subject to the other conditions in IFRS 16 being met).

The standard also points out that a supplier's right or obligation to substitute the asset during repairs or maintenance periods does not, in isolation, represent a substantive right of substitution. The ability to substitute if new technology becomes available should also be disregarded if that new technology is not substantially developed at the inception of the contract.

Identifying leases also requires an open mind, for example considering IT infrastructure that may be located on a third party's premises. Such assessments will, among other things, need to consider whether the infrastructure is

With most leases coming on to lessees' balance sheets, the question as to whether or not an arrangement is a lease has now taken on far greater significance

identified and whether the supplier can substitute the assets (bearing in mind potential restrictions that may have been inserted, for example, to ensure suitable data protection).

PART 2 - THE RIGHT TO CONTROL THE USE OF THE ASSET

The right to control the use of the asset requires a customer to have both the right to direct the use of the identified asset and to obtain substantially all of the economic benefits from use during the arrangement.

One of IFRS 16's illustrative examples considers a contract requiring specified goods to be transported by a specific ship between two specified locations. Because the customer does not direct how and for what purpose the asset is used (it is predetermined in the contract), the assessment moves on to consider who operates the ship, in this case the supplier, and whether the customer designed the ship, which they did not. It is therefore concluded that there is not a lease.

In certain situations, whether a customer 'designed' an asset can be important and may require careful consideration, because it could mean that it is being leased.

The above contrasts with a scenario where a customer has the right for a specific ship to transport any goods between any locations it chooses during a five year period, subject to some protective clauses about avoiding areas at risk of piracy. Even though the supplier operates the ship there is still a lease because the customer has the right to direct the use of an identified asset.

UNBUNDLING SERVICES

IFRS 16 only requires that the leased asset goes on balance sheet for lessees - services are still accounted for in accordance with other standards. Unbundling contracts that contain both a lease and a service is to be done on the basis of relative stand-alone prices.

This may present practical challenges in some cases, although IFRS 16 does permit such contracts to be treated in their entirety as a lease if a lessee so wishes. Such an election is made by class of underlying asset.

STEPPING BACK

For those concerned about the amount of assets and liabilities coming on-balance sheet and spending time assessing whether contracts are leases, it is worth remembering that recognition exemptions are available when the underlying asset is of low value or the lease term is 12 months or less, although the exemptions come with additional disclosure requirements. So the conclusion as to whether an arrangement is a lease still matters from that standpoint.

To conclude, by borrowing (and adapting) a turn of phrase, for many there is already known unknown lease data and that will take time to collect. However, it's also important to consider what IFRS 16 captures as a lease, including arrangements that may not traditionally have been thought of as such. Only by doing so can companies start to capture any unknown unknown lease data.

Challenges may lie ahead and the clock is ticking! ●



Peter Westaway
is a director at Deloitte



CRUNCHING THE NUMBERS

Eddy James looks at how a lessee will account for the right-of-use asset and the lease liability under IFRS 16

IFRS 16 removes the long-standing distinction between finance and operating leases and introduces a single lessee accounting model that - with some limited exemptions for short-term leases and leases of low-value assets - will apply to all leases.

Under this 'right-of-use' model, lessees will recognise an asset reflecting their right to use the leased asset for the lease term and a lease liability reflecting their obligation to make lease payments. Both the asset and the liability will be recognised on-balance sheet at the commencement of the lease. This article looks at the mechanics of this new lessee accounting model.

ACCOUNTING FOR THE LEASE LIABILITY

The lease liability is initially calculated as the present value of the lease payments, discounted at the rate implicit in the lease or, if this cannot be readily determined, the lessee's incremental borrowing rate.

The lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- fixed payments (including 'in-substance' fixed payments) less any lease incentives receivable;
- variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.

In subsequent years the lease liability is increased by the unwinding of the discount and reduced by lease payments made to the lessor.

ACCOUNTING FOR THE RIGHT-OF-USE ASSET

The right-of-use asset is initially recognised at cost, which comprises:

- the amount at which the lease liability is measured initially, as described above;
- any lease payments made to the lessor before the commencement date, less any lease incentives received;
- any initial direct costs - such as

The way in which lease payments are split between fixed and variable amounts can have a big impact on an entity's apparent indebtedness

commissions, legal fees, costs of negotiating the lease and costs of arranging collateral - incurred by the lessee; and

- an estimate of any costs of dismantling, removing or restoring the underlying asset or, when appropriate, restoring the site on which it is located.

In general, the right-of-use asset will subsequently be accounted for at cost less depreciation and impairment. However, if the lessee applies the revaluation model to a class of property, plant and equipment, it may elect to apply the revaluation model to all right-of-use assets that belong to the same class of asset. This choice is not available on a lease-by-lease basis.

CONTINGENT RENTALS

Many leases will include contingent rentals, whereby future lease payments vary in accordance with facts and circumstances occurring after the commencement of the lease. Many variable payments - such as those contingent on the level of sales achieved by the lessee - are excluded when measuring lease assets and lease liabilities.

The standard does, however, require entities to include rentals that are contingent on an index or rate, such as the consumer price index or market interest rates. Any 'in-substance' fixed payments will also have to be included. These are payments that could, according to the contract, be variable but are in reality unavoidable.

The way in which lease payments are split between fixed and variable amounts can have a big impact on an entity's apparent indebtedness. For example, an entity renting a retail unit and paying a fixed rent every year would recognise a higher liability than a similar entity renting a similar unit where the rent is based largely on turnover levels. This

EXAMPLE

A lessee enters into a 10-year lease of a building. Lease payments are £100,000 per annum payable in advance. The lessee incurs direct costs of £10,000. The lease contains neither a residual value guarantee nor a purchase option. The interest rate implicit in the lease is determined to be 4%.

At the commencement date, the lessee makes the lease payment for the first year and incurs the initial direct costs. These payments are therefore excluded when calculating the lease liability, which is initially calculated at the present value of the remaining nine lease payments discounted at the interest rate of 4%. The initial lease liability is therefore £743,533.

The lease liability is subsequently accounted for as follows:

Year	Opening balance £	Lease payment £	Interest expense £	Closing balance £
1	743,533	-	29,741	773,274
2	773,274	(100,000)	26,931	700,205
3	700,205	(100,000)	24,008	624,214
4	624,214	(100,000)	20,969	545,182
5	545,182	(100,000)	17,807	462,990
6	462,990	(100,000)	14,520	377,509
7	377,509	(100,000)	11,100	288,609
8	288,609	(100,000)	7,544	196,154
9	196,154	(100,000)	3,846	100,000
10	100,000	(100,000)	-	-

The right-of-use asset is initially calculated as the amount of the initial measurement of the lease liability of £743,533 plus the lease payments made in advance of £100,000 plus the initial direct costs of £10,000 ie, a total of £853,533. The lessee's accounting policy is to apply the cost model, so it depreciates the asset on a straight-line basis over the life of the lease, with depreciation of £85,353 charged each year.

would be true even if the total rent payable each year was expected to be about the same.

DETERMINING THE LEASE TERM

IFRS 16 defines the lease term as the non-cancellable period of the lease together with periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and periods covered by an option to terminate the lease if the lessee is reasonably certain not to.

In assessing whether the non-cancellable lease term should be extended to include such periods - and by implication whether additional lease payments should be included when measuring lease assets and lease liabilities - the entity will need to consider all relevant facts and circumstances that create an 'economic incentive' for the lessee to exercise the option to extend a lease or to not exercise the option to terminate early. Determining whether there is an

'economic incentive' to exercise an option to extend a lease or to forfeit an option to terminate early will be a matter of judgement.

The application guidance that accompanies the standard includes examples of the factors to consider when making this judgement. They include things such as the level of rent in a secondary period compared to market rates, the amount of any variable payments, whether or not significant leasehold improvements have been undertaken, the costs of terminating the lease, the importance of the underlying asset to the lessee's operations and the availability of suitable alternatives. The lessee's past practice may also help to determine the likely outcome. ●



Eddy James is a technical manager in the faculty

THE DISCOUNT RATE DILEMMA

Paul Sutcliffe explains how to decide the discount rate lessees should use when calculating lease liabilities



One of the major changes for lessees transitioning to IFRS 16 is the requirement to record a liability for future lease payments at the date of the financial statements. However lease agreements, unlike bank loans and other debt instruments, do not usually have a stated interest rate, which means lessees need to use judgement in determining what discount rate to use to calculate the carrying value of the liability.

The standard gives lessees two ways of determining this discount rate. If the interest rate implicit in the lease can be readily determined, this is the rate that should be used to discount the liability. If not, a lessee is required to use its incremental borrowing rate. While there are two methods, it is important to note that both methods have the same objective, which is to reflect the actual pricing of the lease contract.

As both methods take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs they may be similar in many cases.

While the above requirement may appear straightforward, it does give rise to a number of practical issues.

THE INTEREST RATE IMPLICIT IN THE LEASE

Although there are two approaches given, the preparer of financial statements cannot choose which approach to take as the incremental borrowing rate can only be used if the interest rate implicit in the lease cannot be readily determined.

The interest rate implicit in the lease is defined as the rate at which the present value of the lease payments and any unguaranteed residual value is equal to the sum of the fair value of the underlying asset and any initial direct lessor costs.

A major change for lessees transitioning to IFRS 16 is the requirement to record a liability for future lease payments at the date of the financial statements

So if all of these elements are known for a particular lease, the interest rate implicit in the lease should be used, even if this rate is not overtly stated in the lease agreement.

An example of a situation where the interest rate implicit in the lease might be expected to be used is a lease for the whole of an asset's life for which the fair value of the asset is readily obtainable and for which the lessor's initial direct costs are not expected to be significant. However, care is needed if the lease explicitly states a specific interest rate - this may not meet the definition above and so may need adjusting.

INCREMENTAL BORROWING RATE

As noted above, a company's incremental borrowing rate should be used only after concluding that the interest rate implicit in the lease is not readily obtainable. This may be the case if an asset has a significant residual value which is difficult to estimate (which will often be the case for a property lease) or if the lessor incurs significant initial direct costs but the lessee has no reliable way to ascertain the amount.

The determination of the incremental borrowing rate requires a number of important judgements to be made. It would not be appropriate, for example, to simply take a rate from a recent loan agreement and use this for the purpose of discounting lease liabilities. The standard defines a company's incremental borrowing rate as the rate "that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment". This means that the incremental borrowing rate is both entity and contract specific, as it should take account of items such as lease term, entity credit risk, security from the asset and the economic environment.

ADJUSTMENTS

So in order to calculate the incremental borrowing rate the preparer may need to consider benchmarking recent borrowings and also obtaining current hypothetical loan rates from financial institutions and then adjusting these rates appropriately.

Adjustments might include:

- Lease term - leases with fixed

The determination of the incremental borrowing rate requires a number of important judgements to be made

payments are similar to fixed rate debt, so the appropriate discount rate will depend on the lease term.

- Repayment profile - financial institutions generally price amortising loans, which have payment profiles similar to a typical lease, at lower interest rates than loans where repayment is only at maturity.
- Credit risk - a subsidiary may, for example, have a higher risk than the parent of a consolidated group, so it may be necessary to adjust a group borrowing rate.
- Loan security - absent any other agreement, leases tend to be effectively secured on the leased asset itself, but as the lessor has the residual interest in the asset, its security is less than it would be for an owned asset, and may be further reduced with a depreciating asset. Accordingly, starting with an unsecured rate based on credit risk and lease term might be expected, with adjustments made to the extent significant security is considered to be present.

SUMMARY

In summary, the determination of an appropriate discount rate for each lease is a complex area involving judgement, and will be one of the key work streams in an IFRS 16 conversion programme. ●



Paul Sutcliffe is a partner at EY who specialises in the implementation of new accounting standards and advising on complex transactions

REMEASUREMENT - AN ONGOING TASK

Joseph Finn explains what happens when there are changes to lease payments

Once a lease has commenced, charges will be incurred in the income statement each year for amortisation of the right-of-use asset, the impact of interest on the lease liability and any variable lease payments that were not already included in the lease liability.

The standard also requires the lessee to remeasure its lease liability to reflect changes to lease payments. Such remeasurements could arise, for example, as a result of a change in the expected lease term or the rate or index used to determine the original lease liability.

When the lease liability is remeasured, it will generally result in an equivalent adjustment to the right-of-use asset. The revised carrying value of the asset will then be subject to the normal amortisation and impairment considerations. The only exception is where the right-of-use asset has been reduced to zero, in which case any further downward remeasurement adjustments will be recognised in profit or loss.

The question also arises as to whether the discount rate is updated when remeasurement takes place. The standard identifies various reasons why future cash flows will change and clarifies whether or not that will also change the discount rate applied to the lease payments.

EXPECTED CHANGES

For events that were expected to occur, the discount rate remains as originally calculated. These include:

- A change in the amount expected to be payable under a residual value guarantee provided by the lessee.
- Changes to the variable payments within the lease term which affect payments in current and future periods. Changes in indices or rates result in revised contractual payments under the lease and so the future lease

liability should be based on these revised rates. This would include rent adjustments following a market rent review or updates following a change in an index or rate - such as the RPI or CPI - used to determine the lease payments.

- Other situations where the variability of payments is resolved so that the lease payments become in-substance fixed payments.

One exception to the above is where the change in lease payments is triggered by a change in floating interest rates. A revised discount rate which reflects this change in interest rate will then apply.

UNEXPECTED CHANGES

The discount rate is, however, updated for unexpected changes in the original assumptions. So a change in the lease term or a change in the assessment of an option to purchase the underlying asset will change the quantum of payments under the lease and trigger an immediate recalculation of the lease liability.

The revised discount rate is intended to reflect the interest rate implicit in the lease at the date of reassessment. If this cannot be readily determined then the lessee's incremental borrowing rate at that time will apply.

INCREASED VOLATILITY

This reassessment guidance is intended to address situations where the underlying asset remains the same and the original lease agreement remains in force. Where the underlying asset changes then separate lease modification guidance applies with corresponding adjustments to the right-of-use asset.

While under IAS 17 many of these changes in

future payments would have been dealt with as incurred, under IFRS 16 all but the most simple of leases will have to be revisited annually in order to identify any changes in the expected future cash flows or the original key judgements. Each change identified will then require a reassessment of the lease liability and right-to-use asset, triggering a change in the balance sheet and income statement profile for that lease.

These new requirements will create balance sheet volatility for lessees as changes in estimates and judgements could mean frequent adjustments to the carrying amount of both right-to-use assets and lease liabilities. Entities will no longer be able to simply compute a lease amortisation schedule at the lease's commencement date and roll it forward at each reporting date. Consequently, it will be more difficult to forecast accurately an entity's future financial performance and results. ●



Joseph Finn is a senior manager at KPMG

WHAT LESSORS NEED TO KNOW

Sandra McGowan provides a lessor's perspective on the new leasing standard



The guidance in IFRS 16 relating to lessors remains substantially unchanged from that in IAS 17. Lessors continue to account for leases as either operating leases or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset.

Two key areas where lessors may be affected on transition to IFRS 16 are sale and leaseback transactions and sub-lease arrangements.

SALE AND LEASEBACK TRANSACTIONS

The accounting requirements for sale and leaseback transactions under IAS 17 largely depended on whether the leaseback was classified as a finance lease or an operating lease.

IFRS 16, in contrast, requires an entity to apply the requirements for determining when a performance obligation is satisfied in IFRS 15 *Revenue from Contracts with Customers* to determine whether the transfer of an asset is accounted for as a sale of that asset. IFRS 16 does not provide guidance on how IFRS 15 should be applied to determine if a sale has been made in the context of a sale and leaseback transaction. However, the most relevant considerations are likely to be IFRS 15's

requirements in respect of the satisfaction of a performance obligation at a point in time. The possible outcomes are summarised in the table below.

IFRS 16 contains additional provisions where either the sales value of the asset is not its fair value or where payments for the lease are not at market rates.

On transition to IFRS 16, entities are not permitted to reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale.



	Lessee/seller	Lessor/buyer
Transfer of asset qualifies as a sale	De-recognise the transferred asset and apply the lessee accounting requirements to the leaseback Measure right-of-use asset as the retained proportion of the previous carrying value Recognise a gain or loss on the rights transferred to the lessor	Account for purchase of the transferred asset and apply the lessor accounting requirements to the leaseback Apply lessor accounting requirements of IFRS 16 to leaseback
Transfer of asset does not qualify as a sale	Continue to recognise the transferred asset Amounts received recognised as a financial liability under IFRS 9 <i>Financial Instruments</i>	The transferred asset is not recognised Amounts paid recognised as a financial asset under IFRS 9 <i>Financial Instruments</i>

OTHER AREAS OF INTEREST TO LESSORS

Other areas of IFRS 16 which may be of interest to lessors include:

- the new definition of a lease;
- guidance on the separation of lease and non-lease components in a contract;
- guidance on lease modifications
- initial direct costs; and
- enhanced disclosure requirements.

SUB-LEASE ARRANGEMENTS

A lessee may become an intermediate lessor if it sub-leases an asset it in turn leases from another lessor.

IFRS 16 requires an intermediate lessor to determine the classification of the sub-lease by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset as was the case under IAS 17.

Intermediate lessors could face significant changes, particularly if the head lease is currently an operating lease. As a result of the new requirements, such head leases will have to be recognised on the balance sheet.

The fair value of the right-of-use asset will usually be lower than the fair value of the underlying asset. This means sub-leases are now more likely to be classified as finance leases.

The transitional provisions of IFRS 16 require intermediate lessors to reassess sub-leases that were classified as operating leases under IAS 17 and that are ongoing at the date of initial application. The analysis is required to be based on the remaining contractual terms and conditions of the head lease and sub-lease at that date. ●



Sandra McGowan is a senior technical manager at BDO



PLANNING FOR A SUCCESSFUL IMPLEMENTATION PROJECT

Kirsty Ward explains why implementing IFRS 16 is about more than just accounting change

The impact of IFRS 16 will be felt across many different business functions. It doesn't just have an impact on accounting. Planning is key to ensure engagement of the wider stakeholders and the success of the implementation project.

The new lease accounting standard requires almost all leases to be recognised on balance sheet. It will also change the pattern of expense recognition. Key performance indicators based on IFRS measures are often used widely across organisations to manage performance. Stakeholders across the organisation will therefore need to understand the new measurement basis. In addition, functional areas such as property, procurement, financial planning and analysis, treasury, tax, HR and IT will need to become involved in the implementation.

If your organisation's metrics are significantly impacted, you will also need to communicate effectively to lenders, investors and analysts. IFRS 16 may also have a knock-on impact on tax, depending on the applicable tax regulations. Distributable profits are affected due to the adjustment to reserves recognised on transition, regardless of the method chosen.

As illustrated opposite, six broad phases are involved in implementing IFRS 16.

GET ORGANISED

This phase should include the following planning-related activities:

- Understanding the issue - time should be allocated to ensure that the core implementation team has a thorough understanding of IFRS 16's new accounting requirements. For example, what constitutes a lease and what constitutes a service and how to identify any embedded leases.
- Engaging stakeholders and ensuring governance - ideally a steering committee should be established to ensure appropriate resources are assigned and approve the resolution of any significant issues. It is a good idea to make sure that the significantly-impacted areas of your organisation are represented on this committee, for example the CFOs of the main business units impacted. Depending on the level of complexity, a technical sub-committee may also be required. Engaging the right people early-on will help drive engagement, accountability and timely delivery of the project.
- Training affected staff and management - communicating the

changes effectively with appropriate levels of training will be important for the broader stakeholder groups.

- Inflight projects and competing priorities - any project will only be successful if it is planned with an understanding of the competing priorities within an organisation. For example, if there are new systems or upgrades being implemented to property, lease management or financial reporting systems, it will be important to understand the timing and phasing of these projects to plan for the interdependencies. The resource needed may also be only available for blocks of time (eg, outside reporting periods) and this should be incorporated into your planning.

SCOPING AFFECTED AREAS

Until the size of the task ahead is clear, it is hard to determine with certainty the best plan for implementation. Organisations should plan to collate a complete inventory of their lease contracts, including those that may be embedded within service contracts. This should cover understanding the complexity, quantity, size, location and language of the contracts.

MODELLING THE IMPACT

OPERATIONAL IMPACT ASSESSMENT

Conducting an operational impact assessment across the spectrums of data, process, systems and people will help determine the level of effort required to become compliant and to embed the new lease accounting processes. A well planned impact assessment should aim to provide coverage over the countries affected and the types of leased assets to give a representative indication of the impact. Often, starting with a pilot business unit can help test and refine the approach for large multinational organisations.

The results of the business impact assessment will be a key part of the roadmap and plan for you to implement.

FINANCIAL IMPACT ASSESSMENT

In order to really understand the financial impact, practical data and accounting issues, there is no substitute for modelling a sample of contracts.

Organisations find this modelling useful to understand how different assumptions, practical expedients and transition options impact the numbers. These decisions also have an impact on the data, areas and level of effort required. The results of the modelling help other stakeholders to visualise the impact, realise how it affects them, and engage in the project. This will also help drive considerations of the knock-on effects to tax, dividend payments, treasury functions and remuneration.

WIDER BUSINESS IMPLICATIONS

IFRS 16 may result in a better understanding of your full lease population and may provide an opportunity to re-assess current leases, identify opportunities for simplification, or to eliminate clauses which may complicate the accounting but are not required for commercial purposes. Certain lessees may even want to allow time to revisit their 'lease versus buy' strategy.

Companies should also plan to re-engage with HR and treasury departments. HR will need time and resources to work through the impact on key performance indicators that drive bonuses, earn-outs and remuneration to determine whether amendments are necessary. Treasury will need to plan to assess whether covenants could be breached to avoid surprises and difficult negotiations with lenders.

PLANNING TO GATHER AND VALIDATE DATA AND IMPLEMENT SYSTEMS AND PROCESSES

In the early stages of the impact assessment it is important to establish how much effort will be required to ensure that lease data is complete and consistent. This will require companies to determine what data gaps they may have, and what the existing and potential solutions for collating, managing

and storing lease contracts and data could be. Automated document reading and lease data extraction solutions may provide an efficient solution for extraction, validation and analysis.

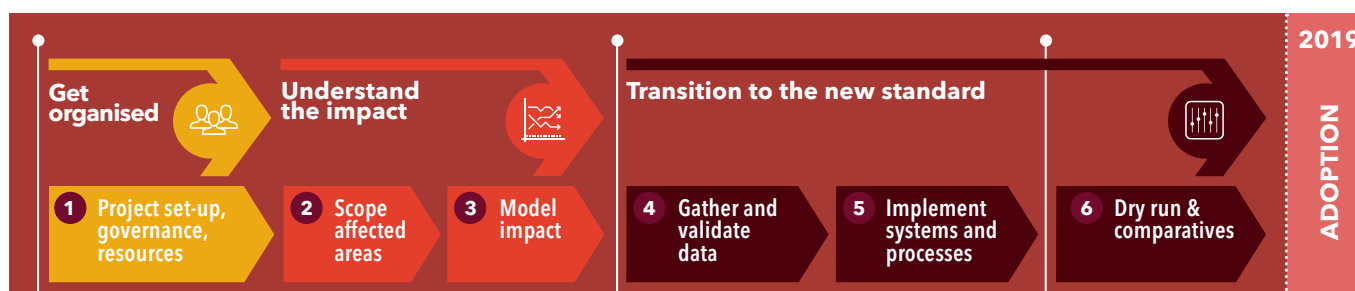
Contract management systems are often in place within organisations with large volumes of leases. However, effective planning will be needed to establish if the contract management system can be extended and improved to capture the data needed for IFRS 16.

As well as managing and storing lease data, new calculations are required to determine the accounting entries under IFRS 16. If your organisation only has a very small number of leases, spreadsheets may be suitable. However, more advanced system solutions will be needed for a robust, industrialised process that can be run in each reporting period for a large number of leases. Defining the business requirements for any new or amended system solution will be a key part of planning and evaluating the various system solutions available. For example, some systems have a particular focus on property or equipment leases.

Effective planning is essential for a successful IFRS 16 implementation. Conducting an impact assessment will help establish where there are gaps in data, processes, systems and staffing. Data and systems are typically the most time consuming aspects of accounting change implementations, and hence having a good grasp of the issues and solutions to evaluate will be a key part of the planning process. ●

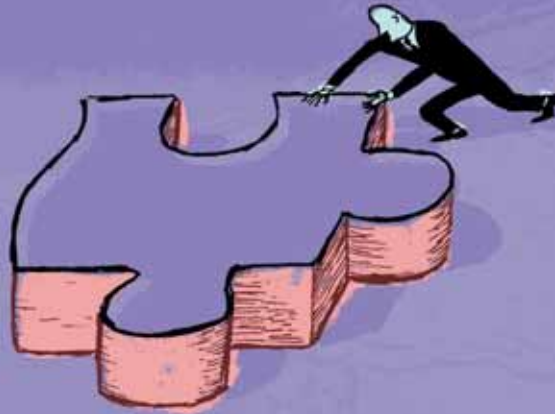


Kirsty Ward is a partner at PwC



SOURCE: PwC

ENSURING A SMOOTH TRANSITION



Steve Brice and
Ben Levy look at the
options available on
transition to IFRS 16

While most of the focus to date has been about the ‘headline impact’ of applying IFRS 16, less time has been spent by many companies on considering the transition options. In order to ensure that the transition is as seamless as possible, this should be high on the agenda of finance directors.

TIMING

The first issue for finance teams to consider is whether they want to wait for the mandatory effective date of 1 January 2019 or whether they want to early adopt (subject, where appropriate, to EU endorsement of IFRS 16).

Finance teams are already busy implementing two new accounting standards - IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*. However, they may decide that it is a better use of resources to make the transition to all three new standards simultaneously. This matter was recently flagged in the European Financial Reporting Advisory Group’s (EFRAG) letter to the European Commission regarding endorsement of IFRS 16. This stated: “Some constituents have indicated to EFRAG that it is very important to them that IFRS 16 is

endorsed in a timely manner so as to facilitate early application of IFRS 16, in order to transition at the same time as IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 is effective from 1 January 2018. These constituents noted that the cost of implementation of IFRS 16 would be increased if they are not able to transition to both standards at the same time.”

As well as preparers, early adoption may also help stakeholders who will benefit from all transition information on these three key standards being presented at one time. Among other things this will also lead to earlier comparability of figures on an annual basis and fewer transition adjustments over a two-year period. Furthermore, as EFRAG has assessed that IFRS 16 would improve financial reporting and concluded that the cost-benefit trade-off is acceptable, adopting early is worth considering.

However, despite these advantages, early adoption may not be the preferred approach for some. Many finance teams may decide that the process of transitioning to all of the new standards at the same time is too onerous and that they simply do not have adequate resources available to prepare for the

The first issue for finance teams to consider is whether they want to wait for the mandatory effective date of 1 January 2019 or whether they want to early adopt

challenges of implementing a third major new standard. There could also be merit in waiting for competitors to transition first, to help to determine the best transition approach and consider in detail the types of judgements and estimates being made.

There may be wider considerations as to why companies may prefer to take more time before implementation. For example, financial services entities subject to prudential capital requirements are still looking for additional clarity about the treatment of the right-of-use asset for regulatory capital purposes.

TRANSITION APPROACHES

Companies have the option of two different transition approaches - the 'fully retrospective' approach and the 'cumulative catch-up' approach. We would expect that the latter approach could be a useful time-saver for many. However, this comes with a health warning - a number of practical expedients are available, each of which requires a decision to be made by the finance team. This could result in the finance teams running a number of models to determine the most beneficial approach.

Let's look first at the fully retrospective approach. This requires companies to account for their leases as if they had always been accounted for in accordance with IFRS 16 and so offers fewer choices to companies. With this approach, the lease liability should be measured at the present value of lease payments at the commencement date of the lease, rolled forward to the date of initial application and the right-of-use asset measured at cost from the commencement date.

This approach is expected to be suited to companies that want to show better comparability in the current and comparative years, but will require the discount rate at the commencement date to be established. However, it should be noted that it still requires a company to apply the previous lease accounting requirements under IAS 17 to their disclosures alongside IFRS 16 disclosures in the first implementation year.

Companies with a low number of leases may find that the cost of using this approach is worthwhile to obtain the comparability. Conversely, although the cost of this approach could be high for companies with a large volume of leases, they nevertheless may find the benefit of comparability outweighs the cost.

As for the cumulative catch-up approach, due to the many practical expedients available, companies have lots of choices to make. These practical expedients, which can be applied on a lease-by-lease basis, include:

- applying a single discount rate to a portfolio of leases with similar characteristics;
- measuring the right-of-use asset at initial application at either its carrying amount as if the standard had always been applied, but discounted using the incremental borrowing rate at the date of initial application, or at an amount equal to the lease liability;
- accounting for and disclosing leases for which the lease term ends within 12 months of the date of initial application as short term leases;
- using hindsight, such as in determining the lease term;
- excluding initial direct costs from the measurement of the right-of-use asset at the date of initial application; and
- adjusting the right-of-use asset by the amount of any provision for onerous leases applying IAS 37 at the date of initial application.

If companies decide to apply the cumulative catch-up approach, the use of any of these practical expedients should be disclosed. It is also necessary to disclose an explanation of any difference between the operating lease commitments disclosed when applying IAS 17 at the year-end immediately preceding the date of initial application and the lease liability at the date of initial application. This should encourage companies to ensure that their IAS 17 operating lease commitment note is complete and accurate ahead of adopting IFRS 16.

Stakeholders should be informed of transition adjustments as soon as possible, due to the impact of the transition on assets, liabilities, results, covenant positions, tax positions, key performance indicators, dividend payments and capital requirements.

CONCLUSION

In cases where the impact of the new leasing standard is significant, companies need to ensure that a full leases project plan, addressing transition options, is in place.

With the variety of transition options available, decisions certainly need to be made sooner rather than later. While it is expected that the new requirements will ultimately improve financial reporting, ensuring the most appropriate approach at transition is a key starting point when looking to apply IFRS 16 to financial statements in the first year of implementation. ●



Steve Brice is a partner in Mazars' Financial Reporting Advisory team
Ben Levy is a senior manager in Mazars' Financial Reporting Advisory team

MORE THAN AN AFTERTHOUGHT?

Neil Parsons explains why it's important to get to grips with disclosures at an early stage



Many finance teams are focusing on the overall impact of IFRS 16 on an entity's financial position but are not considering disclosures. However, leaving the disclosure requirements to the last minute may well result in an unpleasant surprise. Further, where an entity is contemplating applying IFRS 16 without restating comparatives, finance teams should alert both the chairman and the CEO to the fact that stakeholders will not see a continuous trend in results and financial position. A full retrospective implementation would maintain historical reporting consistency.

This article highlights the major challenges that the new disclosure requirements will present for lessees.

WHAT DISCLOSURES SUPPORT FINANCIAL PERFORMANCE?

The following are of relevance:

- depreciation by class of underlying asset;
- income from sub-leases of right-of-use assets;
- interest expense;
- gains and losses on sale and leaseback transactions; and
- variable lease payments expensed.

Information systems must be capable of identifying leases with variable payments. Moreover, accounting systems must be able to capture those payments.

Disclosure is required of the expense recognised for short-term leases and leases of low value assets when either practical expedient is used. When collating data preparers cannot ignore such leases.

WHAT DISCLOSURES SUPPORT RIGHT-OF-USE ASSETS?

Supporting disclosures include:

- additions of right-of-use assets; and
- carrying amount of right-of-use assets by class of underlying asset.

As well as capturing completeness of the overall lease liabilities and right-of-use assets, the underlying data must

also be sufficient to enable the drafting of disclosures by each class of right-of-use asset.

WHAT DISCLOSURES SUPPORT LEASE LIABILITIES?

The main area that preparers should consider is the requirement to disclose a contractual maturity analysis of future lease payments in discrete time bands. The level of detail needed is a judgement call. The higher an entity's liquidity risk, the more time bands are expected.

Analysing the contractual payments of large populations of leases might involve the use of an IT specialist.

The maturity analysis is required on an undiscounted basis (including interest payments) and is unlikely to give assurance on the completeness of the lease liability.

Disclosure is also required of lease commitments where the lease has not yet commenced, requiring a detailed understanding of the reporting entity's procurement procedures.

FINALLY, WHAT ABOUT TRANSITION?

Entities choosing to apply IFRS 16 from the date of initial application (being the date of the start of the current accounting year) must explain:

- the weighted average incremental borrowing cost applied to lease liabilities recognised on initial application; and
- at the date of initial application, the difference between operating lease commitments disclosed in the comparative period (discounted using the above rate) and the carrying amount of lease liabilities.

SUMMARY

We recommend the following six steps:

1. Understand the disclosure requirements up front in the context of the entity's leasing activities and in terms of applying the various practical expedients.

2. Set out in draft form the layout of the disclosures and their formats.
3. Identify those persons in the business who hold the relevant lease information and those who can help capture new information. Those individuals should be an integral part of the implementation team.
4. Through in-house specialists or external support, identify and address as early as possible limitations to existing systems.
5. Capture the relevant data in a logical and efficient manner.
6. Draft the disclosures and check that they comply with the standard, making sure they are cohesive with other areas of the annual report, including the strategic report.

A carefully planned implementation project with the right people gathering the right level of information at the right time will ensure success when drafting the disclosures. ●



Neil Parsons is a senior manager at Grant Thornton UK LLP



TAXING TIMES AHEAD

Paul Martin highlights how UK tax rules might change in the wake of IFRS 16

Section 53 of the Finance Act 2011 deems that lease accounting changes made on or after 1 January 2011 do not have any effect for tax purposes. This means that when lease accounting does change, the accounting entries in the income statement of a business will need to be restated just for tax purposes to what they would have been under the previous accounting rules. Clearly this adds an extra layer of complexity to the calculation of taxable profits that is not aligned with the general policy goal of tax simplification. HMRC recognises this and is considering what the tax response should be to the accounting changes. In August 2016 it published a discussion document to get input from businesses on how tax should respond to these accounting changes.

SIMPLIFICATION

In the document HMRC highlights that any change to the tax rules should recognise the changing commercial environment and seek to meet the tax policy of tax simplification while at the same time protecting government revenues. To this end it has put forward four options for discussion.

OPTION 1

Keep the status quo by retaining the current tax rules with only necessary adjustments made, such as replacing current definitions of finance leases and operating leases with alternative definitions. Under this option the lessor will continue to claim capital allowances (as they currently do) where relevant.

OPTION 2

Tax will follow the entries in the income statement in the accounts, with no adjustments. This means there will be no capital allowances claimed by either

the lessor or the lessee and the depreciation in the accounts of the lessee will be deductible for tax. Other relevant entries in the income statement such as rental payments, finance charges and rental rebates will also be relevant for tax. By removing the capital/revenue distinction and adopting a straightforward 'follow the accounts' approach, this option clearly achieves the simplification objective.

OPTION 3

This amends option 2 by giving the lessee a 'leasing allowance', essentially accelerated depreciation for tax purposes to reflect the current incentives provided by the capital allowances regime (for example, the annual investment allowance). HMRC give an example showing a leasing allowance in early periods of an extra 10% or alternatively suggest a specified reducing balance method.

OPTION 4

This amends option 2 by giving the lessee the option to claim capital allowances rather than the depreciation expense in the accounts for tax purposes.

As well as adopting a 'follow the accounts' approach it is worth noting that options 2, 3 and 4 also remove the capital allowances deduction from the lessor and transfer it to the lessee (either in the form of capital allowances or depreciation).

ANTI-AVOIDANCE MEASURES

HMRC has expressed concerns that the 'follow the accounts' approach (options 2, 3 or 4) may require anti-avoidance measures to deal with certain risks to

revenues such as accelerated rates of depreciation. There are likely therefore to be certain targeted anti-avoidance rules accompanying any of these options.

While these tax changes are driven by changes to lease accounting under IFRS, HMRC has stated that its preference is for one tax regime to cover all businesses. This means that changes to the tax rules in this area are likely to have an impact on all businesses not just those applying IFRS in their accounts, particularly if options 2, 3 or 4 are preferred.

The discussion document closed for responses on 30 October 2016. At the time of writing we have not yet seen a summary of the responses. The expectation is that a formal consultation document outlining HMRC's chosen option will be published in 2017 with a view to include legislation in Finance Act 2018 to take effect in 2019. ●



Paul Martin is national tax training manager at RSM

CREDIT WHERE CREDIT'S DUE



Sam Holland provides a rating agency's perspective on IFRS 16

When analysing corporate debt issuers at S&P Global, we view leasing as a form of financing - irrespective of the accounting treatment. Indeed, we have long viewed the distinction between operating leases and finance leases as an artificial one and for several decades have made adjustments to treat operating leases as debt, while adjusting the income statement and cash flow statement to reflect the financing nature of lease transactions.

In this way, IFRS 16 is conceptually very similar to our methodology and clearly a substantial improvement on the previous accounting rules. The enhanced disclosures will also provide much greater insight into the nature of lease arrangements and the likely profile of future cash flows. The fact that leases will be subject to greater audit scrutiny is another very welcome development.

NO PANACEA

But the new accounting is no panacea. Unlike IFRS 16, the US GAAP equivalent

retains the income statement treatment of the lease cost as an operating expense (rather than interest and amortisation), requiring analysts who wish to make transatlantic comparisons to continue to make adjustments.

Moreover - like many other IFRSs - the new leasing standard is riddled with accounting options, which will allow identical lease arrangements to be presented differently by different companies. Company A could exclude payments for short-term leases, leases of low-value assets and non-lease service components from its balance sheet liability, while Company B includes all of those items. While we understand that these accounting choices have been offered to provide (arguably much-needed) practical relief for preparers of financial information as part of this demanding new standard, there is no denying that these options impede comparability and create hurdles for benchmarking.

STRUCTURING

IFRS 16 - just like IAS 17 - will also be vulnerable to companies aggressively structuring their lease portfolio. There are myriad ways in which this might be attempted, but one method might be for companies to include extension options within lease contracts and then take the position that they are not reasonably

certain to exercise those options.

Depending on how the new accounting is applied in practice, if we believe companies are obtaining an artificially favourable accounting outcome then we will continue to make analytical adjustments to give a fairer reflection of the economics of the lease arrangements.

CREDIT RATINGS

And finally to the question I am most commonly asked about IFRS 16: what will it mean for credit ratings? We believe our opinion of a company's underlying creditworthiness will generally not change as a result of the new lease accounting. We expect to commonly use the IFRS 16 measure of the lease liability in our analysis and for most companies we do not expect this to differ materially from our previous estimates.

That said, if, as a result of the new lease accounting, we are provided with significant new information that we consider to be relevant to our opinion of a company's underlying creditworthiness, it will be factored in to our analysis. Indeed, like other stakeholders, we'd urge companies to be transparent as fully and as early as possible in disclosing the approximate expected impact of IFRS 16 on their financial statements.

A GREAT STEP FORWARD

So IFRS 16 is a great step forward for analysts and investors, superior (and frustratingly different) to the US GAAP equivalent, with very helpful enhanced disclosures. But of course the financial statements are only the starting point for analysis, so users of financial information will need to keep their pencils sharp. ●



Sam Holland leads the accounting specialist team responsible for the EMEA and Asia Pacific region of S&P's corporate ratings group

FASB AND IASB STANDARDS: NOT FULLY CONVERGED

Fred Gill highlights similarities and differences between IFRS 16 and the new US standard



Accounting for leases began as a joint project of the IASB and the US FASB. But after 10 years of work, the boards' final standards - IFRS 16 and FASB ASC Topic 842 - are not completely converged.

While this will be disappointing to some, their respective models still have a lot in common. For example, they agree on the key requirement for leases to be shown on the lessee's balance sheet, how to define a lease and how lease liabilities should be measured.

There are a number of differences between the two standards, including gain or loss recognition in sale and leaseback transactions, and when a lessor should recognise selling profit on some finance leases. But the most significant is the FASB's dual-model approach to the recognition, measurement and presentation of expenses and cash flows arising from a lease.

IFRS 16 accounts for almost all leases in a manner similar to today's finance leases, whereas ASC Topic 842 continues to distinguish between finance leases and operating leases, using a classification approach substantially similar to the current leases guidance.

STAKEHOLDER FEEDBACK

The two boards' 2009 discussion papers and the 2010 exposure drafts proposed an accounting model that would have accounted for all leases in a manner similar to today's finance leases. The boards received differing views on the effect of the proposed model on a lessee's profit or loss. Some stakeholders, including a majority of practitioners, agreed with the proposal. However, many other stakeholders, including most US preparers, disagreed with the single-approach accounting model.

They argued, among other things, that:

- the front-loading of expenses that occurs under the effective interest

method would not reflect the economics of receiving equal benefits for equal payments over the life of the lease, particularly for some kinds of leases, such as leases of retail space;

- because leases vary widely, ranging from those covering almost all of the life of the underlying asset to those covering a very short portion of the life of the underlying asset, a single-approach accounting model would not faithfully reflect the economics of all lease transactions; and
- accounting for all leases in a manner similar to today's finance leases would be a costly way to achieve the recognition of lease assets and lease liabilities for all leases other than short-term leases.

THE DUAL-MODEL APPROACH

In 2013, the FASB proposed a dual approach, distinguishing between leases based on the lessee's level of consumption of the economic benefits embedded in the underlying asset. Under this approach, lessees and lessors would classify leases on the basis of whether the lessee is expected to consume more than an insignificant portion of the economic benefits embedded in the underlying assets. That principle would be applied by presuming that:

- a lease of an asset that is not property is a Type A (finance) lease unless specified criteria are met;
- a lease of property is a Type B (operating) lease unless specified criteria are met.

Although some users of financial statements of lessees with significant real estate leases were supportive of the 'consumption' principle, most US preparers and practitioners were

not. Common concerns included distinguishing property and non-property and determining whether the property or the non-property asset in a single unit is the primary asset.

MORE COSTLY

After two exposure drafts, FASB members' views on the economics of some lease transactions continued to differ. But the board generally recognised that accounting for all leases under a single model would be more costly for US preparers than a dual-approach model.

Ultimately the board concluded that retaining the lease classification approach in current US GAAP, in all material respects, would substantially reduce the costs of implementing the standard as compared with any other classification approach that was considered. This is because the current approach is well established in practice and is substantially aligned with US tax and regulatory accounting and reporting requirements.

Although the two boards did not achieve complete convergence, and although there, no doubt, continue to be differing views on the standards, it should be remembered that the two boards each achieved the principal goal of the project: requiring lessees to reflect most leases on their balance sheets. ●



Fred Gill is a senior technical manager at the AICPA

SUPPORT FROM ICAEW

Trying to get your head around IFRSs? ICAEW offers technical advice, practical guidance, confidential support and a community network

ONLINE RESOURCES

STANDARDS TRACKER



Synopsis of the accounting standards, recent amendments and links to further resources

eIFRS



Full access to the IASB's online resource available to Financial Reporting Faculty members

WEBINARS



Online seminars on IFRS requirements - participate live or watch recordings of events

VISIT ICAEW.COM/FRF

SUBJECT GATEWAYS



A selection of handpicked resources and insight from across the profession

FINANCIAL REPORTING FACULTY FAQs & FACTSHEETS



Analysis of the changes to IFRSs and practical tips on applying the new standards

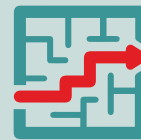
NEWS ALERTS



Sign up to the Financial Reporting Faculty app, ICAEW Alert, *economia*, Practicewire, bulletins and our Twitter accounts

YOUR NETWORKS AND COMMUNITIES

FINANCIAL REPORTING FACULTY



Get access to exclusive bulletins, factsheets, *By All Accounts* magazine, discounted events and more

TALK ACCOUNTANCY



Blog, forum and network for updates and your questions

EVENTS



Training, seminars and conferences around the UK

ONE-TO-ONE TAILORED SUPPORT

TECHNICAL HELPLINE

Qualified experts giving you one-to-one advice on technical and ethical matters

Telephone us on +44 (0)1908 248250



INFORMATION AND LIBRARY SERVICE

Tailored research services, model accounts and ebooks. Email us at library@icaew.com

Telephone us on +44 (0)20 7920 8620



An easier way to produce statutory accounts that tell your company's unique story

There is a global initiative to make statutory accounts and financial reports more meaningful, relevant and company specific.

While the initiative has many advocates, it can prove challenging to implement due to the inherent limitations of the templates and template based tools many companies are using to produce their accounts.

IFRS SYSTEM changes that by enabling preparers to quickly and efficiently produce accounts that tell a unique (and compliant) financial story.

IFRS SYSTEM
software for FRS 101, FRS 102 and IFRS accounts production

visit: www.ifrssystem.com email: enquiries@ifrssystem.com call: 020 3287 0102



LEASE ACCOUNTING SOFTWARE

Simplify compliance with new global accounting standards
IFRS 16 / FASB ASC 842



Are You
Prepared
For IFRS 16?

Comply with the new lease accounting standards, IFRS 16 and FASB ASC 842 with LOIS by Innervision.

See your entire lease portfolio in real-time, run amortisation schedules, journal entries & disclosure summaries with ease.

Discover why global corporates trust Innervision to help support their lease accounting transition to IFRS 16 / FASB ASC 842.

Request a product demo at www.innervision.co.uk | +44 (0)20 7283 9422

