

IFRS 16 Leases

The new leases standard

March 2019

IFRS 16 *Leases*

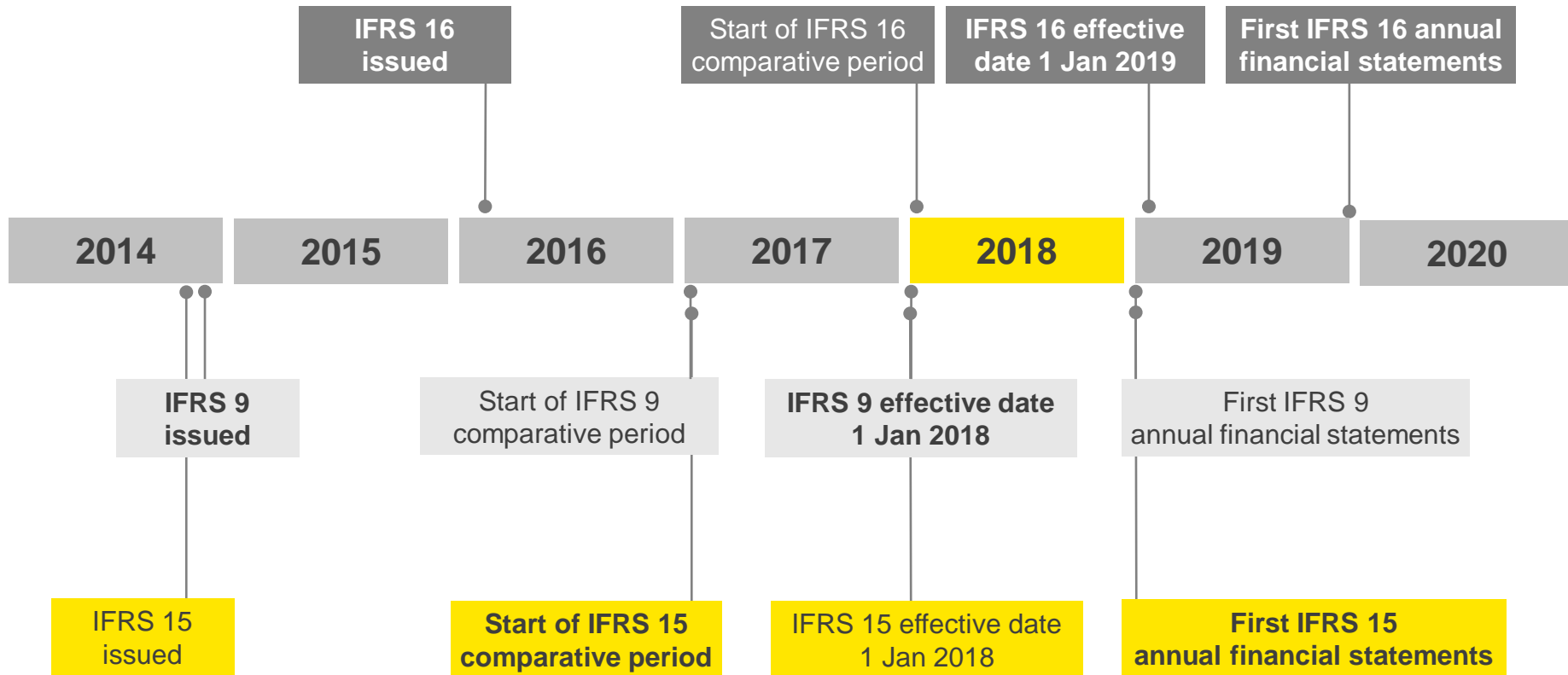
Overview

- ▶ IFRS 16 *Leases* was issued in January 2016
- ▶ Lessees will have a single on balance sheet accounting model for all leases, with exemptions for leases of 'low-value assets' and short-term leases
- ▶ Lessor accounting is substantially unchanged
- ▶ Lessees and lessors will have additional disclosure requirements compared to current accounting
- ▶ The IASB and the FASB made different decisions about lease classification and the recognition, measurement and presentation of leases for lessees and lessors

New standard will be effective for annual periods beginning on or after
1 January 2019

Leases

A crowded timeline for implementation



IFRS 16 *Leases*

Scope and definition of a lease

- ▶ The new standard applies to leases of all assets except:
 - ▶ Leases to explore for or use non-regenerative resources
 - ▶ Leases of biological assets
 - ▶ Service concession arrangements
 - ▶ Licences of intellectual property granted by a lessor
 - ▶ Rights held by a lessee under certain licensing agreements (e.g., films)
- ▶ A contract is, or contains, a lease if:
 - ▶ There is an identified asset (explicit or implicit)
 - ▶ No identified asset if the supplier has a substantive substitution right
 - ▶ The contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration – i.e., throughout the period of use the customer would have the right to:
 - ▶ Direct the use of the identified asset (i.e., direct how and for what purpose the asset is used) **and**
 - ▶ Obtain substantially all of the economic benefits from directing its use

IFRS 16 *Leases*

Separating components of a lease

- ▶ Lease and non-lease components are accounted for separately
 - ▶ Each lease component – apply IFRS 16
 - ▶ Each non-lease component – apply other standards
- ▶ Practical expedient:
 - ▶ Lessees can make a policy election (by underlying asset class) to account for lease and non-lease components as lease components
- ▶ Allocate consideration to lease and non-lease components:
 - ▶ Lessees – on a relative stand-alone price basis (unless the practical expedient is elected)
 - ▶ Lessors – using the new revenue recognition standard (i.e., IFRS 15 *Revenue from Contracts with Customers*)

IFRS 16

A snap shot

What do you need to know?

The obvious

For lessees, most leases will come on balance sheet

The complex

Careful consideration of the terms of each lease contract is required

The hidden

There is a new definition of a lease – an appropriate analysis is critical

How will you respond?

The transition

Extensive transition guidance can reduce the impact and cost

The business impact

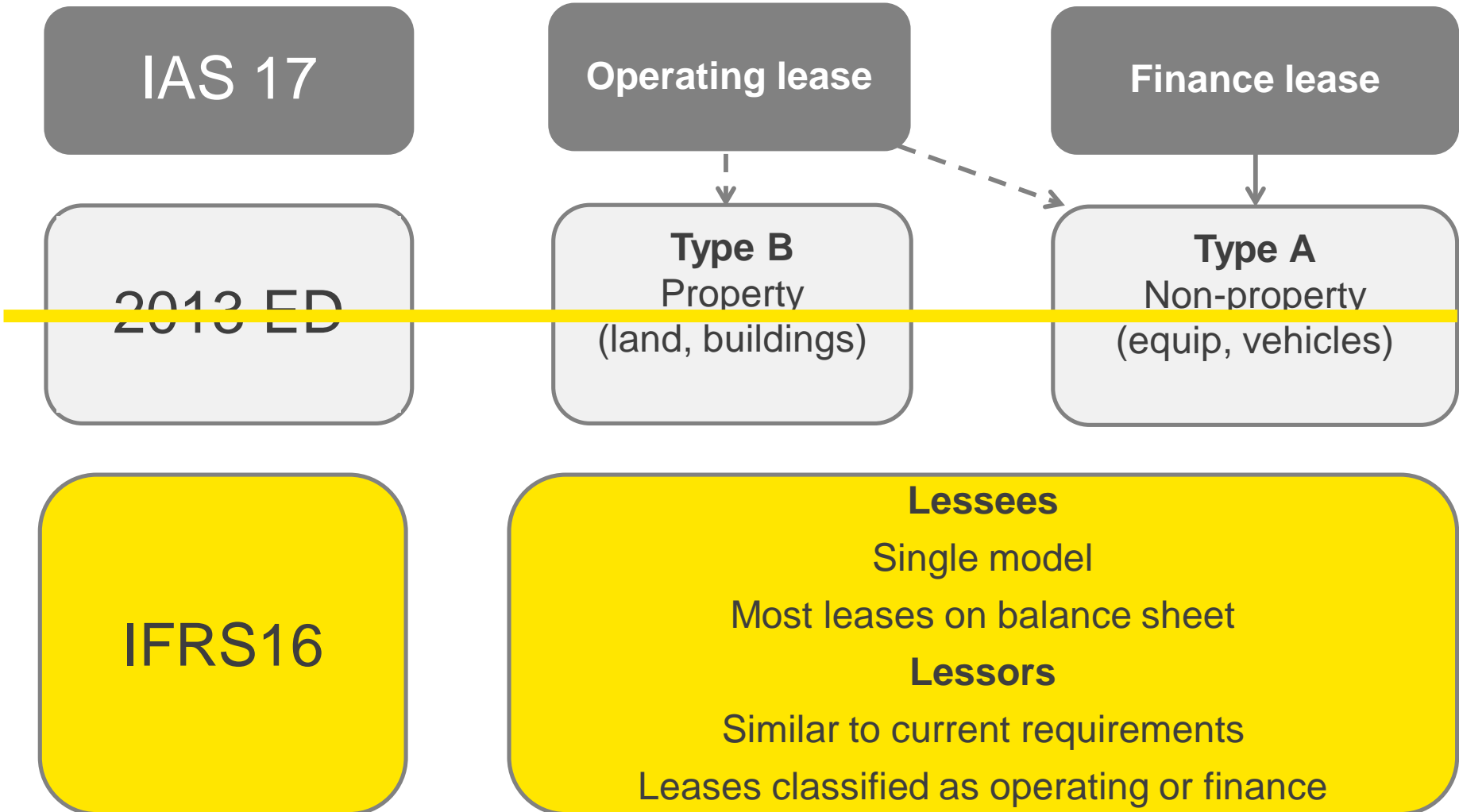
Will change information collection, processing, presentation and interpretation

The response

Careful planning and execution is required – potential changes to systems and processes

The new standard

An overview



The obvious

Most leases on balance sheet

Lessees

A simple example

End of year 1

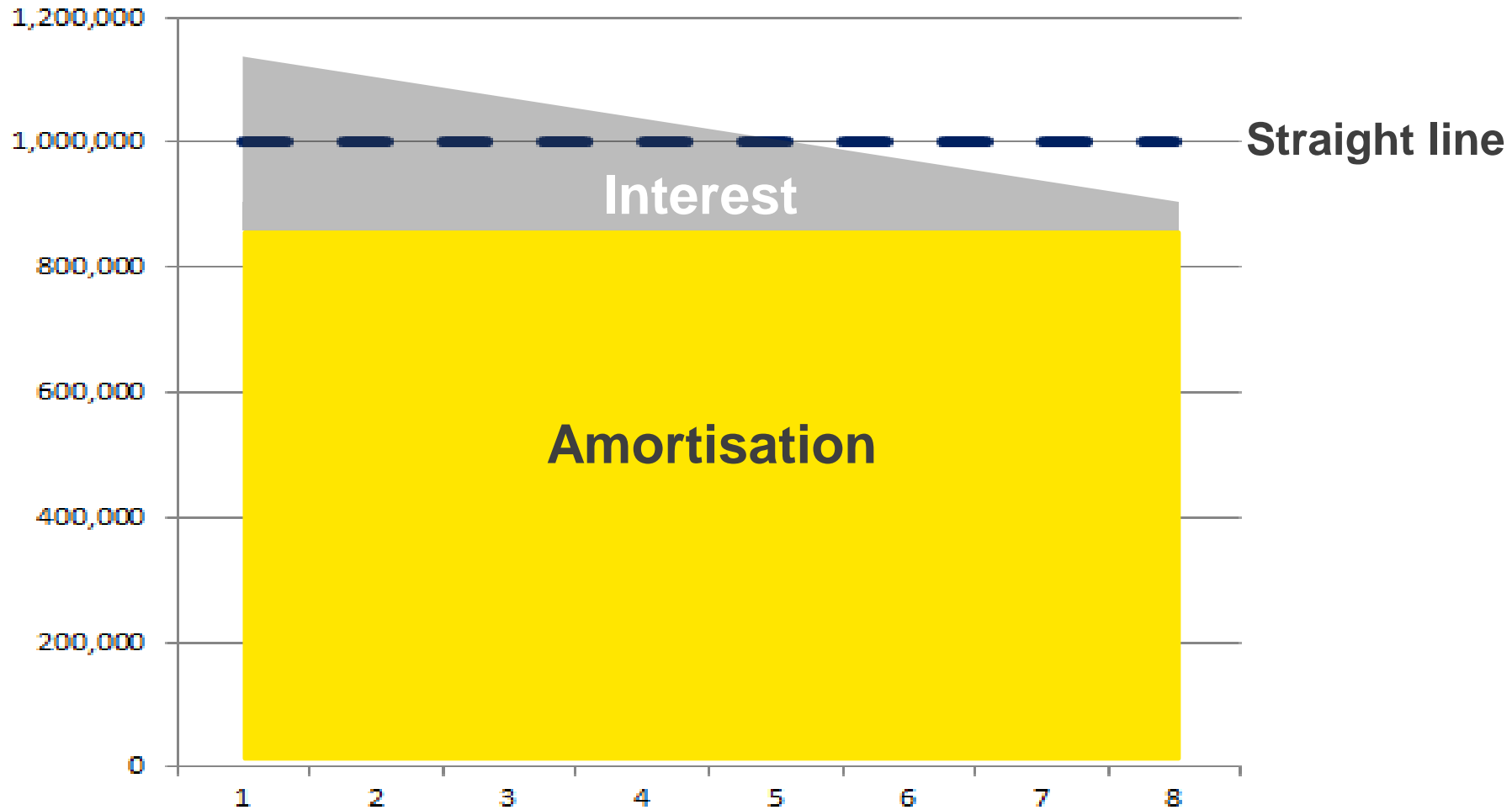
Assumptions
One lease
\$1,000,000 rental p.a.
No straight-lining required
8 year term
4% discount rate
No contingent rentals
Initial asset and liability \$6.7m

Profit (year 1)	IAS 17	IFRS 16	Impact
Lease rentals	(1,000,000)	-	1,000,000
EBITDA	(1,000,000)	-	1,000,000
Amortisation	-	(841,593)	(841,593)
EBIT	(1,000,000)	(841,593)	158,407
Finance costs		(269,310)	(269,310)
Profit before tax	(1,000,000)	(1,110,903)	(110,903)

Balance sheet	IAS 17	IFRS 16	Impact
Assets	-	5,891,152	5,891,152
Liabilities	-	(6,002,055)	(6,002,055)
Equity	-	(110,903)	(110,903)

The obvious

P&L profile



The complex

Measurement of lease liability

Determine the lease term

Identify the lease payments

Apply the discount rate

The complex

Measurement of lease liability

Lease term

- ▶ Non-cancellable period

plus

- ▶ Extension options
- ▶ Termination options

Reasonably certain assessment

Economic incentive to exercise?

- ▶ Favourable terms
- ▶ Significant leasehold improvements
- ▶ Termination or relocation costs
- ▶ Specialised asset or lack of available alternative assets
- ▶ Past practice
- ▶ Interaction with other contract terms
- ▶ Length of non-cancellable period

The complex

Measurement of lease liability

Lease payments

Include:

- ▶ Fixed payments
- ▶ Payments that are in-substance fixed
- ▶ Exercise price of purchase options
- ▶ Termination penalties
- ▶ Variable lease payments based on an index or rate
- ▶ Residual value guarantees – amounts expected to be payable

Exclude:

- ▶ Variable lease payments that do not depend on an index or rate (e.g., performance- or usage-based payments) unless they are in-substance fixed

The complex

Measurement of lease liability

Discount rate

Lease-by-lease analysis

- ▶ Rate implicit in lease, if readily determinable
- ▶ Otherwise, incremental borrowing rate for each lease

Lessee's incremental borrowing rate

The rate of interest 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**

Reassess discount rate if:

- ▶ Lease term changes (e.g. if lessee exercises an extension option not previously included in lease term)
- ▶ There is a change in the assessment of an option to purchase the underlying asset
- ▶ When there is a lease modification

The complex

Measurement of ROU asset

Right of use asset

Lease liability, adjusted for:

Prepayments

Lease incentives received

Initial direct costs

Dismantling / restoration costs

The complex

Other key principles

Exemptions

Short term leases

Policy choice – class of assets
Lease term 12 months or less
No purchase options
No assets of liabilities, SL P&L

Low value assets

Policy choice – lease by lease
No assets of liabilities, SL P&L
Examples provided
Set a threshold say \$5,000

Other considerations

Non-lease components

Separate non-lease components (e.g. services)
Practical expedient (policy) – account all as a lease

Sale and lease backs

Use IFRS 15 to determine where a sale occurs (control passes to the buyer/lessor)
Otherwise financing

Combining contracts

Negotiated as packaged with single objective OR
Price of contract depends on price / performance of another

Allocating consideration

Relative stand-alone basis
Use observable inputs where available, otherwise use estimates

Lease modifications

New lease if additional ROU and price commensurate with stand-alone price – otherwise remeasure liability and ROU

Sub leases

Generally treated as two leases unless meet contract combination requirements

The hidden

Definition of a lease

Use of an identified asset (explicitly or implicitly)

A portion of an asset is an identified asset if it is **physically distinct** (e.g. floor of a building)

Would not be identified asset if supplier has substantive right to substitute the asset

- ▶ Has practical ability to substitute the asset; **and** can benefit from substituting the asset

Customer has the right to obtain **substantially all of the economic benefits** from the use of the identified asset

Customer has the right to the **right to direct the use** of the identified asset

Conveys the right to control the use

Customer would have the right to:

- ▶ Direct the use of the identified asset
- ▶ i.e., direct **how and for what purpose** the asset is used, including the right to change how and for what purpose the asset is used

Neither the customer nor the supplier directs how and for what purpose the asset is used

E.g. decisions are predetermined in a contract, or when decisions are made jointly.

Customer has right to direct the use if it:

- ▶ Has the right to operate the asset or direct others to operate the asset in a manner that it determines (with the supplier having no right to change those operating instructions) **or**
- ▶ Designed the asset, or caused it to be designed, in a way that predetermines how and for what purpose the asset will be used or operated

The hidden

IFRS 16 illustrative examples

- ▶ The IFRS 16 illustrative examples provide ten detailed scenarios, and variations to those scenarios, that demonstrate the application of the lease definition requirements
- ▶ Examples cover a range of different assets and sectors

Assets / sectors

- | | |
|---------------------------|---------------------------------|
| ▶ Rail cars | ▶ Ship |
| ▶ Retail concession space | ▶ Aircraft |
| ▶ Fibre-optic cable | ▶ Shirt factory |
| ▶ Retail property space | ▶ Contract for energy / power |
| ▶ Truck | ▶ Contract for network services |

The transition

Transition methods

Option 1		PY 31 December 2018		CY 31 December 2019
	<p>Full retrospective As if IFRS 16 has always applied</p>	Cumulative catch-up	Contracts restated	Contracts under new standard
Option 2	<p>Modified retrospective Liability = PV lease payments and either (a) or (b) below</p>	Contracts not restated	Cumulative catch-up	Existing and new contracts under new standard
	<p>(a) Carrying amount of ROU asset as if IFRS 16 had always applied</p>			
	<p>(b) Carrying amount of ROU asset = lease liability</p>			

The transition

Definition of a lease - transition relief

Lease?		IFRIC 4 / IAS 17	
		Yes	No
IFRS 16	Yes	Apply new standard	Can continue to apply accounting as services contract under IAS 17 [Grandfathered]*
	No	Not required to apply new standard, but can elect to*	New standard is not applicable

- * Option (i.e., not to reassess existing contracts), would be an accounting policy decision. To be applied to all contracts that are ongoing at the date of initial application. An entity would not be permitted to apply this option on a lease-by-lease basis.

The transition

Disclosures

- ▶ If the modified retrospective approach is adopted, a lessee must disclose:

an explanation of any difference between:

- (i) operating lease commitments disclosed applying IAS17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application;

and

- (ii) lease liabilities recognised in the statement of financial position at the date of initial application.

- ▶ Important for companies to improve IAS 17 operating lease commitments to avoid significant unexplained differences

The business impact

Financial impact

- Diagnostic
- Impact modelling and assessment
- Benchmarking

Investor relations

- Effective disclosure
- Business model

Financing

- Debt advisory
- Lease vs buy

Renegotiate

- Contract analysis
- Restructuring opportunities
- Covenants

Performance measure

- Business performance analysis
- Metric analysis

Debt covenants

- Covenant analysis, negotiation, renegotiation

Tax

- Tax accounting implications?
- Thin capitalisation implications?

Lessors

- Effective disclosure
- Business model

Employee benefits

- STI measurement / assessment

Accounting DD

- Transaction DD
- Valuation – multiples
- Earn-outs

Dividends

- Impact assessment

Impairment

- Impairment analysis
- Impact assessment and modelling

The response

Change management

- Diagnostic
- Project planning and management
- IFRS 9 & IFRS 15
- Early adopt?

Governance

- Centralised vs decentralised
- Delegations of authority (opex vs capex)

Data and systems

- System design and implementation
- Data collection / analytics

Accounting policy manual

- Policy review / update
- APM and procedure manuals

Training

- Workshops
- Education - inception
- Training - implementation

Transition method

- Impact modelling and assessment
- Transition exemptions / grandfathering

Outsourcing

- Outsource contract management and lease accounting

Assurance

- Post-implement review
- Internal audit

Industry considerations



Preparing for the first discussion

Useful information that may be readily available

The obvious

- ▶ Lease commitment disclosures
- ▶ Net balance sheet and P&L metrics

The complex

- ▶ Common contractual terms? E.g. property leases: renewal options, CPI, contingent rentals

The hidden

- ▶ Think about the types of arrangements that are dependent on the use of significant assets

The transition

- ▶ Consider whether your company is focussed on P&L or balance sheet metrics

The business impact

- ▶ EBITDA or EBIT used to present results to the market?
- ▶ External debt held (debt covenants)?
- ▶ Recent or potential acquisitions?

The response

- ▶ Is the finance function centralised or decentralised?

Industry considerations

Real estate



- ▶ Lease payments based on CPI or other index / rate – *variable lease payments, remeasurement – IFRS 16 IE ex14*
- ▶ Extension options and termination options are common – *lease term and lease payments*
- ▶ Changes to floor space leased are common – *lease modification, identified asset (physically distinct portion of an asset) – IFRS 16 IE ex13*
- ▶ New leases are often negotiated before existing lease ends – *lease modification*
- ▶ Payments often include maintenance, security or other ancillary payments – *separating non-lease components*
- ▶ Subleases are common with property – *subleases IFRS 16 IE ex20*
- ▶ Sale and leaseback transactions are common with property – *sale and leasebacks IFRS 16 IE ex24*
- ▶ Lease incentives are common – *lease incentives*
- ▶ Lessors: lessees may be influenced by IFRS 16 in negotiating new terms (e.g. shorter lease terms, fixed rental increases) – *business impact*

Industry considerations

Retail and consumer products



- ▶ Often a large retail property lease portfolio
 - ▶ *Real estate considerations are relevant*
 - ▶ *Often a significant obvious impact – often a large volume of similar value leases*
- ▶ Concession stores and other rental arrangements – *lease definition – IFRS 16 IE ex2 & ex4*
- ▶ Shopping mall advertising contributions – *separating non-lease components*
- ▶ Extension options and online retailing – *lease term (reasonably certain)*
- ▶ Storage contracts (e.g. distribution centres) – *lease definition*
- ▶ Point-of-sale (“POS”) systems – *low value asset exemption*
- ▶ Sole (or significant) customer for supplier, e.g. factory, farms – *lease definition – IFRS 16 IE ex8*

Industry considerations

Telecommunications



- ▶ Often a large retail property lease portfolio
 - ▶ *Real estate considerations are relevant*
 - ▶ *Often a significant obvious impact – often a large volume of similar value leases*
- ▶ Network services – *lease definition (identified asset, substitution rights, right to control use) – IFRS 16 IE ex10*
- ▶ Mobile towers, pole attachments, fibre cables – *lease definition (capacity portions)*
- ▶ Assets located on land or buildings owned by others (e.g. mobile tower on an office building) – *lease definition*
- ▶ Assets located on the customer's premises, e.g. set-top boxes, gateways (modems / routers), servers – *lease definition*
- ▶ Contracts are often coupled with an arrangement to purchase or sell other goods or services – *non-lease components*

Industry considerations

Logistics and transport



- ▶ Extension options common for aircraft, ships, trucks and rail assets – *renewal options and lease term*
- ▶ Customer specific modifications to assets (e.g. truck livery, topside equipment on a ship) – *lease definition (specified asset, substantive substitution rights)*
- ▶ Shipping contracts ‘time charter’ or ‘bareboat charter’ arrangements – *lease definition (substantially all economic benefits, right to control use) - IFRS 16 IE ex6*
- ▶ Transportation of cargo occupying portion of capacity of a ship, truck or rail assets – *lease definition (capacity portions, substantially all economic benefits)*
- ▶ Arrangements of contain clauses that prohibit the customer from transporting particular types of cargo – *right to control use (protective rights) IFRS 16 IE ex1*

Industry considerations

Airlines



- ▶ Leasing is a common source of financing
 - ▶ *Often a significant obvious impact – often a smaller volume of large value leases (transition methods)*
 - ▶ *Often complex arrangements*
 - ▶ *IFRS 16 IE ex7*
- ▶ Portfolio management: multiple leases often negotiated together – *transition methods*
- ▶ Airport terminal access (e.g. terminal, check-in facilities) – *lease definition*
- ▶ Ground vehicles (e.g. push back, refuelling, baggage handling) – *lease definition (identified asset, substantive substitution rights), variable lease payments*
- ▶ Aircraft simulators (sole or significant user): *lease definition*
- ▶ Wet lease, damp lease, dry lease: aircraft leases often also include flight and / or cabin crew, maintenance, insurance – *separating non-lease components*
- ▶ FX denominated leases (which differs from FJD) – *ROU asset (non-monetary asset) is often not remeasured for FX, lease liability (monetary liability) is remeasured for FX – P&L and balance sheet volatility*

Industry considerations

Financial services



- ▶ Banks have an extensive retail store presence:
 - ▶ *Real estate considerations are relevant*
- ▶ ATMs arrangements – *lease definition*
- ▶ Financial services entities contract with data storage providers to store sensitive customer information – *lease definition (substantive substitution rights)*
- ▶ Regulators such as RBF require financial services entities to hold a certain amount of capital – Capital Adequacy: treatment of ROU asset and lease liability could impact regulatory capital requirements – *business impact*
- ▶ The financial statement ratios of customers (borrowers) may change significantly – *business impact*
- ▶ As lessor: lessees may be influenced by IFRS 16 in negotiating new terms (e.g. shorter lease terms, fixed rental increases) – *business impact*

Industry considerations

Mining



- ▶ Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources – *scope*
- ▶ Joint arrangements – *the joint arrangement is considered to be the customer in the contract (assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use)*
- ▶ Mining services contracts (e.g. mining fleet, drilling contracts) – *lease definition (right to direct the use)*
- ▶ Freight, shipping and other transportation agreements – *lease definition*
- ▶ Take or pay arrangements and other long-term supply agreements – *lease definition*
- ▶ Storage arrangements – *lease definition*
- ▶ Surface rights and rights of way – *lease definition*
- ▶ Tolling arrangements – *lease definition*
- ▶ Dedicated utility infrastructure (electricity, water, gas, telecommunications) – *lease definition*

Industry considerations

Infrastructure



- ▶ Often long-term deals – *early adoption, transition provisions (grandfathering of lease definition)*
- ▶ What are the economic benefits of the infrastructure and who shares in those benefits – *lease definition*

IFRS 16 Leases

Lessee accounting – Recognition and measurement

Initial recognition and measurement	<ul style="list-style-type: none">▶ Initially measure right-of-use (ROU) asset¹ and lease liability at present value of lease payments
Subsequent measurement of lease liability	<ul style="list-style-type: none">▶ Accrete the lease liability based on the interest method using a discount rate determined at lease commencement²▶ Reduce lease liability by payments made
Subsequent measurement of ROU asset	<ul style="list-style-type: none">▶ Depreciate ROU asset, based on IAS 16 <i>Property, Plant and Equipment</i>▶ Alternative measurement of ROU asset under IAS 16 and IAS 40 <i>Investment Property</i>
Profit and loss	<ul style="list-style-type: none">▶ Generally ‘front-loaded’ expense for individual lease▶ Separate interest and depreciation

1 Initial measurement of the ROU asset would also include the lessee’s initial direct costs; prepayments made to the lessor, less any lease incentives received from the lessor; and restoration, removal and dismantling costs.

2 As long as a reassessment and a change in the discount rate have not occurred.

IFRS 16 Leases

Lessee accounting – Presentation

Balance sheet	Income statement	Statement of cash flows
<p>ROU asset:</p> <ul style="list-style-type: none"> ▶ Separately from other assets (e.g., owned assets), or with corresponding underlying assets and disclose line items containing ROU assets 	<ul style="list-style-type: none"> ▶ Depreciation expense (separate from interest expense) 	<ul style="list-style-type: none"> ▶ Principal payments within financing activities
<p>Lease liability:</p> <ul style="list-style-type: none"> ▶ Separately from other liabilities, or together with other liabilities and disclose line items containing lease liabilities 	<ul style="list-style-type: none"> ▶ Interest expense (separate from depreciation expense) 	<ul style="list-style-type: none"> ▶ Interest payments consistent with policy election in <i>IAS 7 Statement of Cash Flows</i>
	<p>Present or disclose:</p> <ul style="list-style-type: none"> ▶ Variable lease expense ▶ Short-term lease expense ▶ Low-value asset lease expense 	<ul style="list-style-type: none"> ▶ Lease payments for low-value assets, short-term leases and variable lease payments (not included in the lease liability) within operating activities ▶ Supplemental non-cash disclosure of new leases

IFRS 16 *Leases*

Lessor accounting – Recognition and measurement

- ▶ Many aspects of today's lessor accounting will remain the same
- ▶ Finance leases – similar to today's finance leases
 - ▶ Derecognise underlying asset
 - ▶ Recognise net investment
 - ▶ Recognise selling profit (if any)
- ▶ Operating leases – similar to today's operating leases

IFRS 16 Leases

Lessor accounting – Presentation

Balance sheet	Income statement	Statement of cash flows
<p>Operating lease:</p> <ul style="list-style-type: none">▶ Underlying assets presented according to the nature of the underlying asset <p>Finance lease:</p> <ul style="list-style-type: none">▶ Lease receivable (i.e., net investment in the lease – present value of lease payments and unguaranteed residual value)	<p>Not addressed in IFRS 16; current practice:</p> <p>Both lease types:</p> <ul style="list-style-type: none">▶ Generally, lease-related income is presented either separately from other activity, or disclosed in the notes <p>Finance lease:</p> <ul style="list-style-type: none">▶ Profit or loss recognised at commencement presented in accordance with IAS 1 <i>Presentation of Financial Statements</i>▶ Generally, interest on net investment presented as interest income	<p>Not addressed in IFRS 16; current practice:</p> <p>Both lease types:</p> <ul style="list-style-type: none">▶ Cash lease payments received presented in accordance with IAS 7, generally within operating activities

IFRS 16 *Leases*

Disclosure

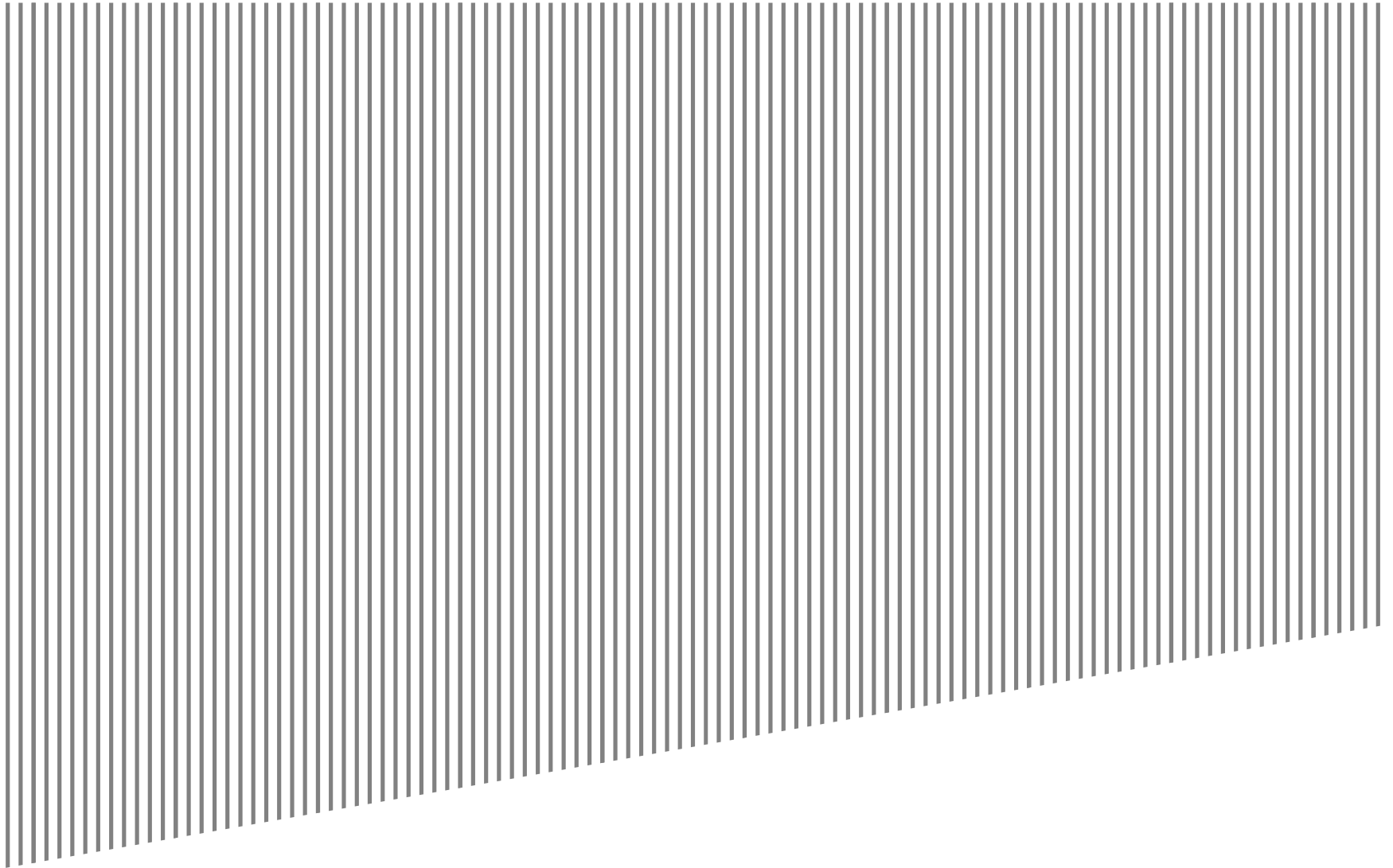
- ▶ New disclosures for lessees include:
 - ▶ Depreciation of ROU assets by class of underlying asset
 - ▶ Interest on lease liabilities
 - ▶ Expenses for short-term leases and leases of low-value assets
 - ▶ Sublease income
 - ▶ Total cash outflows
 - ▶ A single location; quantitative disclosures in tabular format
- ▶ New disclosures for lessors include:
 - ▶ How lessor manages risk associated with rights retained in underlying asset
 - ▶ Qualitative and quantitative explanations of significant changes in balance of net investment in finance leases
 - ▶ Table of lease income
 - ▶ Maturity analysis, including a reconciliation of undiscounted cash flows to the lease receivable for finance leases

IFRS 16 *Leases*

Subleases

- ▶ Head lease (as a lessee) and sublease (as a lessor) generally accounted for as two separate leases
 - ▶ Subject to contract combinations requirements
- ▶ Consider the ROU asset (rather than the underlying asset under the head lease) for classification purposes of the sublease
- ▶ Sublease income required to be disclosed

Questions?



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