IFRS 16: *Leases*

A more transparent balance sheet

Presented by:
Agnes Lutukai

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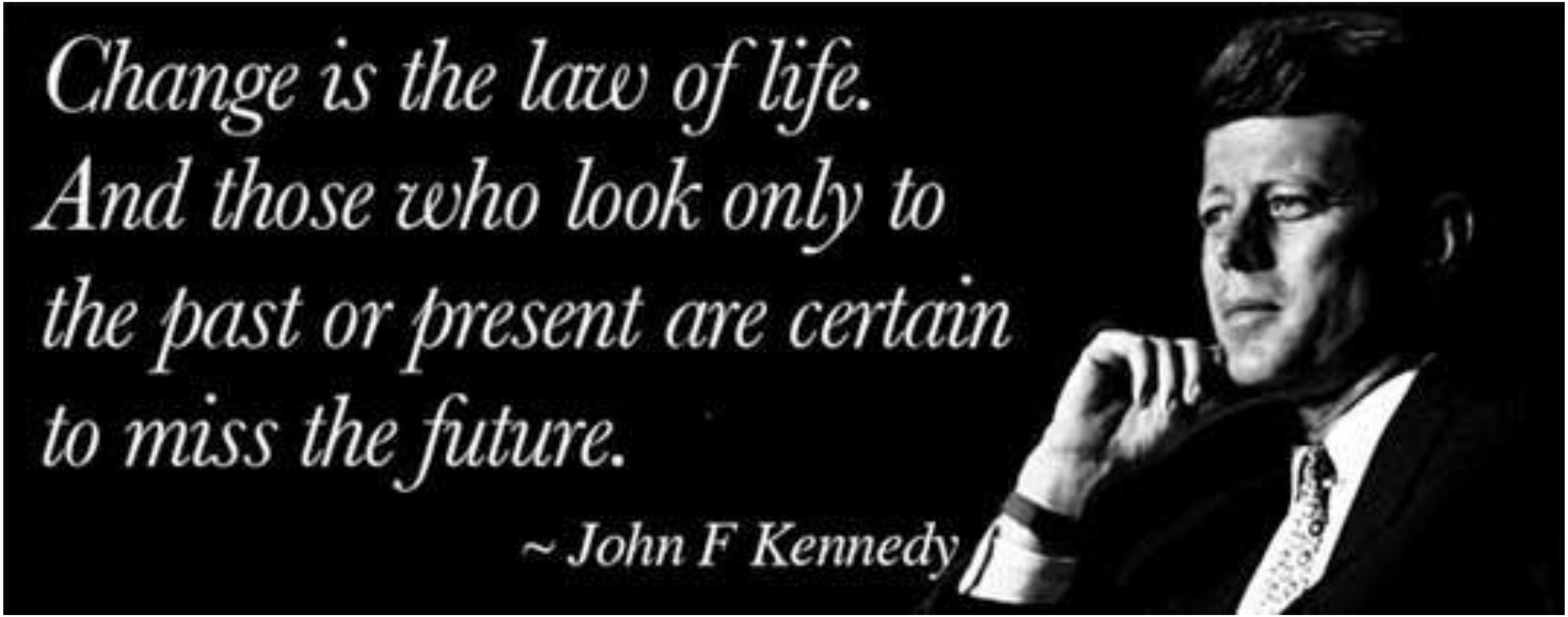
Agenda

- ✓ Introduction/Overview
- ✓ Basic concepts
- ✓ Key policy decisions
- ✓ Application challenges
- ✓ Disclosures
- ✓ Next steps

Introduction/Overview

Quotable Quote



An Overview…

On 13 January 2016, the International Accounting Standards Board ("IASB") issued a new standard - IFRS 16: Leases, thereby realising its long-standing goal of ensuring that entities that engage in lease transactions present more transparent balance sheets by providing relevant information in a manner that faithfully represents the transactions.

IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of lease transactions and replaces the following standards and interpretations:

- IAS 17 Leases
- IFRIC 4 Determining whether an Arrangement contains a Lease
- SIC-15 Operating Leases - Incentives
- SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease

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The $3 trillion standard

“One of my great ambitions before I die is to fly in an aircraft that is on an airline’s balance sheet…”

Sir David Tweedie
(Former IASB Chairman)
April 2008

“Listed companies are estimated to have US$3.3 trillion of lease commitments, over 85% of which do not appear on their balance sheets…”

Hans Hoogervorst
(IASB Chairman)
January 2016

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Why is this important?

- **Most companies lease assets and there is a radical overhaul of lessee accounting.**
- **Under IFRS 16, both operating and finance leases will be on balance sheet.**
- **On/off-balance sheet test for leases will be based on whether the contract meets the definition of a lease.**
- **Significant changes in key reporting metrics.**
- **Stakeholders/investors will want to understand the impact on their businesses.**

What is in and outside the scope of the standard?

Leases of all assets, except for:

- **Leases to explore minerals, oil and gas and similar non-regenerative resources**
- **Leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee**
- **Service concession arrangements (IFRIC 12)**
- **Licences of intellectual property granted by lessor within the scope of IFRS 15 *Revenue from Contracts with Customers*;**
- **Rights held by a lessee under certain licensing agreements within the scope of IAS 38 *Intangible Assets* (e.g. films, patents)**

Comparing IAS 17 to IFRS 16

The new on/off-balance sheet test for lessees – a key judgement area

ON/OFF Balance Sheet?

	Lease classification test	ON	OFF
New standard	✗	**Lease**	**Service**
Old standard	✓	**Finance lease**	**Operating lease**

IFRS vs US GAAP

A joint project but not a joint standard

IFRS and US GAAP standards converged?

✓	Lease definition	Leases on balance sheet for lessees	Lessor accounting
✗	Lessee accounting model	Detailed measurement and transition requirements	Exemption for low value items

Basic Concepts

New definition, new accounting

What is a lease?

NEW!

A contract is, or contains, a lease if it conveys the <u>right to control the use of an identified asset</u> for a period of time in <u>exchange for consideration</u>. [IFRS 16:9]

OLD!

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. [IAS 17.4]

The criteria for identifying a lease is based on the <u>right to control the use of the asset</u> and therefore, <u>significant judgment</u> is required in the <u>determination of who controls the use of the identified asset</u>.

Lease definition – Exemptions

Two major optional exemptions make the standard easier to apply.

Short term leases

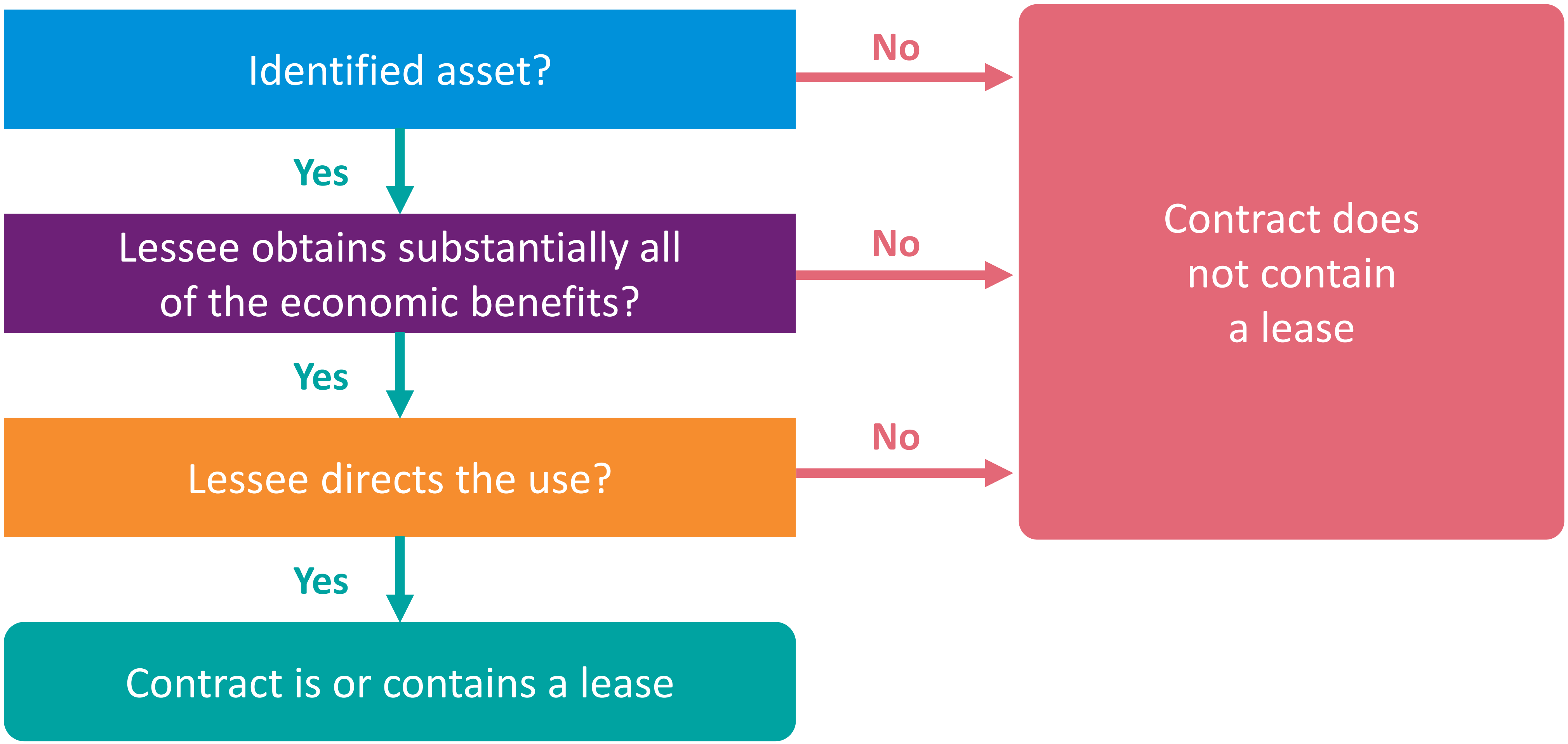
≤ 12 months

Leases of low value items

e.g. personal computers, small items of office furniture and telephones.

No threshold for low value.

Lease identification



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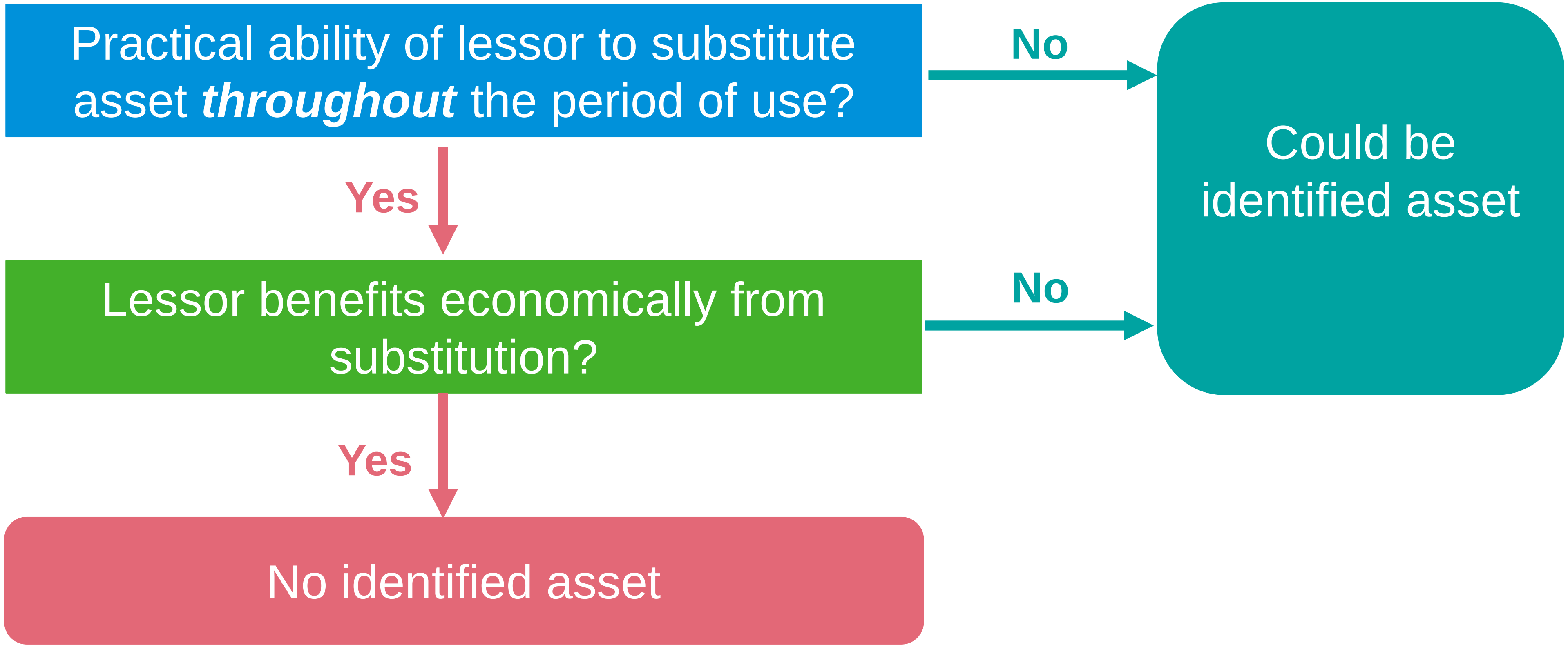
Substantive substitution rights



Economic benefits

	25-year contract for customised solar panel output. Supplier receives renewable energy credits.	Office contract. Tenant sublets 25% of space.	Retail store contract. Rental = fixed amount + 20% of revenue.	Car hire contract. Limited to 20,000 miles per year and inside country X.	2-years jet charter. Share access and use with another party.
Primary output	✓	✓	✓	✓	✗
+ Other benefits	✗	✓	n/a	n/a	n/a
= ***Substantially all economic benefits***	✗	✓	✓	✓	✗

Directing the right to use

Who takes the ***'how and what purpose' decisions*** throughout the period of use?

Customer

Predetermined

Customer ***operates asset*** or directs others to do so

Customer designed asset

Other

Supplier

Contract is or contains a lease*

Contract does not contain a lease

Protective rights of the supplier

* If other criteria are met.

Measuring the lease liability

Lease liability = **Present value of lease rentals** + **Present value of expected payments at end of lease**

Lease definition… *An illustration*

Lease definition test

- Customer enters into a two year contract with supplier to transport cargo from Mombasa in Kenya to Tanga port in Tanzania.
- Ship is explicitly specified in the contract, supplier has no substitution rights.
- Cargo will occupy substantially all of the capacity of the ship.

	Identified asset	Economic benefits	Directing the right to use
	✓	✓	?

Examples

Case A	Case B	Case C
▪ Contract specifies the cargo to be transported and dates of pickup and delivery. ▪ Supplier operates and maintains the ship, is responsible for safe passage of cargo on board.	▪ Contract specifies the cargo to be transported and dates of pickup and delivery. ▪ Customer hires the captain, supplier provides the rest of the crew which is crucial in operating the ship and maintains it.	▪ Customer decides whether and what cargo will be transported and when the ship sails between Mombasa and Tanga. ▪ Supplier operates and maintains the ship, is responsible of safe passage of cargo on board.

Is this a lease?

	Case A	Case B	Case C
Is this a lease?	✗	✓ Judgement required	✓

Lessee accounting – *Overview*

Single lease accounting model

Balance sheet

Asset

= 'Right-of-use' (ROU) of underlying asset

Liability

= Obligation to make lease payments

P&L

Lease expense

Depreciation

\+ Interest

= Front-loaded total lease expense

ROU asset is neither an intangible asset nor an item of property, plant and equipment. IFRS 16 does not specify that a ROU asset is in the scope of either IAS 16 or IAS 38. Instead, it appears that a ROU asset is a new category of asset in the scope of IFRS 16 itself.

The Aircraft

Five year lease of an aircraft

$1,000,000 per annum due at 31 Dec

No renewal no purchase option

Discount rate: 7%

Aircraft useful life: 20 years

Journal entries

1 January 20X1	Debit ($)	Credit ($)
ROU asset (present value of 5 x $1,000,000 @ 7%)	4,100,000	
Lease liability		4,100,000
To recognise lease at commencement date		
31 December 20X1		
Depreciation expense ($4,100,000/5)	820,000	
ROU asset		820,000
Lease liability (i.e. $1,000,000 - $287,000)	713,000	
Interest expense ($4,100,000 * 7%)	287,000	
Cash (payment for Year 1)		1,000,000
To recognise payment and expenses for Year 1		
Total P&L expense (i.e. $820,000 + $287,000)	**1,107,000**	

Lessor accounting – *Overview*

Lessor accounting

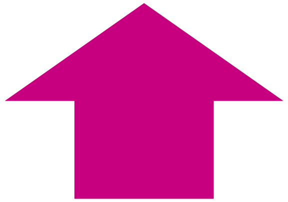
Lessor accounting remains similar to current practice…

but lacks consistency with new lessee accounting model

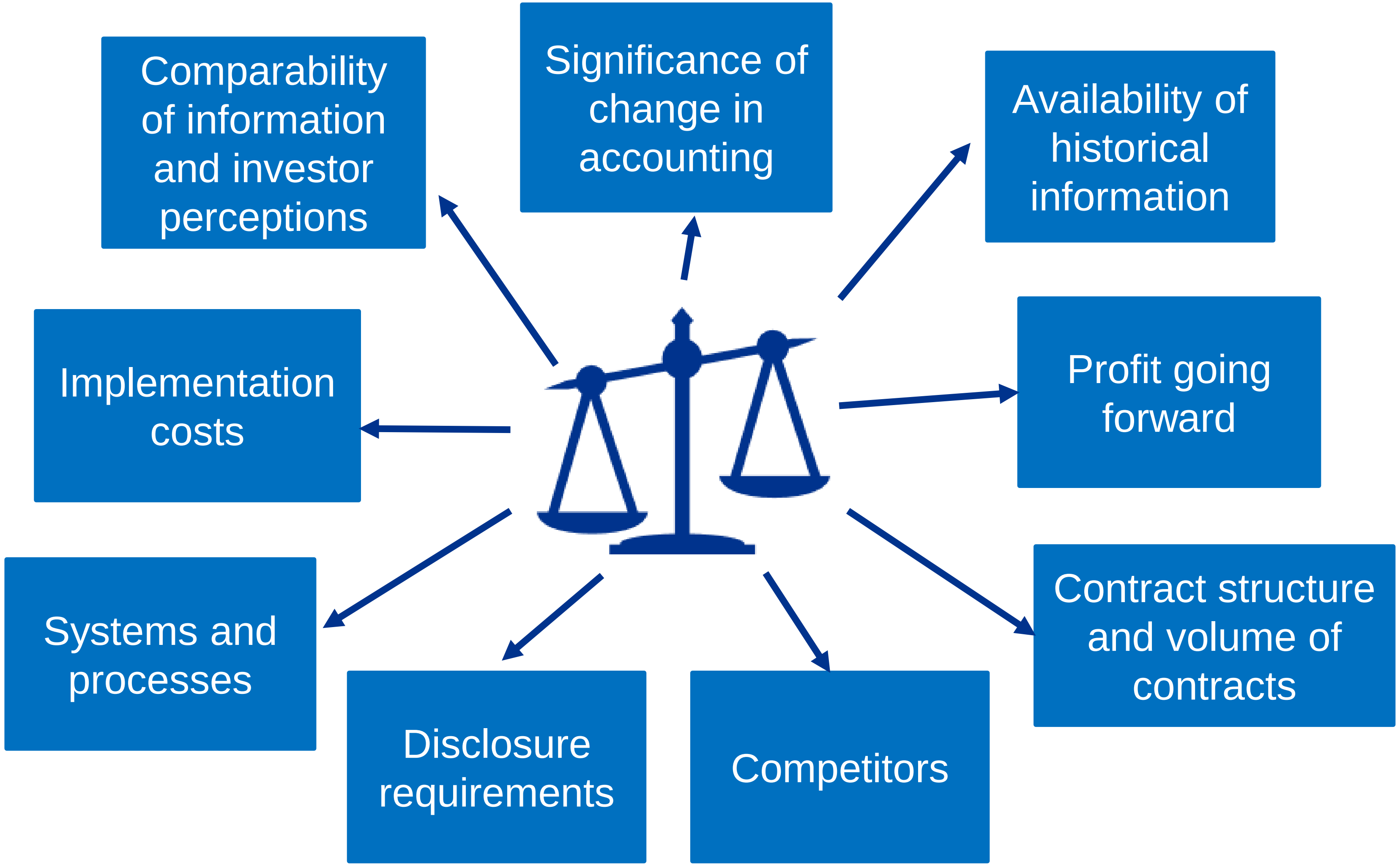
- Lease classification test ✓
- Finance leases and operating leases ✓
- Consistent accounting model for lessors and lessees ✗

Impact assessment

Impact on financial ratios

	Profit/loss	Balance sheet	Ratios
	EBITDA	Total assets	Gearing
	EPS (in early years)	Net assets	Interest cover Asset turnover

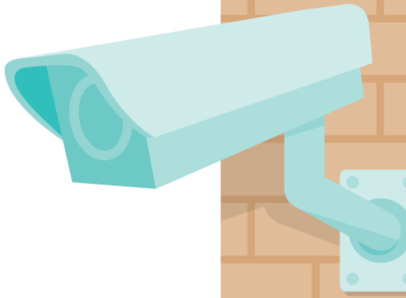
Additional factors to be considered by lessee



Key Policy Decisions

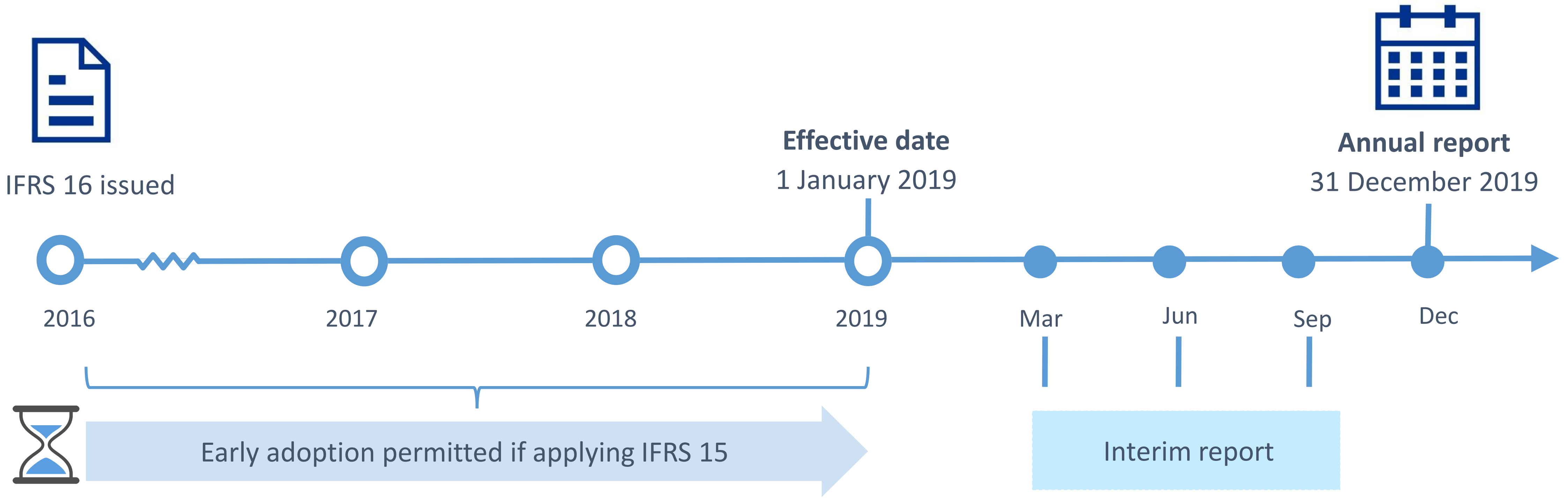
Why is this important?

- Multiple transition options are available.
- The choice of transition option impacts:
  - – *Opening balance sheet.*
  - – *Income statements in subsequent years.*
  - – *Information required.*
  - – *Implementation costs.*
- An early decision is key to a successful implementation project!!!



Multiple transition options

Effective date

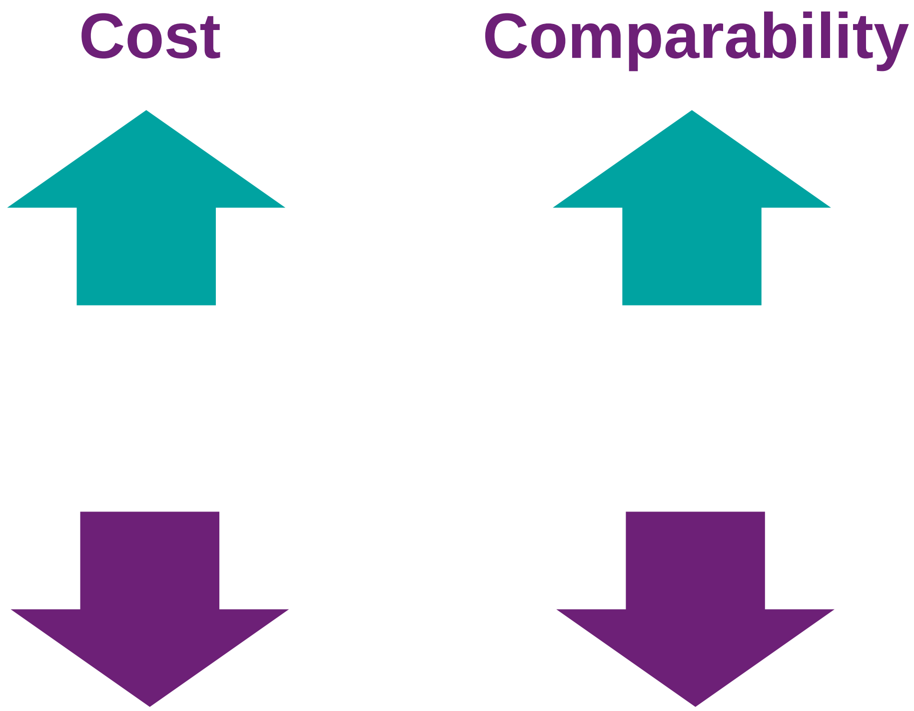


Transition options

Approach	2018	2019	Date of equity adjustment
Full retrospective (no practical expedients)	IFRS 16	IFRS 16	1 January 2018
Modified retrospective (with practical expedients)	IAS 17/IFRIC 4	IFRS 16	1 January 2019

- Full retrospective: parallel systems for 2018.
- Modified retrospective approach: additional disclosure.

Applying the new standard

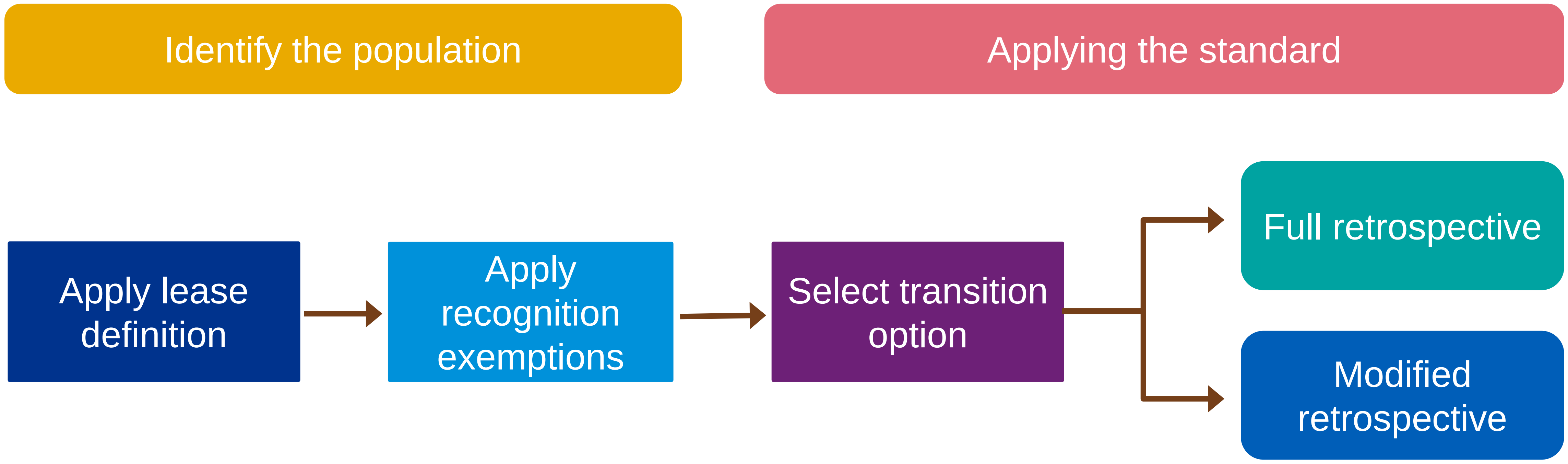


Apply the new definition to all contracts (Retrospectively to all accounting periods)

OR

Grandfather existing contracts and apply the new definition only to new contracts *(Practical expedient)*

Lessee approach to transition



Lease liability – modified retrospective

Lease liability = **Present value of remaining rentals** + **Present value of expected payments at end of lease**

Discount rate = lessee's incremental borrowing rate at *initial application*

Transition options – example

7-year equipment lease from 1 Jan 2016

$10,000 per annum in arrears

Discount rate: 6%

Discount rate: 4%

Approx. present value of $10,000 per annum ($)	7 years 6%	7 years 4%	4 years* 6%	4 years* 4%
	56,000	60,000	34,000	36,000

*** Lease term remaining on date of initial application of IFRS 16***

Transition options – solution

	Full retrospective	Modified retrospective
ROU asset at 1 Jan 2019	$32,000*	$36,000
Lease liability at 1 Jan 2019	($34,000)	($36,000)
Net lease position at 1 Jan 2019	**($2,000)**	**-**
Depreciation for 2019	($8,000)	($9,000)
Interest for 2019	($2,100)	($1,400)
Total lease expense for 2019	**($10,100)**	**($10,400)**

***** ***$56,000 less depreciation of $24,000 for 3 years (i.e. 1 Jan. 2016 – 31 Dec. 2018 @ $8,000 p.a.)***

More practical expedients!

PE#1 Account for leases expiring within 12 months as short term leases.

Lease liability	ROU asset
PE#2 Apply single discount rate to leases with similar characteristics.	PE#4 Exclude initial direct costs from ROU asset measurement.
PE#3 Use of hindsight e.g. determining lease term.	PE#5 Onerous contracts – alternative to performing impairment review.

Modified retrospective approach *only!*

Lessor approach to transition

Except for sub-leases and sale-and-leaseback transactions, a lessor does not make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with IFRS 16 from the date of transition.

Application challenges

Key impacts summarised

- **Implementation costs**
- **Identifying all lease agreements and extracting lease data.**
- **Changes in contract terms and business practices.**
- **Changes in financial metrics.**
- **Tax considerations.**

- **Balance sheet volatility** due to the requirements to reassess certain key estimates and judgements at each reporting date.
- **New estimates and judgements** that affect the identification, classification and measurement of lease transactions.
- **New systems and processes** may be required to capture the data necessary to comply with the new requirements, including creating an inventory of all leases on transition.

Some impacts cannot yet be quantified, some challenges are yet unseen, but early preparation is key to a good start.

Implementation and transition

Preparing for an accounting change of this magnitude presents a considerable challenge.

Understanding how the new standard will affect your company is critical. All companies with significant leasing activities should review the new standard and begin thinking about the implications now.

Starting early is the best way to reduce the overall cost of implementation, avoid unwanted surprises and costly mistakes.

Disclosures

Disclosures

The general disclosure objective is for lessees and lessors to disclose information that provides a basis for users of financial statements to assess the effects that leases have on financial position, financial performance and cash flows.

Key disclosures for lessees

QUANTITATIVE INFORMATION

SOFP
Additions to ROU assets.
Year-end carrying amount of ROU assets by class of underlying asset.
Lease liabilities and their maturity analysis.

SOPOLOCI
Depreciation charge for ROU assets by class of underlying asset.
Interest expense on lease liabilities.
Expense relating to leases for which the recognition exemption is applied.
Expense relating to variable lease payments
Income from sub-leasing ROU assets
Gains or losses arising from sale-and-leaseback transactions

SOCF
Total cash outflow for leases

Others
Amount of short-term lease commitments if current short-term lease expense is not representative for the following year

QUALITATIVE INFORMATION

Description of how liquidity risk related to lease liabilities is managed;
Use of exemption for short-term and/or low-value item leases.

Key disclosures for lessors

Finance lease	Operating lease
QUANTITATIVE INFORMATION	
Selling profit or loss	Lease income relating to variable lease payments that do not depend on an index or rate
Finance income on the net investment in the lease	Other lease income
Lease income relating to variable lease payments not included in the net investment in the lease	Detailed maturity analysis of the lease payments receivable
Significant changes in the carrying amount of the net investment in the lease	If applicable, disclosures in accordance with IAS 16 (separately from other assets), IAS 36, IAS 38, IAS 40 and IAS 41 *Agriculture*
Detailed maturity analysis of the lease payments receivable	
QUALITATIVE INFORMATION	
Significant changes in the carrying amount of the net investment in the lease	Not Applicable

Next steps...

Initial discussion points

- Discuss initial thoughts on the expected impact of IFRS 16.
- Highlight non-accounting areas potentially affected.
- Planned communications with external stakeholders, where relevant.

Next steps

- Start impact assessment
- Early adoption?
- Transition approach?

Key points to remember

- **New leases standard will impact most companies.**
- **Lease definition changes – there may be fewer leases under IFRS 16.**
- **Assessing whether there is a lease can be very judgemental.**
- **Lessee-only exemptions for short term leases and leases of low value items.**
- **Different scope exclusions for lessees and lessors.**
- **Multiple transition options are available.**
- **Process of assessing impact should start now.**

Questions?

Thank you!

Agnes Lutukai
Partner and Head of the Department of Professional Practice, West Africa

KPMG Professional Services – Nigeria

Tel: 01-2718964 or +2348129114452
agnes.lutukai@ng.kpmg.com
www.kpmg.com/ng