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IFRS workshop

IFRS 16

Leases

PwC Business School

2019

TFRS 16-Leases



The new lease standard – all started with a plane!

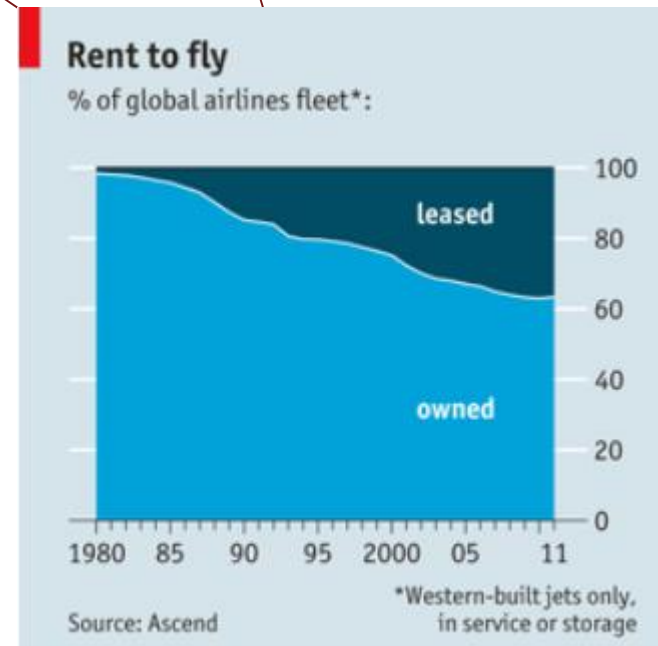


“One of my great ambitions before I die is to fly in an aircraft that is on an airline’s balance sheet.”

Sir David Tweedie Chairman of the IASB (25 April 2008)



“... approximately \$1.25 trillion in non-cancellable future cash obligations committed under operating leases are not recognized on issuer balance sheets...”



The Economist, Jan 21st 2012

SEC 2005





IFRS 16 – and now it is flying?!



January 20, 2016

Accounting's big shake-up to bring more transparency

FINANCIAL TIMES

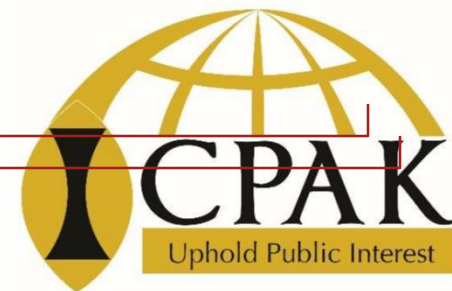
Industry		Median increase in debt	% entities with over 25% increase	Median increase in EBITDA
	Retail	+ 98%	35%	+ 41%
	Airlines	+ 47%	50%	+ 33%
	Professional services	+ 42%	40%	+ 15%
	Health Care	+ 36%	62%	+ 24%

- **January 2016:** Final standard
- **Effective date:** 1 January 2019 (earlier adoption in conjunction with IFRS 15 permitted)

Replaces IAS 17

PwC, A study on the impact of lease capitalisation IFRS 16: The new leases standard, p. 5

What are we telling our clients:



Lessees have to show a lease liability for almost every lease contract so there will be a huge impact on KPIs (e.g.. EBIT/EBITDA; debt to equity ratio)

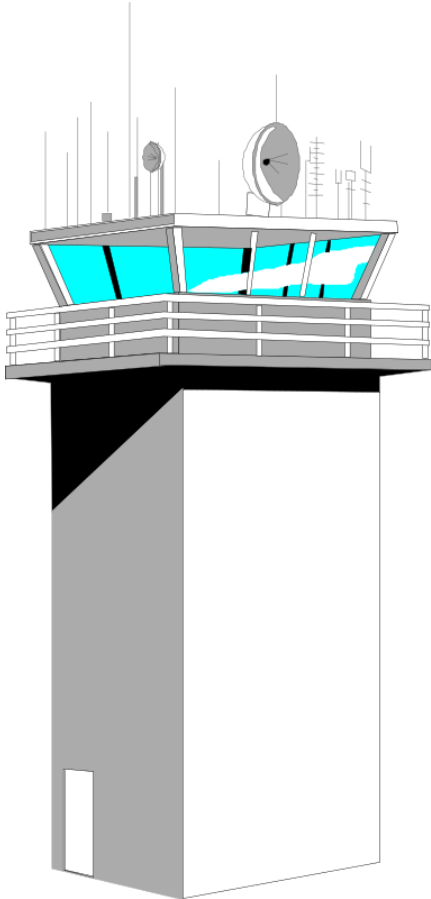
Lessee has to identify each lease contract

Clients need to put in place systems and processes to capture information/determine measurement

Clients need to communicate the effect of the new standard to the outside world

.....2019 is not that far away!

D1. “Under IFRS 16 lessees have to recognise a lease liability for every lease contract”



Yes

There are exemptions for short-term leases and leases of low-value assets

No

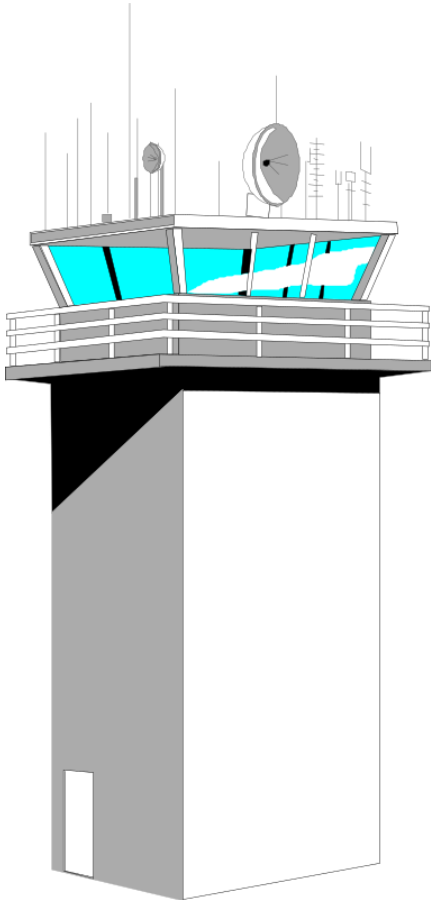


D1. "Under IFRS 16 lessees have to recognise a lease liability for every lease contract"



Yes

No



D2. “Under IFRS 16 lessor accounting stays substantially the same”

Yes

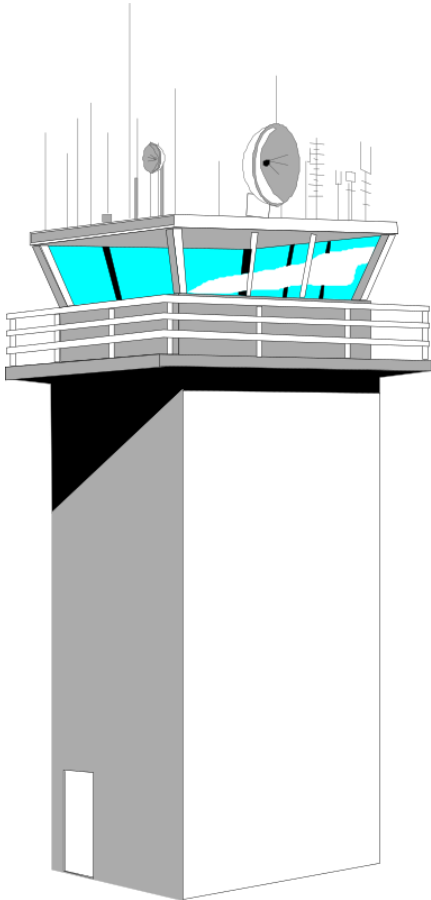
Be aware of new disclosures!

No



D2. "Under IFRS 16 lessor accounting stays substantially the same"





D3. “Under IFRS 16 variable lease payments that are not based on an index or a rate are generally part of the lease liability.”

They are taken into account if they are in substance fixed!
To be covered later on.....

No

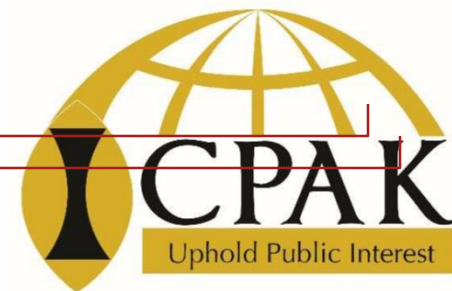


D3. "Under IFRS 16 variable lease payments that are not based on an index or a rate are generally part of the lease liability."

Yes

No

Agenda

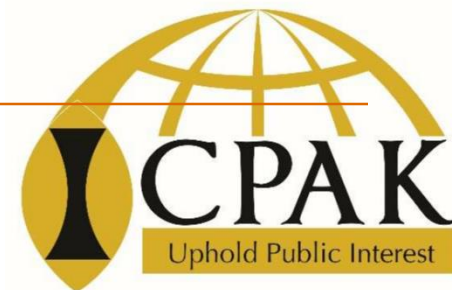


Overview – what it's all about!

Definition of a lease

Lessee accounting

Scope of IFRS 16



Lease = A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange of consideration.

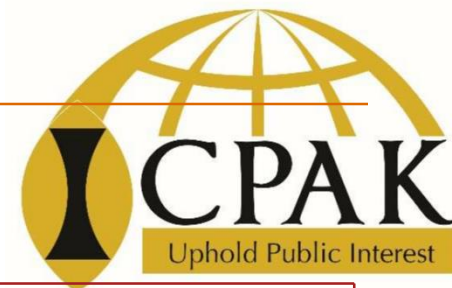
Identifying a lease

All leases are in the scope of IFRS 16, except for:

Lease to explore for or use non-regenerative resources	Out of scope
Biological assets within the scope of IAS 41	Out of scope
Service concession arrangements within the scope of IFRIC 12	Out of scope
Licences of intellectual property granted by lessor within the scope of IFRS 15	Out of scope
Rights held by lessees under certain licensing agreements (motion picture films, patents, copyrights etc.)	Out of scope
Other intangible assets	Policy choice for lessees

Definition of a lease

Identifying a lease



1

There is an **identified asset**



No identified asset if supplier has *substantive right to substitute* asset

and

2

Contract conveys the **right to control the use** of an identified asset

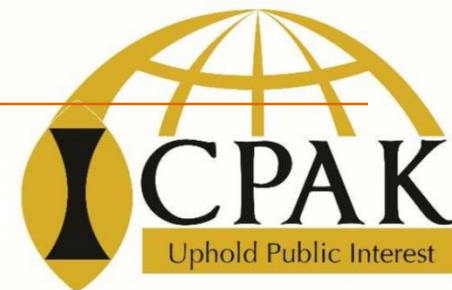


Right to obtain **substantially all of the economic benefits** from use of the identified asset throughout the period of use *and*



Right to direct the use of the identified asset throughout the period of use

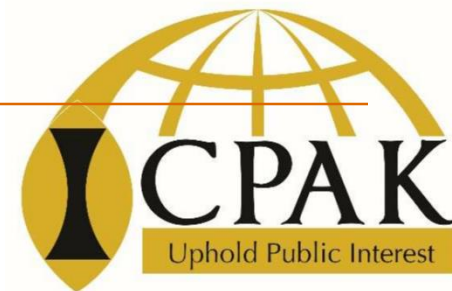
Definition of a lease – identified asset



Identified asset

- Identified asset can be specified *explicitly* (e.g. serial number) or *implicitly*
- Right to substitute the asset is substantive if
 - a) supplier has *practical ability* to substitute *and*
 - b) supplier would *benefit* economically from substituting
- *Practical ability*:
 - a) supplier has right to substitute asset *and*
 - b) alternative assets are readily available or could be sourced within a reasonable period of time

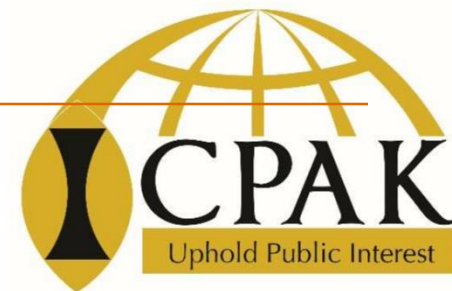
Definition of a lease – identified asset



Identified asset

- Right or obligation to substitute in case of asset not working properly or in case of technical upgrade not substantive
- Substitution rights that can only be exercised *on or after a particular date* or at the occurrence of *a future event*
→ not substantive
- Assessment shall *exclude future events* that are *not* considered *likely* to occur
- When lessee *cannot readily determine* whether right is substantive
→ presumption that right is not substantive

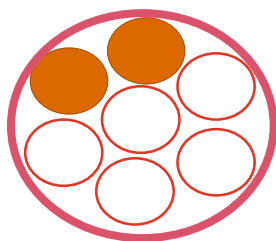
Definition of a lease – identified asset



Portion of assets

Physically distinct portion

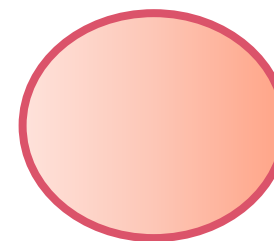
e.g.. floor of a building



Identified asset

(provided the other criteria are met)

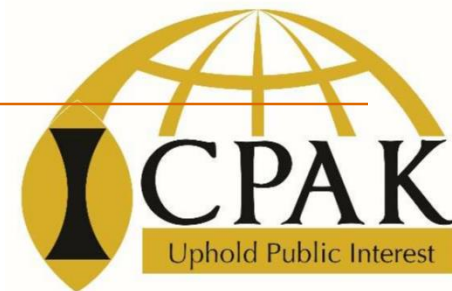
Capacity portion




No identified asset

(unless portion represents substantially all the capacity and other criteria are met)

Definition of a lease – Right to control the use

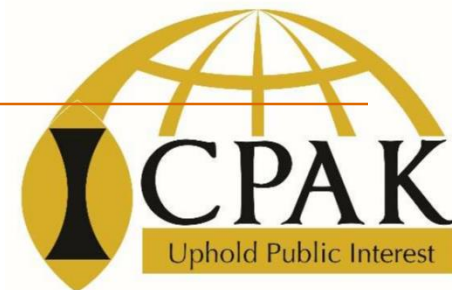


 Customer has the right to obtain **substantially all of the economic benefits** throughout period of use

For example:

- Primary output and any by-products
- Payments from third parties relating directly or indirectly to use of asset (e.g. renewable energy credit resulting from use of a solar farm)
- Excludes: Benefits relating to ownership of asset (e.g. tax credits relating to the ownership of the underlying asset)

Definition of a lease – Right to control the use

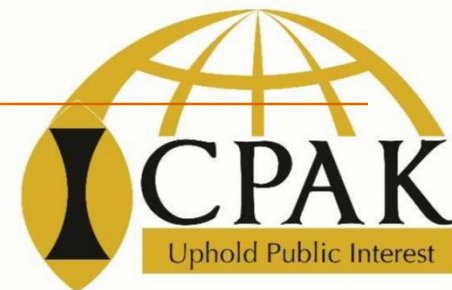


Customer has the **right to direct the use** throughout period of use if

- Right to direct *how and for what purpose* asset is used throughout period of use *or*
- Relevant decisions are *predetermined and*
 - (a) customer has the right to *operate* the asset throughout period of use *or*
 - (b) customer *designed* the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used

Protective rights of the supplier do not prevent the customer from having right to direct the use

Definition of a lease – Right to control the use



Fibre-optic cable:

How do you determine who has the relevant decision making rights?

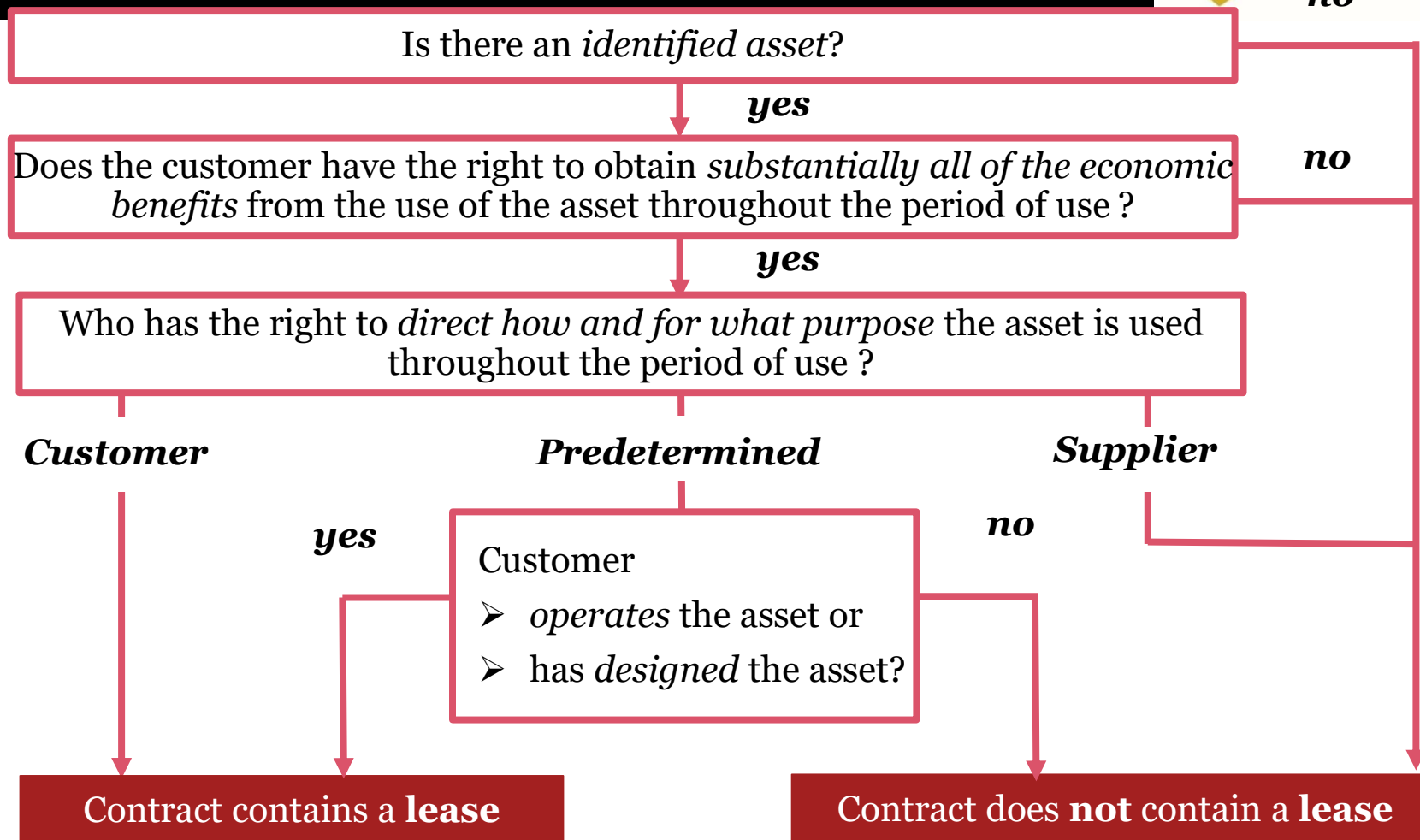
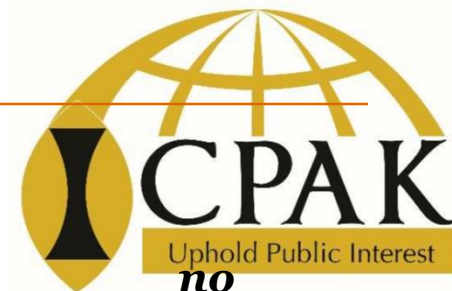
When and whether to light the fibres?

What and how much data the cable will transport?

How to run the cable?

Through which routes the data will be delivered?

Definition of a lease - process



D4. Concession space



- Company A enters into contract with airport operator to use space to sell goods for three-year period.
- Contract states exact amount of space and that the space must be located at any one of several boarding areas within the airport.
- Airport operator can change location at any time: minimal costs to airport operator associated with doing so.

Identified asset?	Substantive substitution right!	no
Substantially all of the economic benefits?		n/a
Right to direct the use?		n/a

The contract does not contain a lease.

D5. Retail unit

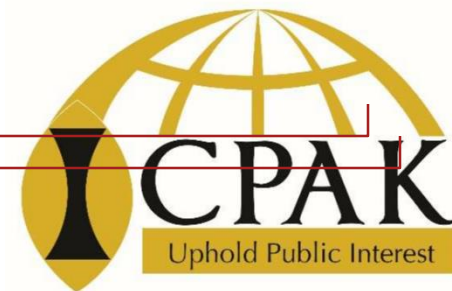


- Contract conveys exclusive use of explicitly specified retail unit
- Supplier can require Customer to move to another unit; several similar units are available
- Supplier benefits from ~~relocating only if there is a new tenant that pays a certain rate~~; it is possible that these circumstances arise but not likely
- Customer makes all decisions about use of retail unit throughout period of use
- Payments: fixed component plus percentage of sales

Does the contract contain a lease?	
Identified asset?	Substitution right is not substantive! ✓
Substantially all of the economic benefits?	✓
Right to direct the use?	✓

The contract contains a **lease**.

D.6 Network services



- Customer enters into contract with Supplier for network services for 2 years; supplier supplies network services that meet a specified quality level.
- Supplier installs and configures servers at Customer's premises to supply services. Supplier determines speed/quality of data transportation and can reconfigure/replace servers when needed to continuously provide the network services.
- Customer does not operate servers or make any significant decisions about their use.

Does the contract contain a lease?	
Identified asset?	n/a
Substantially all of the economic benefits?	n/a
Right to direct the use?	no

The contract does **not contain a lease**.

Lease term (1/2)

Identifying a lease



Non-cancellable period of lease

+

*Periods covered by
option to extend*

+

Periods covered by option to terminate

if lessee is **reasonably certain** to exercise option

if lessee is **reasonably certain** not to exercise option

Assessing “**reasonably certain**” – consider all facts/circumstances creating economic incentive to exercise, e.g.:

- contractual terms/conditions for optional periods compared with market rates
- significant leasehold improvements undertaken (or expected to be undertaken)
- costs relating to termination of lease/signing of new replacement lease
- importance of underlying asset to lessee’s operations
- conditionality associated with exercising the option

Lease term (2/2)

Identifying a lease



Modification of contract
not accounted for as
separate lease (lessee)

Exercise of **option** becomes or ceases to
be reasonably certain

Because:

- Event occurs that obliges lessee to exercise [prohibits from exercising] option *or*
- Lessee does not exercise [exercises] option previously included [not included] in lease term *or*
- Significant event or significant change in circumstances within control of lessee occurs and affects reasonably certainty of exercising option

D.6.2. Example, Assessing the lease Term

- Entity A enters into a perpetual lease of retail space. Both the lessor and the lessee have termination options. Termination options exercisable at any time; the entity exercising it will bear no more than an insignificant penalty. For both options, there are notice periods.
- If the lessee exercises its option, the termination will be effective six months after exercise. If the lessor exercises its option, the termination will be effective 18 months after exercise.
- lessee is reasonably certain to continue the lease for a period of 60 months if the lessor does not exercise the termination option.

What is the lease term of the contract at the commencement date?

A. 6 months B. 18 months C. 60 months

18 months

Recognition and measurement exemptions

Identifying a lease



Short-term leases

- *Lease term* of 12 months or less (may include periods covered by options)
- **Accounting policy choice** (by class of underlying assets)
- Reassessment in case of modification or change in lease term
- Only applicable for **lessee**

Low value assets

- Assets with a value, when new, of USD 5,000 or less
- **Accounting policy choice** (lease-by-lease basis)
- Only applicable for **lessee**



Recognition and measurement exemption

- Portfolio approach (3/3)

Identifying a lease



Lease contracts with *similar* characteristics

and

Applying standard to portfolio does not differ materially from applying to individual leases within portfolio

Portfolio approach permitted for
lessee and lessor



D7. “Most lease contracts result in the recognition of a right of use asset and a lease liability for the lessee.”

Yes

No



D7. "Most lease contracts result in the recognition of a right of use asset and a lease liability for the lessee."

Yes

No

D7. “Most lease contracts result in the recognition of a right of use asset and a lease liability for the lessee.”



Yes

There are exemptions for short term leases and leases of low value assets.

D8. Recognition and measurement exemptions?



Entity A enters into a lease of small office space.

Lease continues in perpetuity, but both the lessor and the lessee have termination options, exercisable at any time, with a three-month notice period. The entity exercising the termination option will bear no more than an insignificant penalty.

Does the contract qualify as a short-term lease for the lessee?

Yes

No



D8. Does the contract qualify as a short-term lease for the lessee?

Yes

No

D8. Recognition and measurement exemptions?



Entity A enters into a lease of small office space.

The lease continues in perpetuity, but both the lessor and the lessee have termination options. The termination options are exercisable at any time, with a three-month notice period. The entity exercising the termination option will bear no more than an insignificant penalty.

Does the contract qualify as a short-term lease for the lessee?

Yes

No

Lessee accounting initial measurement (1/5)

Lessee accounting



Right-of-use asset

Lease liability

Lease payments made before
or at commencement date

Restoration costs

Initial direct costs

Depreciation/Impairment

Lease liability

Lease payments

Discount rate

Provision

Interest expense

D9. “The carrying amount of the right-of-use asset normally equals the carrying amount of the lease liability.”

Yes

No



D9. "The carrying amount of the right-of-use asset normally equals the carrying amount of the lease liability."

Yes

No

Start the presentation to see live content. Still no live content? Install the app or get help at [PollEv.com/app](https://www.poll-ev.com/app)

Total Results

D9. “The carrying amount of the right-of-use asset normally equals the carrying amount of the lease liability.”



The measurement concepts for the right-of-use asset and the lease liability are substantially different

No

Lessee accounting – initial measurement (2/5)

Lessee accounting



Lease payments

Fixed payments

+

Variable lease payments

+

Residual value guarantees

+

*Exercise price of a
purchase option*

+

Penalties for terminating

➤ Including *in-substance fixed payments*

➤ Only if they depend on index/rate

➤ Measured using index/rate as at commencement date

➤ *Expected* payments lessee has to make under guarantee

if the lessee is **reasonably certain** to exercise the option

if the **lease term** reflects the termination by the lessee

Lessee accounting – initial measurement (3/5)

Lessee accounting



Variable lease payments

dependent on

rate/index

*e.g. inflation/
interest rate or
market rental rates*



Part of lease
liability

other variable

e.g. sales in a retail store



Not part of lease
liability

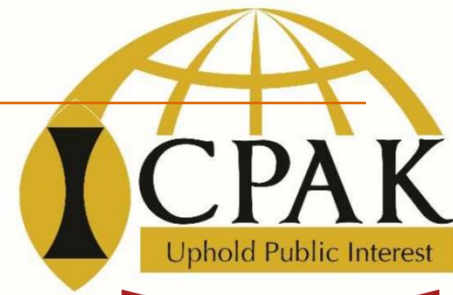
In-substance fixed payments

*e.g. payments made only if
asset is proven capable of
operating*



Part of lease liability

Lessee accounting – initial measurement (4/5)



Lessee accounting

Discount rate

Interest rate implicit in the lease

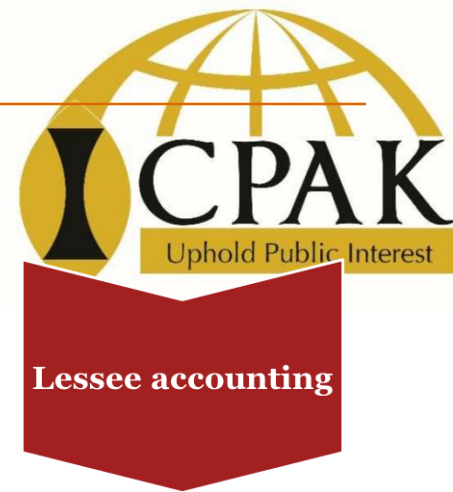
*if rate cannot be readily
determined*

Incremental borrowing rate at commencement date

Initial direct costs

- *Incremental costs* of obtaining a lease that would have not been incurred if lease had not been obtained
- E.g.: commissions, payments to existing tenant to obtain lease

Lessee accounting – initial measurement (5/5)



Restoration costs

- Costs to
 - Restoring underlying asset to conditions required by lease contract
 - Dismantle and remove underlying asset
 - Restore the site on which underlying asset is located

- Measured at estimated costs (IAS 37)

Lessee accounting – subsequent measurement



Right-of-use asset

- Depreciation (in general on straight-line basis)
- Impairment test based on guidance in IAS 36
- Adjustments for remeasurement of lease liability

Lease liability

- Measured using effective interest rate method
- Remeasured to reflect reassessment, modifications or revised in-substance fixed payments

Variable lease payments (not dependent on rate/index)

- Recognised in profit/loss in period in which incurred

Other measurement models for r



Property, plant and equipment

Lessee may elect to apply revaluation model in IAS 16 to right-of-use asset (by class) if

- a) it relates to a class of property, plant and equipment and
- b) lessee applies revaluation model to all assets in that class

Investment property

Lessee shall apply fair value model in IAS 40 to right-of-use asset if

- (a) it meets definition of investment property in IAS 40 and
- (b) lessee applies fair value model in IAS 40 to its investment properties

D10. Lessee accounting

Which variable
payments are
included?



[PollEv.com/](https://poll-ev.com/)

Change in index/rate used to calculate variable lease payments

- RetailCo enters into 10-year lease contract for a retail unit
- Annual lease payments of CU 75,000; payable at the end of the year
- Annual lease payments are adjusted every **two years** to reflect changes in the market rental index (MRI) in this area. Entity expects MRI to increase by 2 per cent every year

*Commencement
date*

MRI = 100

*Beginning of
second year*

MRI = 109

*Beginning of
third year*

MRI = 105

Lessee accounting – presentation



Statement of cash flows

Cash flows from operating activities

Short-term lease payments

Payments for leases of low value assets

Variable lease payments not included in lease liability

Cash payments for the interest portion of the liability

Depending on
entities' policy for
interest payments

Cash flows from financing activities

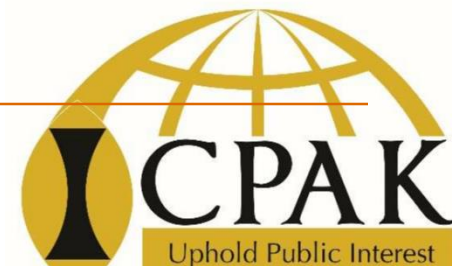
Cash payments for the principal portion of the liability

Cash payments for the interest portion of the liability

Disclosures

Link

Disclosures – lessee

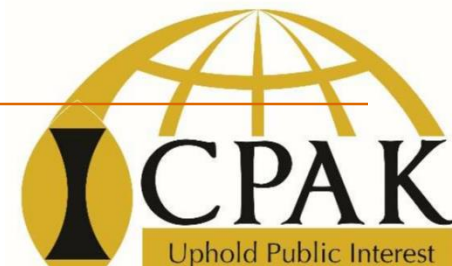


Quantitative disclosure requirements:

- | |
|--|
| (a) Lease expense, split between amortisation of ROU assets and interest expense |
| (b) Lease expense, split by class of underlying asset |
| (c) Short term lease expense |
| (d) Small asset lease expense |
| (e) Variable lease expense |
| (f) Sublease income |
| (g) Total cash flow for leases |
| (h) Additions to ROU assets |
| (i) Gains and losses arising from sale and leaseback transactions |
| (j) Carrying amount of ROU assets, split by class of underlying asset |

- This table covers the major disclosure requirements; depending on the particular facts and circumstances additional disclosures might be necessary.
- Maturity analysis of lease liability and additional information to meet the disclosure objectives are also required.

Disclosures – lessee



Qualitative disclosures

Nature of the lessee's leasing activities

Restrictions or covenants imposed by leases

Sale and leaseback transactions

* This table covers the major disclosure requirements; depending on the particular facts and circumstances additional disclosures might be necessary.

Disclosures – lessor



Classification

Distinction based on
risk and rewards

Finance lease

Lease receivable
(net investment in lease)

**Operating
lease**

Underlying asset

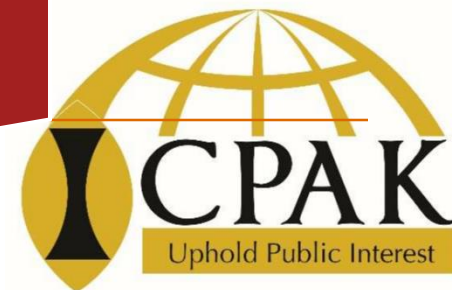


**No significant change compared to
current guidance**

Transition Lessees

Transition

Date of initial application
= 1 Jan 2019



Dec
2018

Dec
2019

Full Retrospective

IFRS 16

IFRS 16

- Apply IAS 8

Adjust equity*
at 1 Jan 2018
with cumulative effect

Simplified approach

No restatement

IAS 17

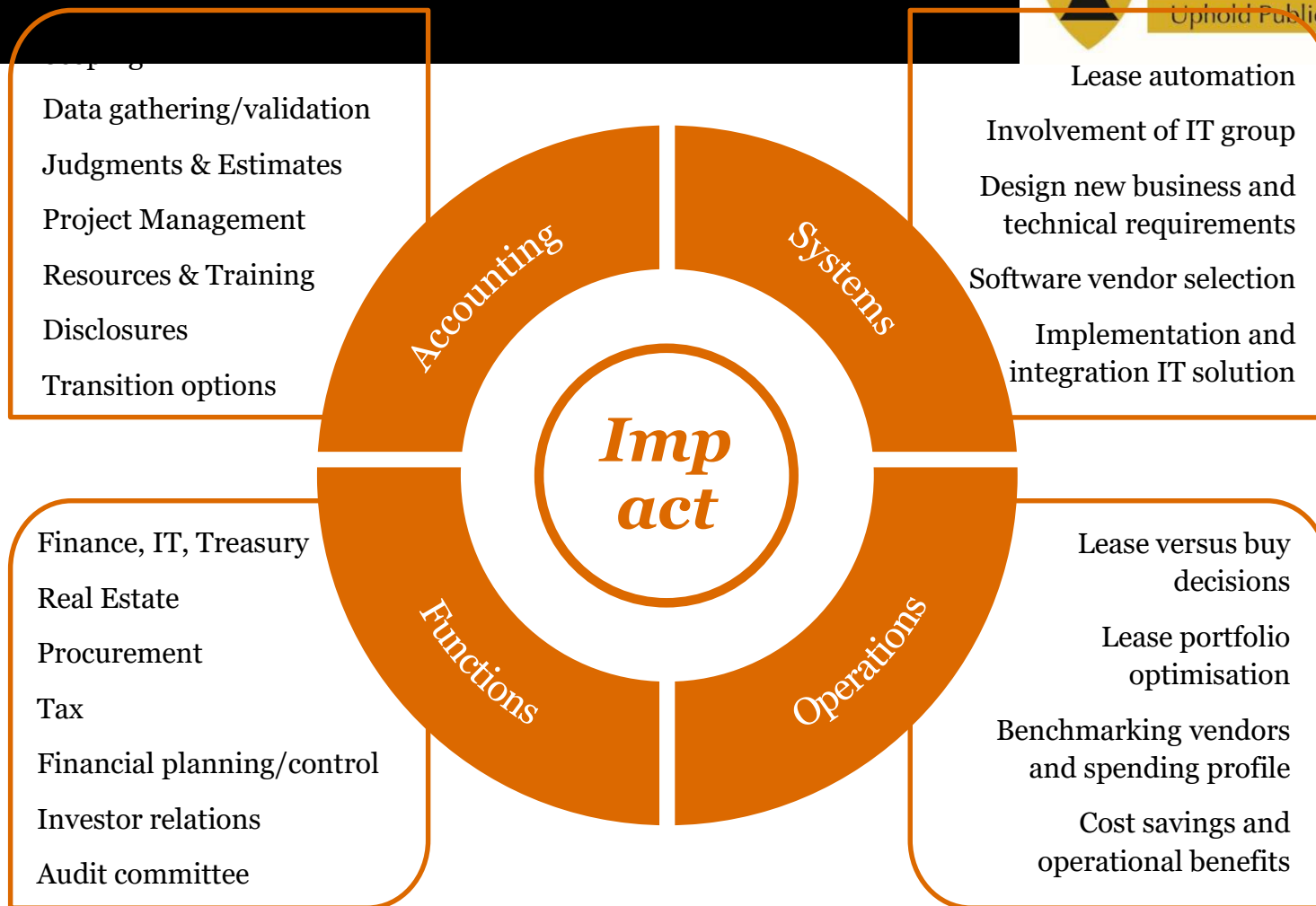
IFRS 16

- Measurement simplifications for leases previously classified as operating leases and finance leases

Adjust equity*
at 1 Jan 2019
with cumulative effect

* retained earnings or other component of equity

Business impact



Recap.....



Lessee has to recognise a *right-of-use asset* and a *lease liability* for almost all lease contracts

Lessee has to present interest expense (on lease liability) and *depreciation charge* (for right-of-use asset) separately

Exemptions for short-term leases and leases of low value assets

Huge impact on KPI (debt/equity ratio; EBIT/EBITDA/ operating cash flow)

Lessor accounting stays almost the same as under current guidance

Enhanced *disclosure* requirements

Effective date
1 January 2019

IFRS 16 was published on 13 January 2016

Earlier application permitted (together with IFRS 15)

Have a good flight!



May 2018