

IFRS 16 *Leases*: Overview

Emerging Economies Group
May 2018

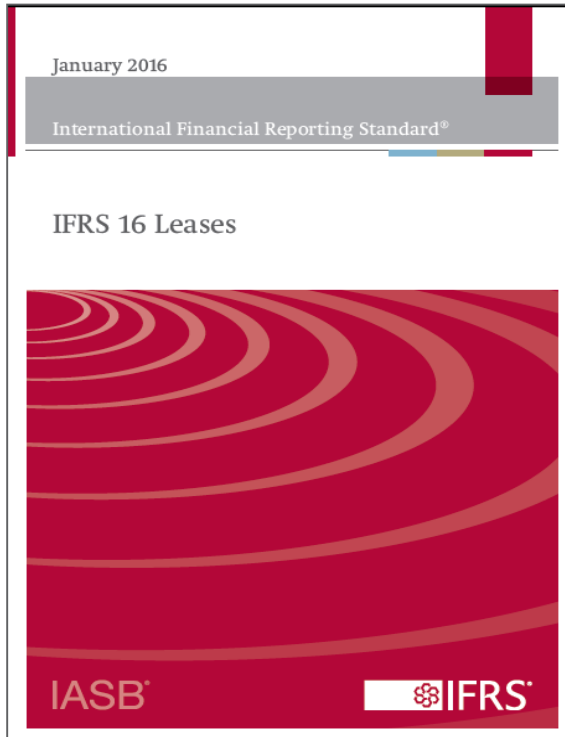
Agenda paper 1

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New Leases Standard

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- **IFRS 16** Leases published in January 2016

- **replaces IAS 17** and related interpretations
- **changes lessee accounting** substantially
- little change for **lessors**

- Effective date **1 January 2019**
 - early application permitted (only with application of IFRS 15 Revenue from Contracts with Customers)

Program for today

1. The standard
2. Drilling down
3. Operational and other practical considerations
(including feedback from EEG countries)

Why?

The need for change

The need for change

Leases are an **important and flexible source** of financing—
listed companies using IFRS Standards or US GAAP
estimated to have US\$3.3trillion lease commitments

Over 85% of lease commitments **do not appear** on balance
sheet today

Therefore, it is **difficult** for investors and others **to**:

- **Get accurate picture** of entity's lease assets and liabilities
- **Compare** companies that **lease** assets with those that **buy**
- **Estimate** the amount of off balance sheet obligations: often overestimated

The need for change

Currently a lack of information

- 6 retail chains that ultimately went into liquidation

Retailer	Off balance sheet leases		On balance sheet debt ¹	Discounted leases as multiple of debt ³
	(undiscounted) ¹	(discounted) ²		
Borders (US)	\$2,796M	\$2,152M	\$379M	5.68
Circuit City (US)	\$4,537M	\$3,293M	\$50M	65.86
Clinton Cards (UK)	£652M	£525M	£58M	9.05
HMV (UK)	£1,016M	£809M	£115M	7.03
Praktiker (DEU)	€2,268M	€1,776M	€481M	3.69
Woolworths (UK)	£2,432M	£1,602M	£147M	10.90

¹ Based on averaged published financial statement data available for 5 years before company entered Chapter 11 (US), liquidation (UK) or bankruptcy (DEU).

² Estimated using (i) a discount rate of 5% and (ii) estimated average lease terms based on the information disclosed in the financial statements.

³ Off balance sheet leases (discounted) as a multiple of on balance sheet debt

The Standard

What's changed for lessors & lessees?

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Changes to lessor accounting

- **Substantially carry forward** IAS 17 accounting requirements; some additional disclosure requirements

Changes to Lessee accounting

- **Former operating leases capitalised.** All¹ leases accounted for similarly to today's finance leases

Balance Sheet

- ↑ Leased assets
- ↑ Financial Liabilities
- ↓ Equity

Income statement

- ↓ Operating expense
- ↑ Finance cost

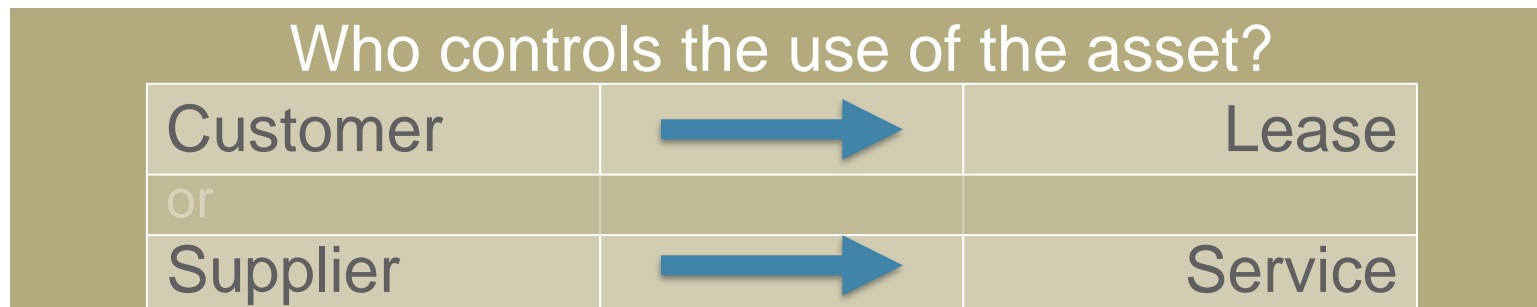
Cash flow statement

- ↓ Operating flows
- ↑ Financing flows

¹ Exemptions for short-term leases and leases of low-value assets

Definition of a lease

- **Similar** to previous definition, changed **requirements on control**
- Control = **directing the use** and **obtaining the benefits** from use
- Based on control of the **use of an identified asset**



- **Separate services** provided with leases
 - Separate using available information (including estimates)
 - Option to not separate components

Contracts that contain both leases and services:

- **Separate** lease and non-lease components
- **Allocate** consideration using stand-alone prices
 - can use estimates
- **Practical expedient** not to separate non-lease components
- account for as part of lease component

Lessee Accounting

Right-of-use model

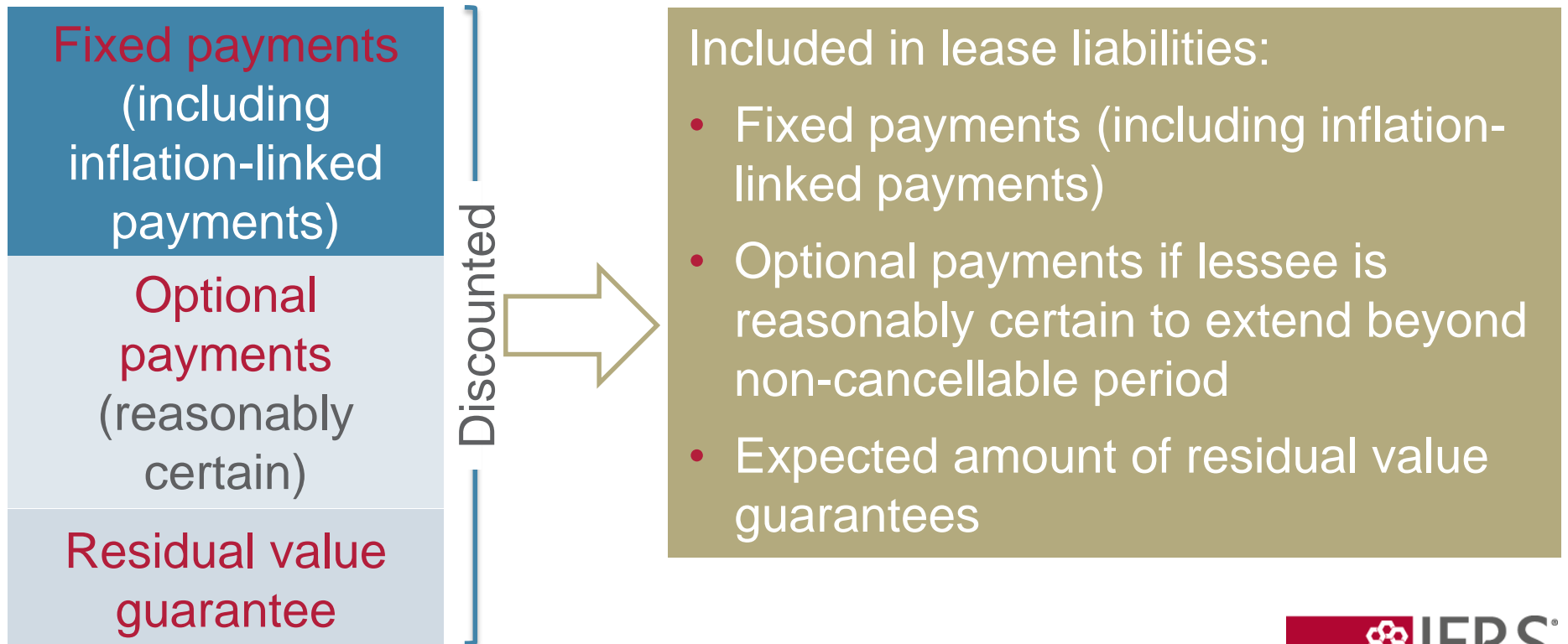
- A lease conveys the right to use an asset for a period of time in exchange for cash payments
- Lessee reports **lease assets and liabilities on balance sheet**, except for short-term and for low-value asset leases, at **present value of future lease** payments
- **Discount rate**: the rate implicit in the lease, or, if rate implicit not available, lessee's incremental borrowing rate
- **Exclude variable payments** and most optional payments
- **Portfolio application**, simplified reassessment

Lessee Accounting

Balance sheet: what's included?

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- **Increase in lease assets and financial liabilities**—all leases reported on balance sheet (other than short-term leases and leases of low-value assets)



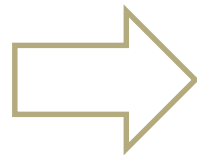
Lessee Accounting

Balance sheet: what's excluded?

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Leases of low-value assets

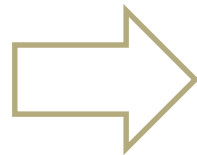
Short-term leases



Not required to be included in lease liabilities

Variable lease payments linked to sales or use

Optional payments (not reasonably certain)



Excluded from lease liabilities

Variable lease payments

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Variable lease payments—how a lessor might cover its risk:

Example: Minimum rent clause	E.g. if sales are less than CU1m rent is CU50k	In-substance fixed lease of CU50,000p.a. included in lease liability
Example: Higher variable payments compensate for risk of zero return	E.g. variable payments based on 7% of sales	Genuine variability: variable payments not included in lease liability, but in P&L when incurred
Example: Lessee options	E.g. sales < CU1m, either: <ul style="list-style-type: none">▪ Penalty of CU50k; or▪ Penalty of CU100k; lease terminated	Recognise in-substance fixed lease payments based on IFRS 16 para B42 requirements

Balance sheet measurement

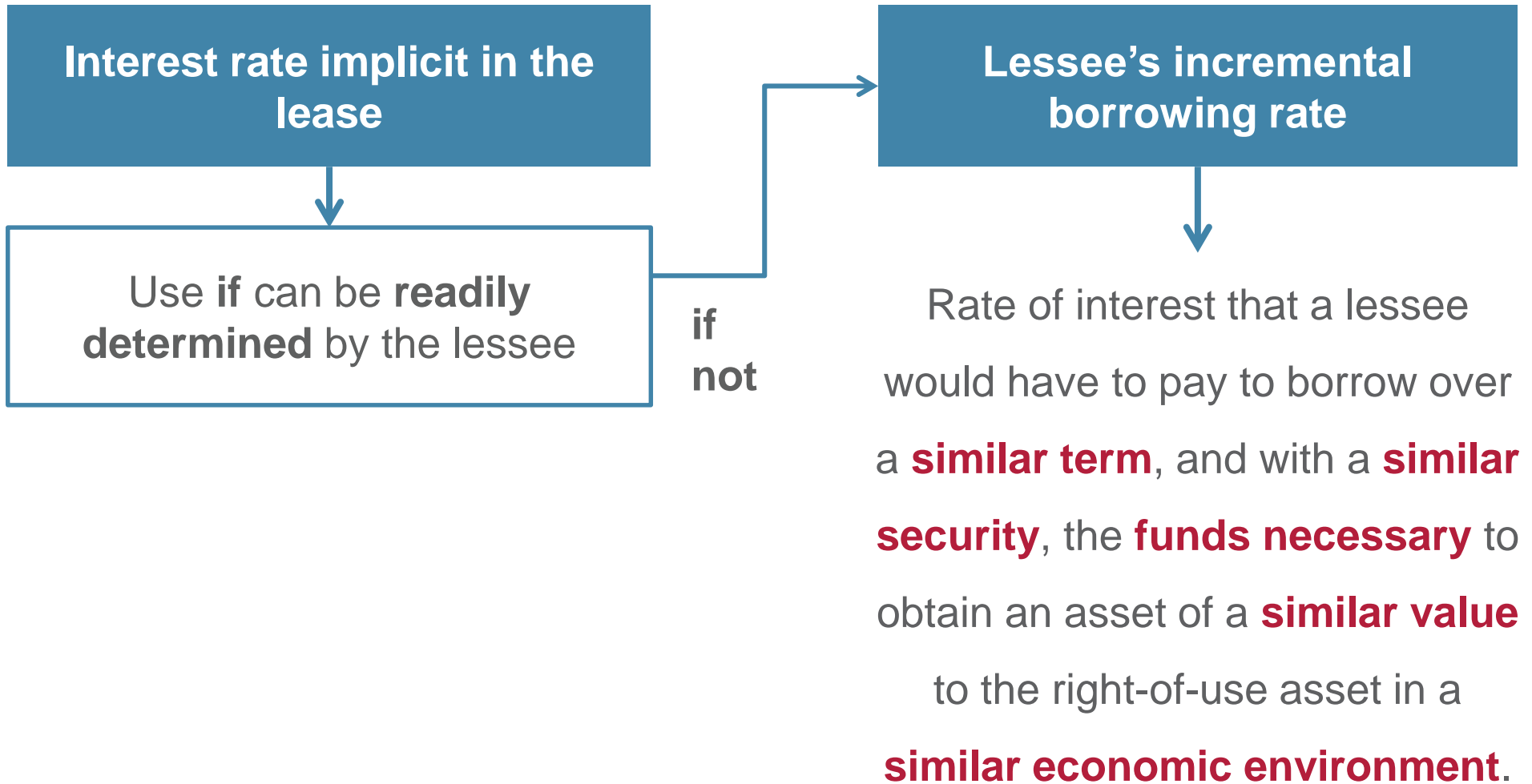
Lease liability

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$$\begin{array}{c} \boxed{\text{Lease liability}} \\ \text{=} \\ \text{Lease payments during} \\ \text{lease term} \\ \text{X} \\ \text{Discount rate} \end{array}$$

Next slide....

Discount Rate



Lessee Accounting

Initial measurement

Right of use
asset
(at cost)



Lease
liability
(present value
of lease
payments)

Balance sheet measurement

Right-of-use asset

Initially measure equal to lease liability, adjusted for:



Prepayments



Lease incentives



Initial direct costs



Dismantling/restoration costs

Lessee Accounting

Initial measurement

- Assets and liabilities measured on a **present value basis**
- Lease payments
 - Those **payable during non-cancellable period plus optional periods** that the lessee is **reasonably certain to exercise**
 - Include **fixed payments and inflation-linked payments**
 - **Exclude variable payments** linked to future sales or use
- Discount rate
 - Rate in the contract or lessee's incremental borrowing rate

Lessee Accounting

Subsequent measurement

- **Right of Use (ROU) Asset**
 - Balance sheet presentation separately as an **asset**
 - **Depreciated** over the life of the lease
 - Depreciation carried **in profit and loss**
 - Reassessed for **impairment**
- **Liability**
 - Balance sheet presentation separately as a **liability**
 - **Interest expense** (discount unwind) through profit and loss as interest
 - **Simplified reassessment**

Change in **scope** or **consideration** of lease

- Separate **new lease** if:
 - Increase in scope (ie additional ROU); and
 - Price is commensurate with standalone price
- **Modified** lease:
 - Re-measurement of lease liability
 - Decrease in scope: adjust ROU and recognise gain/loss
 - Increase in scope or change of consideration: adjust ROU

Lease modifications

Examples

- Original lease = 1,000 per month



Amended to add new car

New price: 1,450 per month

Separate new lease

- Increase commensurate with price to lease additional car on its own (adjusted to reflect circumstances of contract)
- 450 per month treated as new lease

Amended to remove one car

New price: 650 per month

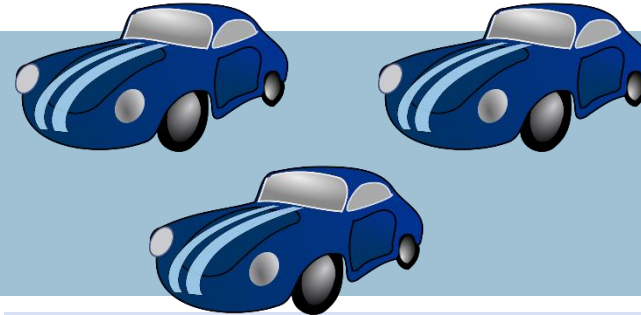
Modified lease (decrease in scope)

- Recalculate lease liability
- Determine decrease in scope, and adjust pre-modification ROU asset and lease liability (recognise gain/loss)
- Any additional difference in liability: adjust ROU asset

Lease modifications

Examples

- Original lease = 1,000 per month
- Amended to add one car



New price: 1450 per month

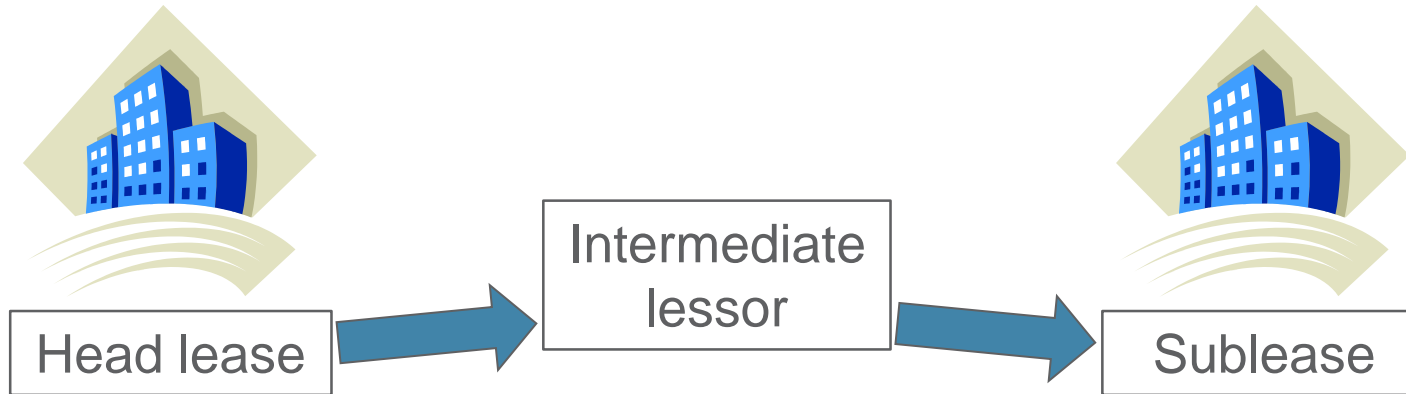
Separate new lease

- Increase commensurate with price to lease additional car on its own (adjusted to reflect circumstances of contract)
- 450 per month treated as new lease

New price: 1200 per month

Modified lease (increase in scope)

- Increase not commensurate with price to lease additional car on its own (adjusted to reflect circumstances of contract)
- Recalculate lease liability and ROU

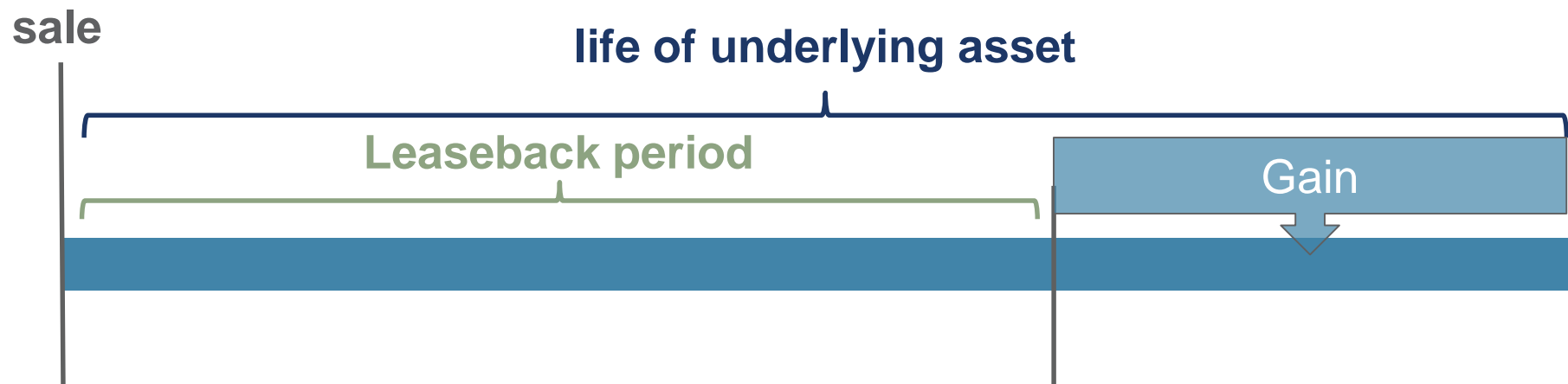


- Subleases—**Intermediate** lessor
 - Account for head lease and sublease **as two separate contracts**
 - Classify sublease with reference to ROU asset arising from head lease
 - **Should not offset** lease assets and liabilities, or income and expenses, unless meets existing IFRS guidance for offsetting

Sale and leaseback transactions

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- Sale must meet the requirements in **IFRS 15**
- If a sale:
 - Adjust for **off market terms**
 - Seller-lessee recognises gain related **to rights transferred**



Lessee Accounting *Presentation*

Balance sheet

- **ROU assets** together with **PPE** or as own line item
- **Lease liabilities** in accordance with **IAS 1**

Income statement

- **Depreciation** of all leased assets
- **Interest** expense for all lease liabilities

Cash flow statement

- **Principal** within financing activities
- Interest within either operating or financing activities (IAS 7 option)

Quantitative disclosures

- Breakdown of **lease costs**
- Total lease **cash flows**
- **Maturity** analysis of undiscounted commitments
- Information about **ROU assets by major class** of leased asset

Entity-specific information

- Additional information, if relevant
 - **Extension and termination** options
 - **Variable** lease payments
 - **Residual** value guarantees
 - Sale and leaseback

- **Substantially retained** the lessor accounting model in IAS 17

Enhanced disclosures:

- Information about residual asset risk
- Disaggregated IAS 16 disclosures for assets subject to operating leases

Lessee Accounting

Performance metrics

- New requirements will affect key ratios that are used to analyse a company's financial leverage and performance:

Metric	Measure	Calculation	Effect
Leverage	Solvency	Liabilities / Equity	Increase
Asset turnover	Profitability	Sales / Total assets	Decrease
EBIT/Operating profit	Profitability	Various methods	Increase
EBITDA ¹	Profitability	Refer name	Increase
EBITDAR ²	Profitability	Refer name	No change

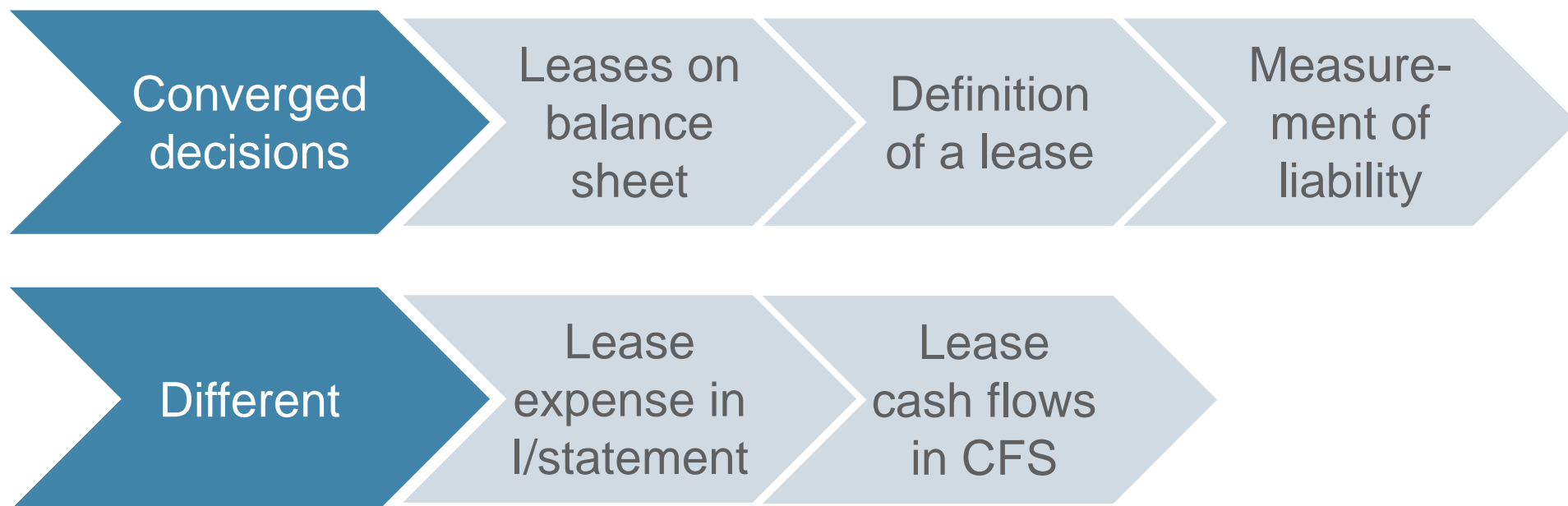
¹ Earnings before interest, tax, depreciation and amortisation

² Earnings before interest, tax, depreciation, amortisation and rent

- IFRS 16 effective for annual periods beginning **on or after 1 January 2019**
- **Early application permitted if IFRS 15 Revenue from Contracts with Customers** applied
- If **cumulative catch-up transition method elected**:
 - **No restatement** of comparatives
 - No need to apply IFRS 16 to leases ending within 12 months
 - Simplified measurement option on transition

Convergence with the FASB

- In practice, little difference in profit or loss reported for many companies



Similarities and differences

IASB vs FASB

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		IFRS 16	FASB	
			Finance	Operating
Balance sheet				
<i>Recognition</i>	All leases on balance sheet	✓	✓	✓
	Exemption: short-term leases	✓	✓	✓
	Exemption: low-value leases	✓	---	---
<i>Measurement</i>	Liabilities on discounted basis	✓ ¹	✓ ¹	✓ ¹
	Initial lease asset = lease liability	✓	✓	✓
	Depreciation of lease asset	Straight-line	Straight-line	Increasing
<i>Presentation</i>	Lease liabilities	Financial liabilities or own line item ²	Separate presentation (from existing operating leases)	Separate presentation (from existing capital leases)
	Lease assets	PPE or own item		

¹ Different reassessment of inflation-linked payments

² IAS 1 requirements apply

Similarities and differences

IASB vs FASB

	IFRS 16	FASB	
		Finance	Operating
Income statement			
<i>Operating costs</i>	Depreciation	Depreciation	Single expense
<i>Finance costs</i>	Interest	Interest	---
Cash Flow statement			
<i>Operating activities</i>	Interest ¹	Interest	Interest and principal
<i>Financing activities</i>	Principal	Principal	---

¹ Under IFRS, interest payments can be presented within either operating or financing activities

Who?

Lessee—who will be affected?

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% of IFRS/US GAAP listed entities reporting material off balance sheet leases	
North America	62%
Europe	47%
Asia / Pacific	43%
Africa / Middle East	23%
Latin America and Caribbean	23%
Future minimum payments for off balance sheet leases ¹	US\$2.9tl
PV future minimum payments for off balance sheet leases ²	US\$2.2tl

- Off-balance-sheet lease financing numbers substantial
- About 50% of listed companies report material off balance sheet leases
- Use of off balance sheet leases is highly concentrated

¹ 2014 annual reports for the vast majority of companies.

² Estimate using the average cost of debt for these companies, that was 5%.

Benefits

Effects of lessee accounting changes

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IAS 17 issues	Benefits of IFRS 16
<ul style="list-style-type: none">• A lack of information• Investors attempt to estimate• Companies provide lease-adjusted information	<ul style="list-style-type: none">• Improved quality of financial reporting
<ul style="list-style-type: none">• A lack of comparability• No level playing field	<ul style="list-style-type: none">• Improved comparability

¹ 2014 annual reports for the vast majority of companies.

² Estimate using the average cost of debt for these companies, that was 5%.

Key benefits of IFRS 16

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- Greater transparency about financial leverage and capital employed
- More level playing field for all market participants
- Reduce the need to make adjustments and to provide 'non-GAAP' information
- Improve comparability between those who lease and those who borrow to buy

Facilitate better capital allocation by enabling better credit and investment decision-making by both investors and companies

Some key effects

Sector	Accounting
Airlines	<ul style="list-style-type: none">• Significant level of aircraft leasing activities• Uneven use of leases (change in accounting expected to lead to increased comparability)• Effects analysis: Average increase of 22.7% in assets
Retailers	<ul style="list-style-type: none">• Significant level of store leasing activities• Effects analysis: Average increase of 21.4% in assets
Travel and leisure	<ul style="list-style-type: none">• Significant level of property and asset leasing activities• Effects analysis: Average increase of 20.7% in assets


Some key effects continued

Sector	Accounting
Transport	<ul style="list-style-type: none">• Significant level of equipment leasing (aeroplane and ship) leasing activities• Effects analysis: Average increase of 11.6% in assets
Telecom- munication	<ul style="list-style-type: none">• Significant level of property and equipemnt leasing activities• Effects analysis: Average increase of 6.1% in assets
Total Assets	<ul style="list-style-type: none">• Effects analysis: Average increase of 5.4% in assets


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