Beyond the GAAP

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Mazars' newsletter on accounting standards

Contents

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Editorial

The long-awaited (but not necessarily hoped-for) publication of IFRS 16 on 13 January was accompanied by a number of educational tools designed to facilitate understanding of the standard and of the issues at stake: *Project Summary and Feedback Statement*, *Effects Analysis*, *Webcast*, *Video: Introducing the new Leases Standard*, *Investor Perspectives - A New Lease of Life*.

To these official publications, the last weeks have seen a host of events, articles and conferences on this burning topic. Beyond the GAAP plays its part, with a 18page study in this edition to help you to absorb the technical challenges that the introduction of IFRS 16 represents. Although application will not be mandatory until 2019, it is best to stay on the front foot, especially for entities which might prefer to adapt their financial communication and their information systems just the once to meet the needs of IFRS 15 and IFRS 16 simultaneously.

Enjoy your reading!

Michel Barbet-Massin Edouard Fossat

IFRS Highlights

IASB publishes limited amendments to IAS 12

On 19 January 2016, the IASB issued amendments to IAS 12 - *Income taxes* entitled *Recognition of Deferred Tax Assets for Unrealised Losses.* The final text remains faithful to the principles set out in the exposure draft published in August 2014 (see Beyond the GAAP no 80, July-August 2014). Readers will remember that these amendments aim primarily at clarifying the accounting of deferred tax assets for unrealised losses on debt instruments measured at fair value (in particular through a detailed illustrative example).

Entities are required to apply these amendments for annual periods beginning on or after 1 January 2017. Early application is permitted (subject to their endorsement by the EU).

We shall return in detail to these amendments in a forthcoming edition.

IFRS 15: a stabilised standard on revenue recognition at last!

In January 2016, the IASB completed its redeliberations of the clarifications required by IFRS 15 on revenue recognition (see Beyond the GAAP no 95, December 2015). The transitional arrangements for the amendments that will be published in March 2016 have therefore been agreed upon. In practice, these amendments shall be applied retrospectively and will be mandatory from 1 January 2018 (i.e. the date on which IFRS 15 itself becomes applicable).

At the same time, the IASB has announced that it will put on standby the *Transition Resource Group* (TRG), which was set up after the publication of IFRS 15 and which met six times between July 2014 and November 2015. The IASB hopes that this will reassure stakeholders that there will be no further changes to IFRS 15 between now and 1 January 2018. However, it encourages these stakeholders to submit any practical question that may still arise via its website. If necessary, the IASB will organise a public debate to discuss any topics that may be relevant.

The American members of the TRG will continue to meet. The IASB will monitor the discussions across the Atlantic, but it observes that entities preparing their financial statements under IFRS are not expected to follow the FASB's decisions or public debates (even if Topic 606 is almost identical to IFRS 15).

It may be difficult in practice to ignore what might be said on the American side in the coming months. Nevertheless, the transitional projects can now be carried out against the background of a stabilised IFRS.

Better disclosures on the statement of cash flows

In January 2016 the IASB published amendments to IAS 7 - *Statement of cash flows*.

These amendments aim to improve disclosures on changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.

An entity should therefore break down its financing activities in order to identify changes in liabilities arising from:

- financing cash flows,
- obtaining or losing control of subsidiaries,
- the effect of changes in foreign exchange rates,
- changes in fair values,
- other changes, including transactions with no cash flows, such as the conclusion of a finance lease.

These disclosures can be made in the form of a reconciliation between the opening and closing balances in the statement of financial position for liabilities arising from financing activities. They can also be provided in reconciliations that include other components (such as a net debt reconciliation), but they must then be presented separately from changes due to other items.

Note that the IASB was seeking to meet the needs of investors quickly and without requiring a reconciliation of net debt, which could not have been defined in a reasonable time-frame.

The amendments to IAS 7 do not include some of the proposals in the 2014 exposure draft (see the special study in Beyond the GAAP no 84, December 2014) regarding restrictions on cash and cash equivalents. Following comments from the stakeholders, the IASB decided that more time and research would be needed to finalise these proposals.

The amendments published will come into force for financial years current at 1 January 2017, subject to endorsement by the European Union. Early application is authorised. Nonetheless, as these are additional disclosures which are not incompatible with the existing texts endorsed by the EU, in practice they can be applied straight away.

The text of the amendments can be consulted at:
http://www.ifrs.org/Current-Projects/IASB-Projects/Debt-disclosures/Pages/Home.aspx

IFRS Interpretations Committee clarifies some aspects of IFRS 5

In three agenda decisions published in the January 2016 IFRIC Update, the IFRS Interpretations Committee clarified certain aspects of IFRS 5 and issued a list of unresolved questions that may persuade the IASB to launch a broad-scope review of the standard.

Impairment of the non-current assets of a disposal group

IFRS 5 states that a disposal group must be measured at the lower of its net carrying value and its fair value less costs to sell (IFRS 5.15). In the event of impairment, the loss is allocated to non-current assets that are within the scope of the measurement requirements of IFRS 5, following the rules set out in IAS 36.122. This means that it is first allocated to goodwill and then to other non-current assets pro-rata to their carrying value (IFRS 5.23).

The Interpretations Committee confirmed:

- that the impairment loss would be measured in accordance with IFRS 5, and not IAS 36;
- that the allocation of the impairment loss was carried out with reference to IAS 36;
- but that the other provisions of IAS 36 did not apply.

Consequently, the allocation of an impairment loss recognised under IFRS 5 to the non-current assets of a disposal group can reduce the value of a non-current asset to a value lower than its fair value less costs to sell, contrary to the provisions of IAS 36.105 in respect of impairment losses recognised under IAS 36.

How to present intragroup transactions between continuing and discontinued operations

The Interpretations Committee confirmed that IFRS 5 does not introduce any exemptions to IFRS 10 for intragroup transactions, even if they take place between continuing and discontinued operations. This means that unless there is loss of control of the disposal group, intragroup transactions must continue to be eliminated.

The Committee also observed that if the disclosures arising from the application of IFRS 5 after elimination of intragroup transactions do not enable users of the financial statements to evaluate the financial effects of discontinued operations, an entity may have to provide additional disclosures.

Finally, if the IASB were to undertake a review of IFRS 5, the issue of how an entity should disaggregate results between continuing and discontinued operations while respecting the principle of eliminating intragroup transactions ought to be examined.

Other matters examined by the Committee without answer at this stage

The third agenda decision lists a number of topics that had been submitted to the Interpretations Committee but which it has referred for resolution in a future review of IFRS 5. These topics were as follows:

- Scope: must a planned loss of control, without sale or distribution, be accounted for in accordance with IFRS 5? This relates to the planned end of *de facto* control (for example, due to the concentration of previously spread voting rights) or contractual control (non-renewal of a shareholders' agreement). Under these circumstances the assets and liabilities of the entity are derecognised, as in the case of a sale. However, the scope of IFRS 5 only explicitly applies to losses of control arising from operations of sale or distribution.

- Scope: insofar as the measurement requirements of IFRS 5 do not apply to financial assets, the inclusion of disposal groups consisting entirely or mainly of financial instruments within the scope of the standard is a matter for debate.

- Impairment of a disposal group: where the impairment to be accounted for in application of IFRS 5.15 (i.e. to reduce the value of the disposal group to its fair value less costs to sell) exceeds the carrying amount of the non-current assets that are included in the measurement scope of IFRS 5, should the impairment be limited to:
  - the carrying amount of assets that are within the measurement scope of IFRS 5?
  - the net assets of a disposal group?
  - the total assets of a disposal group?
  - the non-current assets within the measurement scope of IFRS 5, and recognise a liability for any excess?

- Reversal of an impairment loss relating to a disposal group: if impairment must be reversed in application of IFRS 5.22, can this loss be reversed if it has been allocated to the goodwill of a disposal group under IFRS 5.23?

- Definition of a 'discontinued operation': the notion of 'separate major line of business or geographical area of operations' (IFRS 5.32) has been interpreted in a number of ways.

- How to present the effects of remeasurement of a non-current asset that is no longer classified as held for sale: IFRS 5.28 requires these effects to be recognised in profit or loss in the current period, with restatement of the comparative periods if the disposal group or non-current asset is a subsidiary, joint operation, joint venture, or an associate. Where a disposal group that consists of both a subsidiary and other non-current assets ceases to be classified as held for sale, should an entity recognise the effects relating to the subsidiary and the other non-current assets in different accounting periods?

- How to present intragroup transactions between continuing and discontinued operations: where these transactions are significant, should they be eliminated:
  - without adjustment, or
  - with adjustments to illustrate how transactions between continuing or discontinued operations are expected to be affected in the future?

The January IFRIC Update can be consulted at the following address:
http://media.ifrs.org/2016/IFRIC/January/IFRIC-Update-January-2016.pdf

The IASB will decide whether or not to include a project to review IFRS 5 on its agenda during the deliberations following the public consultation on its 2016-2020 work programme (this consultation period ended on 31 December 2015).

A Closer Look

IFRS 16: key points of the new *Leases* standard

On 13 January 2016, the IASB published its new *Leases* standard, IFRS 16. This signals the end of a major and highly controversial project, which was launched ten years ago in conjunction with the FASB.

The IASB says that this standard, which supersedes IAS 17 and the related interpretations (IFRIC 4, SIC 15 and SIC 27), will provide a more faithful representation of leases in IFRS financial statements. Companies have until 1 January 2019 to prepare for this substantial change. Early application is permitted (subject to EU endorsement), but the new standard may not be applied before IFRS 15 – *Revenue from Contracts with Customers.* In other words, an entity that wishes to apply IFRS 16 from 1 January 2018 can do so, as this will coincide with the mandatory effective date of IFRS 15. However, if the entity wants to apply IFRS 16 from 2017, it will have to opt for early application of IFRS 15 from 1 January 2017 as well.

We decided to get ahead of the game by presenting the key elements of the new *Leases* standard in this special feature, allowing all of our readers to form an idea of the impact on the financial statements, and start planning ahead.

Now is the time for preparers to start thinking about the new definition of a lease, which redraws the boundary between leases and service contracts, and about the new accounting approaches. They should also consider the impact of the standard on key financial indicators and, where appropriate, on financial covenants.

This is particularly important for lessees, as the standard will have the greatest impact on their financial statements. Under the new standard, they will be required to recognise all leases – whether operating leases or finance leases – in the balance sheet.

Lessors will certainly have been following the project with great attention as well, as it relates very closely to their activities. They will be relieved to see that the IASB has opted for the approach that is least onerous for lessors. The new standard will have only a very marginal impact on their financial statements, as the IASB has retained similar accounting approaches to those used currently.

1. What is the scope of the new standard?

The standard will apply to all contracts that meet the definition of a lease, with the exception of:

- leases to explore for or use mineral resources (mining, gas, etc.), which fall within the scope of IFRS 6 – *Exploration for and Evaluation of Mineral Resources;*
- leases of biological assets, which fall within the scope of IAS 41 – *Agriculture*;
- service concession arrangements, which fall within the scope of IFRIC 12 – *Service Concession Arrangements*;
- licences of intellectual property granted by a lessor, which fall within the scope of IFRS 15 – *Revenue from Contracts with Customers*; and
- rights held by a lessee under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights, which fall within the scope of IAS 38 – *Intangible Assets.*

Finally, lessees, but not lessors, may apply the requirements of the new standard to leases of intangible assets other than licensing agreements. This is optional and they are under no obligation to do so.

Key points to remember

Certain contracts that are covered by specific standards are excluded from the scope of IFRS 16. The new standard may be applied to intangible assets other than licensing agreements.

2. What exemptions and practical expedients have been introduced?

Throughout the *Leases* project, the IASB has faced criticism for the complexity of its proposed approach. Some commentators felt that the cost of meeting some of the requirements relating to the financial statements outweighed the hoped-for benefits.

In response, the IASB has introduced:

- exemptions for short-term leases and leases of low-value assets, for lessees only; and
- practical expedients which permit both lessees and lessors to apply the requirements at a portfolio level.

Short-term leases

Lessees may choose not to recognise assets and liabilities relating to short-term leases.

A short-term lease is defined as one with a lease term of less than 12 months, including extensions to the lease term if there is an economic incentive to renew the lease.

The lessee shall decide whether or not to apply this exemption for each class of underlying assets.

Leases of low-value assets

Lessees may also opt to apply a recognition exemption to leases of low-value assets.

Regarding this optional exemption, the standard states that:

- the lessee shall assess whether the asset is of low value based on the value of the asset when new, regardless of the age of the asset at the start of the lease term. Thus, leases relating to second-hand assets would not be eligible for this exemption if the value of the asset when new exceeded a certain amount;
- the assessment is carried out on an absolute basis, and is not affected by whether or not the leases are material to the lessee. Moreover, the assessment is not affected by the size, nature or circumstances of the lessee. Consequently, different lessees of the same asset should reach the same conclusion as to whether or not it is a low-value asset;
- for an asset to be classified as low value, the lessee must be able to use it on its own or together with other resources that are readily available to the lessee; the underlying assets should not be highly interrelated with or dependent on other assets that do not meet the definition of low-value assets;
- an asset does not qualify as a low-value asset if the type of asset is not typically of low value. For example, a lease of a 'low cost' car would not be classified as a lease of a low-value asset, as new cars would not typically be of low value.

After reading the criteria, it quickly becomes apparent that applying this exemption may involve some difficulties in interpretation, and will require the use of judgement.

The standard itself does not stipulate a threshold above which an asset would not qualify as low value. However, the Basis for Conclusions states that when discussing the issue, the Board had in mind a figure of US$5,000 or less. Thus, this figure can be used as a guideline to distinguish between leases that are eligible for the exemption and those which must be recognised in the lessee's balance sheet.

Portfolio application

The IASB has added a practical expedient that permits both lessees and lessors to measure and recognise leases on a portfolio basis, if they have a large number of leases with similar characteristics. An entity may only apply this option if it reasonably expects that the impact on the financial statements of portfolio application would not differ significantly from the impact of recognising the leases on an individual basis.

This option should make the accounting treatment of multiple leases significantly less onerous, particularly where leases form part of a master lease agreement.

Key points to remember

- The standard introduces optional exemptions from the requirement to recognise assets and liabilities in the balance sheet. These exemptions apply to short-term leases and leases of low-value assets.
- Judgement is required to assess whether a lease is eligible for these exemptions.
- Leases with similar characteristics that form part of a master lease agreement may be accounted for on a portfolio basis.

3. What is the definition of a lease?

IFRS 16 defines a lease as a contract (or part of a contract) that conveys to the customer the right to use an asset for a given period, in exchange for consideration. This single definition applies to both the customer (lessee) and the supplier (lessor).

Under IFRS 16, the following criteria must both be met in order for a contract to be classified as a lease:

- the contract involves the use of an identified asset; and
- the contract conveys to the customer the right to control the use of the asset.

These two apparently simple criteria presuppose a number of other criteria, which are explained below.

What is an identified asset?

An asset is identified if:

- it is explicitly or implicitly specified in the contract; and
- the supplier may not substitute the asset, as it does not have the substantive right to do so.

As regards **substitution rights**, IFRS 16 stipulates that a supplier only has a substantive substitution right if both of the following criteria are met:

- the supplier has the practical ability to substitute an alternative asset; and
- the supplier has an economic incentive to exercise its substitution right (i.e. costs > benefits).

The assessment of whether a supplier has a substantive substitution right should take account of all facts and circumstances at inception of the contract. However, this assessment should exclude future events that are not considered likely to occur at that time. For example, the assessment should exclude the introduction of a new technology that is not substantially developed at inception of the contract, as it would be considered unlikely to occur.

Finally, it is worth noting that the IASB stipulated that, in the event that the lessee cannot easily determine whether the substitution right is substantive, it shall presume that the supplier does not have a substantive substitution right. In other words, the lessee does not have the benefit of the doubt.

What does "the right to control the use of the asset" mean?

Under IFRS 16, the contract conveys to the customer the right to control the use of the asset if the following two conditions are met:

- the lessee receives substantially all of the economic benefits from use of the asset during the period of use (e.g. by having exclusive use of the asset); and
- the lessee has the right to direct the use of the asset over the lease term.

The lessee has the right to direct the use of the asset:

- if it makes the relevant decisions regarding:
  - how the asset is used (i.e. the lessee decides how it intends to use the asset, and the supplier cannot change these decisions); and
  - for what purpose the asset is used.
- or if the relevant decisions and the use of the asset are predetermined, and:
  - either the lessee operates the asset (i.e. the owner cannot change how the asset is operated over the lease term);
  - or the asset was designed by the lessee in such a way that it predetermines how and for what purpose the asset is used, and this cannot be changed.

Can a (capacity) portion of an asset be an identified asset as defined under IFRS 16?

A portion of an asset can meet the definition of an identified asset if it is physically distinct from the rest of the asset (e.g. a floor of a building). However, a capacity portion of an asset that is not physically distinct cannot be an identified asset, unless it represents substantially all the capacity of the asset. In such cases, the lessee would receive substantially all of the economic benefits from use of the asset.

How should an entity go about identifying leases?

Although the new standard retains the definition of a lease set out in IAS 17, some changes are to be expected in the population of contracts covered by the standard.

The new standard provides guidance on the definition of a lease, to make it easier to identify leases and to distinguish them from service contracts.

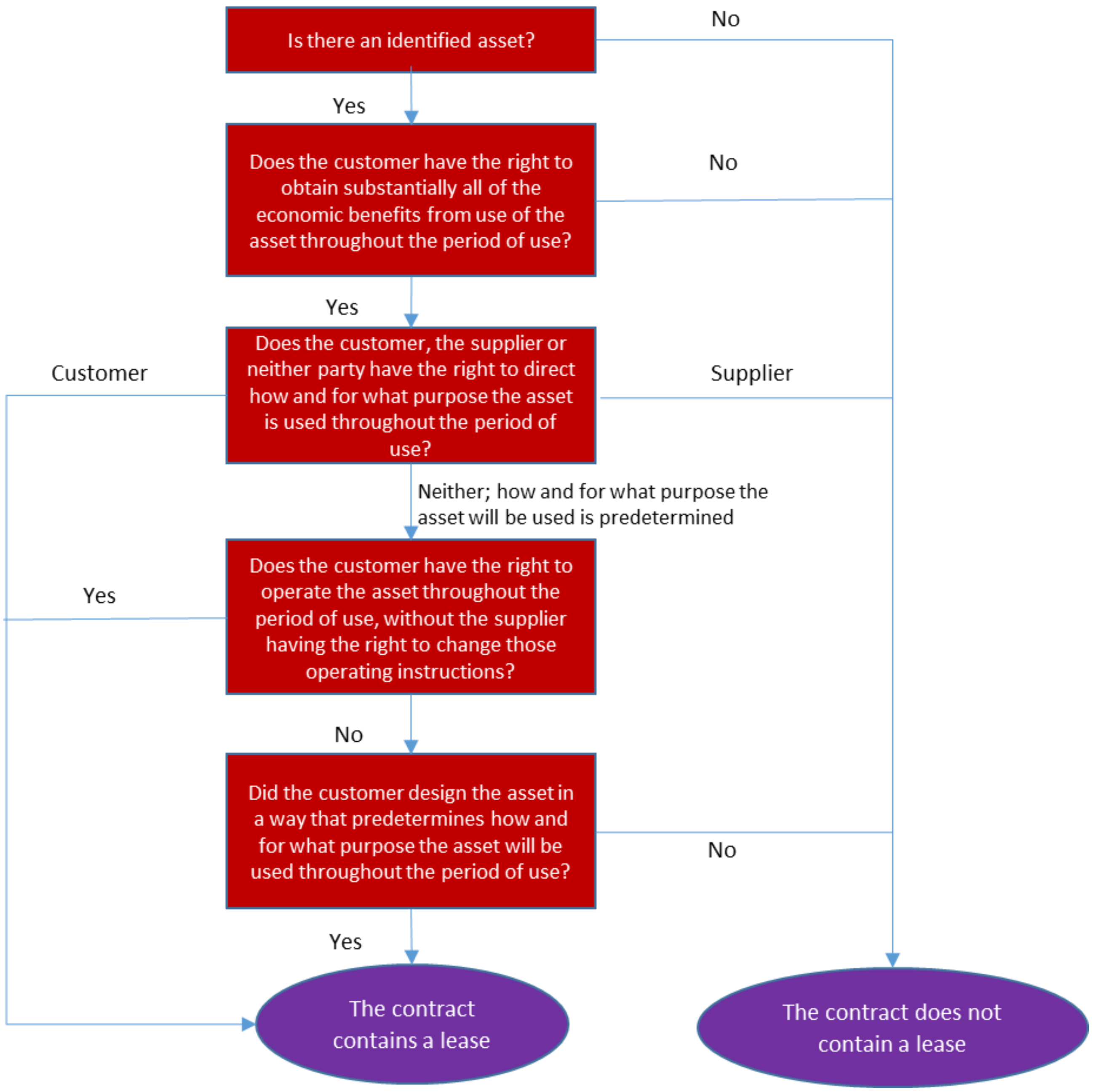
This distinction is centred around the concept of control of an identified asset. In most cases, the classification of a contract will remain the same (i.e. a lease under IAS 17 will still be a lease under IFRS 16). However, the IASB's effects analysis, which was published together with the standard in January 2016, states that some contracts that are currently classified as leases under IFRIC 4 (notably some supply contracts) are likely to be reclassified as service contracts. This effects analysis is available on the IASB's website via the following link: http://www.ifrs.org/Current-Projects/IASB-Projects/Leases/Documents/IFRS_16_effects_analysis.pdf.

As service contracts are not recognised in the balance sheet whereas leases are, the distinction between the two is of key importance when applying IFRS 16. In the future, a contract that is classified as a service contract rather than a lease will be accounted for in a similar way to operating leases under IAS 17.

We may therefore expect some companies to draw up contracts that mix both service and lease elements, and that are designed to avoid meeting the lease criteria. We then need to consider the following question: is the contract a lease, or does it contain a lease component?

IFRS 16 includes very detailed guidance on identifying leases and distinguishing them from service contracts. Plenty of illustrative examples are provided.

The procedure for identifying leases must be extremely rigorous. It is carried out at the commencement date, and follows the process summarised in the decision tree below.



Finally, it should be noted that the question of whether or not a contract is (or contains) a lease only needs to be reassessed if the terms and conditions of the contract are changed. We will return to this later.

Key points to remember

- It is essential to identify whether a contract is a service contract or a lease, as this determines whether or not assets and liabilities must be recognised.
- A contract is a lease when it conveys to the customer the right to control the use of an identified asset over a given period.
- The supplier's right to substitute the underlying asset is only taken into account in the assessment if the supplier has an economic incentive to substitute it.
- Some contracts that were classified as leases under IFRIC 4 may be reclassified as service contracts under IFRS 16, notably in situations where:
  - the supplier retains control over the use of the asset; and
  - the contract relates to a capacity portion of an asset. Capacity portions do not meet the criteria to be identified assets.

4. How should components be separated, and when should they be combined?

Separating and allocating components

Once an entity has determined that a contract contains a lease component, it must identify the various components of the contract so that each can be accounted for separately, and an appropriate proportion of the consideration can be allocated to each component.

A right to use an asset is recognised as a separate lease component if:

- the lessee can use the asset on its own or together with other resources that are readily available (readily available resources are goods or services that are sold or leased separately, or resources that the lessee has already obtained, e.g. from the lessor or from other transactions or events); and
- the asset is neither highly interrelated with, nor highly dependent on, other underlying assets in the contrat.

The consideration (i.e. the lease payment) is allocated based on the relative value of the lease component alone and the aggregate value of the non-lease components.

The relative price of the components of the contract is determined on the basis of the price at which the lessor, or a similar supplier, would sell each component, or a similar component, separately. If observable stand-alone prices are not readily available, the lessee shall estimate the stand-alone price of each component, maximising the use of observable information. This approach to allocation of consideration is consistent with the requirements of IFRS 15.

Finally, a lessee may elect not to separate the lease and non-lease components of a contract, and to treat the whole contract as a lease. The lessee may elect to apply this accounting option by class of underlying asset.

When should contracts be combined?

An entity shall combine contracts that were entered into at the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if one or more of the following criteria are met:

- The contracts were negotiated as a package and the overall commercial objective cannot be understood without considering the contracts as a whole;
- The amount of consideration to be paid in one contract depends on the price or performance of another contract;
- The rights to use assets conveyed in the contract form a single lease component.

Key points to remember

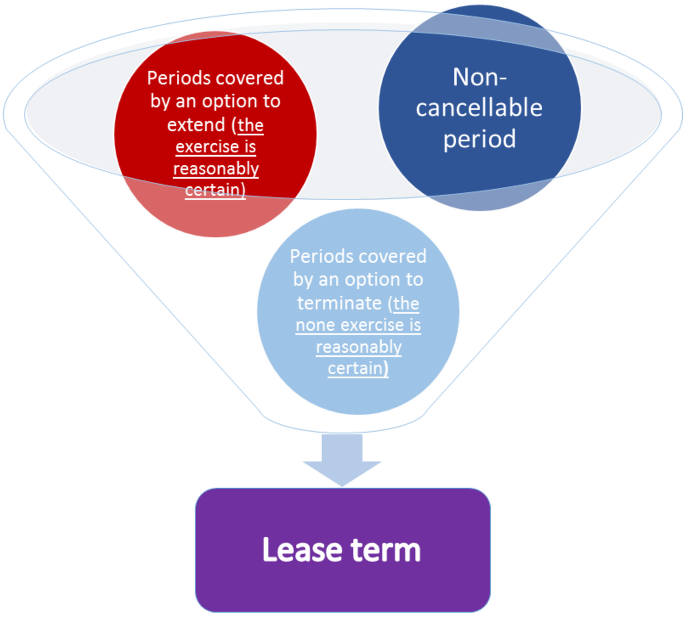
The criteria for combining contracts, and the rules on separating a contract into components and allocating the consideration to these components, are similar to those set out in IFRS 15.

5. How is the lease term determined?

Initial assessment of the lease term

A lease term is defined as the non-cancellable period during which the lessee has the right to use the underlying asset. This period includes both:

- periods covered by an option to extend the lease if **the lessee** is reasonably certain to exercise this option; and
- periods covered by an option to terminate the lease if **the lessee** is reasonably certain not to exercise this option



When assessing whether it is 'reasonably certain' that an extension, termination or purchase option will be exercised, an entity shall consider the situation from the lessee's perspective. All relevant factors that provide an economic incentive to exercise, or not to exercise, an option shall be taken into account.

To help preparers, IFRS 16 provides several examples of factors to be taken into account, including:

- attractive terms and conditions (e.g. incentive purchase options, extension options at below market rates, etc.);
- improvements made by the lessee that are expected to have significant economic benefits when the option to extend or terminate the lease becomes exercisable;
- costs relating to the termination of the lease (negotiation costs, relocation costs, costs of identifying a new underlying asset, costs of returning the asset to a specified condition, etc.).

Reassessing/revising the lease term

IFRS 16 makes a distinction between reassessing and revising the lease term.

Reassessing the lease term

The lessee shall reassess the lease term if, and only if, a significant event or change in circumstances occurs that is within the control of the lessee and that affects whether or not the lessee is reasonably certain to exercise an option.

An example of this would be a situation in which the lessee makes substantial improvements to the underlying asset that were not anticipated at the commencement date, and that would give the lessee an economic incentive to extend the lease, which it did not have at the commencement date.

Conversely, a significant change in market conditions during the contract, which would make the lessee likely to exercise an extension option, would not give rise to a reassessment of the lease term as the change in circumstances is beyond the control of the lessee.

Revising the lease term

An entity shall revise the lease term if there is a change in the non-cancellable period of the lease. Examples of this would be a situation in which the lessee exercises a cancellation option that it had not initially planned to exercise, or the occurrence of an event that places the lessee under a contractual obligation to exercise an option that it had not planned to exercise at the commencement date.

Key points to remember

The lease term may be longer than the non-cancellable period of the lease, if the lessee has an economic incentive to extend the lease.

6. Lessee accounting

What are the key principles of lease accounting for lessees?

From the start of the project, the IASB has favoured a model which would require lessees to recognise all leases in the balance sheet.

The rationale for this is that operating leases are a type of financing, which is poorly reflected in the financial statements.

The IASB has therefore opted for a single approach to lease accounting for lessees, which will apply to all contracts that are classified as leases as defined in IFRS 16.

Under this approach, a lessee must recognise a right-of-use asset for each lease (representing the lessee's ability to use the asset over the lease term), together with a lease liability.

Under this approach:

- the lessee shall depreciate the right-of-use asset over the lease term (usually on a straight-line basis) and shall recognise the lease liability at amortised cost; and
- the annual lease expense shall reflect the depreciation of the underlying asset and the interest expense on the lease liability. It will therefore decrease over the lease term.

How should leases be presented in the lessee's financial statements?

Having opted for a single approach to lease accounting for lessees, the IASB decided on the following requirements for presentation of leases in the financial statements:

Balance sheet

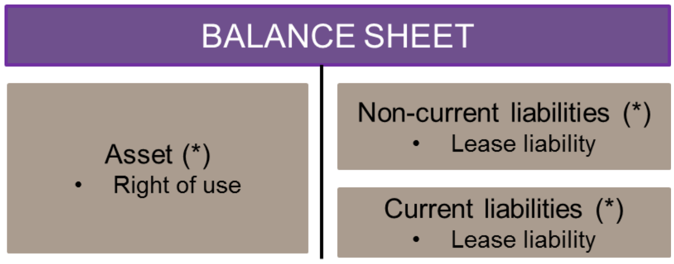
Right-of-use assets shall be presented:

- separately from other assets;
- or together with similar assets that are owned by the lessee, with a disclosure in the notes indicating which line items include right-of-use assets.

Lease liabilities shall be presented:

- separately from other liabilities;
- or together with other liabilities, with a disclosure in the notes on which line items include lease liabilities.
  Lease liabilities shall be broken down into current and non-current liabilities, based on the payment schedule.

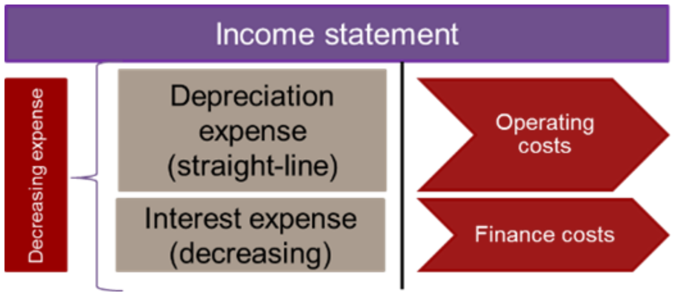
The required presentation in the balance sheet can be summed up as follows:



(*) Separate line item or split into more than one line item

Income statement

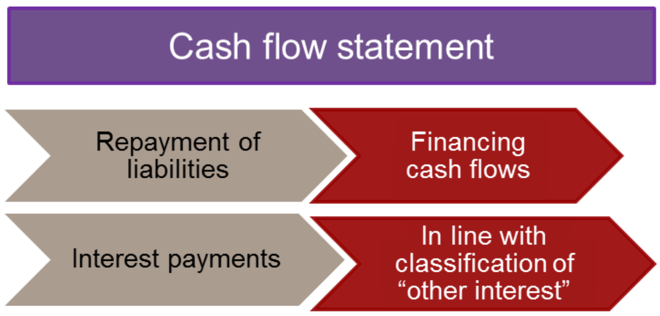
The depreciation expense for the right-of-use asset and the interest expense on the lease liability shall be presented separately, in operating costs and finance costs respectively.



Cash flow statement

To ensure consistency between the balance sheet, the income statement and the cash flow statement, the IASB has decided that cash flows relating to leases should be presented as follows:

- repayments of the principal portion of the lease liability shall be presented within financing activities; and
- payments for the interest portion of the lease liability shall be presented within either operating activities or financing activities, in line with the entity's presentation of "other interest payments" under IAS 7.



It should be noted that cash flows relating to short-term leases (less than 12 months), leases of low-value assets and variable lease payments (other than those that depend on an index or a rate) shall be presented within operating activities.

Initial measurement of the right-of-use asset

At the commencement date (i.e. the date on which the lessor makes the asset available to the lessee), the lessee shall measure and recognise the right-of-use asset at cost. Cost is calculated as follows:

- the amount of the initial measurement of the lease liability (see below);
- plus any payments made by the lessee at or before the commencement date, less any lease incentives received from the lessor;
- any initial direct costs (costs that would not have been incurred if the lease had not been obtained, e.g. leasing commissions); and
- an estimate of any costs to be incurred by the lessee under the terms and conditions of the lease for dismantling the asset, removals, or restoring the asset to a specified condition.

Thus, the initial measurement of the asset is largely dependent on the initial measurement of the lease liability.

Initial measurement of the lease liability

At the commencement date, the lessee shall measure the lease liability at the **discounted present value of the lease payments**. Although this sounds simple in theory, there are some challenges in practice, relating to the discount rate and the lease payments.

More specifically: what discount rate should be used to calculate the present value of the lease payments, and what payments should be included when measuring the lease liability?

What discount rate should be used?

The standard states that the lessee should use the interest rate implicit in the lease, i.e. the rate that the lessor charges to the lessee.

This is the discount rate that, at the commencement date, causes the present value of the lease payments (see below) and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

If the interest rate implicit in the lease cannot be readily determined, the standard states that the lessee's incremental borrowing rate should be used. This is defined as the interest rate that the lessee would have had 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.

It should be noted that the discount rate must be revised during the lease term if there is a change in the lease term as described above, or in whether there is an economic incentive to exercise a purchase option. If no such events occur, the discount rate calculated at the commencement date shall be used throughout the lease term.

What payments should be included when measuring the lease liability?

The standard specifies the payments that should be included when measuring the lease liability at the commencement date.

The initial measurement of the lease liability comprises the minimum payments to be made over the lease term (cf. section 5, above), which fall into the following categories:

- fixed payments, less any lease incentives receivable from the lessor;
- variable lease payments that depend on an index or a rate (the index or rate at the commencement date is used for the initial measurement of these payments);
- amounts that the lessee expects to pay under residual value guarantees;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option;
- penalties for terminating the lease, if the lessee is reasonably certain at the commencement date to exercise the option to terminate the lease.

Variable lease payments that do not depend on an index or a rate are excluded from the calculation, unless they are in-substance fixed lease payments, i.e. payments that are actually unavoidable as there is no genuine variability (i.e. the variable clauses do not have real economic substance).

Genuinely variable lease payments, i.e. those that are linked to future performance or use of the asset, are recognised in the income statement when the performance or use occurs.

Subsequent remeasurement of the lease liability and impact on the right-of-use asset

During the lease term, it may be necessary to remeasure the lease liability. The standard states that the lessee shall remeasure the lease liability if any of the following four situations occurs:

- **Situation 1:** There is a change in the lease term (and thus in the payment schedule) because a significant event or change in circumstances has occurred, resulting from an action or decision that is within the control of the lessee (see section 5, above);
- **Situation 2:** There is a change in the assessment of whether or not the lessee is reasonably certain to exercise a purchase option, because a significant event or change in circumstances has occurred, resulting from an action or decision that is within the control of the lessee. The lease payments must be revised to take account of the fact that the lessee is now reasonably certain to exercise the purchase option, or (conversely) that it is no longer reasonably certain to do so;
- **Situation 3:** There is a change in the amounts expected to be payable under a residual value guarantee; or
- **Situation 4:** There is a change in future lease payments resulting from a change in the index or rate used to calculate variable lease payments.

In all of these situations, the lessee must remeasure the lease liability, and recognise the amount of the remeasurement as an adjustment to the right-of-use asset.

It should be noted that the discount rate may or may not need to be revised, depending on whether the remeasurement of the lease liability is due to:

- a change in the lease term or the assessment of whether or not the lessee is reasonably certain to exercise a purchase option (which would *de facto* affect the lease payments); or merely
- a remeasurement of an assumption relating to the amount of certain payments (which would not have an impact on the lease term).

In the former situation, the lessee would use a revised discount rate (the interest rate implicit in the lease at the date of reassessment, or failing that, the lessee's incremental borrowing rate at the date of reassessment).

In the latter situation, the lessee would continue to use the original discount rate.

The table below presents the various possible combinations:

	Revised discount rate	Unchanged discount rate
Change in the lease term	X	
Change in the assessment of an option to purchase	X	
Change in the amounts expected to be payable under a residual value guarantee		X
Change in future lease payments resulting from a change in an index or a rate		X

Lease modifications in the lessee's financial statements

Like IFRS 15, the new IFRS 16 – *Leases* standard includes provisions on contract modifications and the appropriate accounting treatment of such modifications.

What is a lease modification?

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease.

An example would be adding or terminating the right to use one or more underlying assets during the lease term. Another example would be extending or shortening the lease term from what was originally stipulated in the contract.

In contrast, the exercise of an option that was part of the original terms and conditions does not constitute a lease modification.

For example, a lease of additional office space, at the market rate, for the remaining lease term, would be a lease modification.

However, the exercise by the lessee of a lease extension option, at a price stipulated in the original terms and conditions, is not a lease modification.

How should a lease modification be accounted for?

Under IFRS 16, a lessee shall account for a lease modification as a new lease (separate from the original lease) if both the following conditions are met:

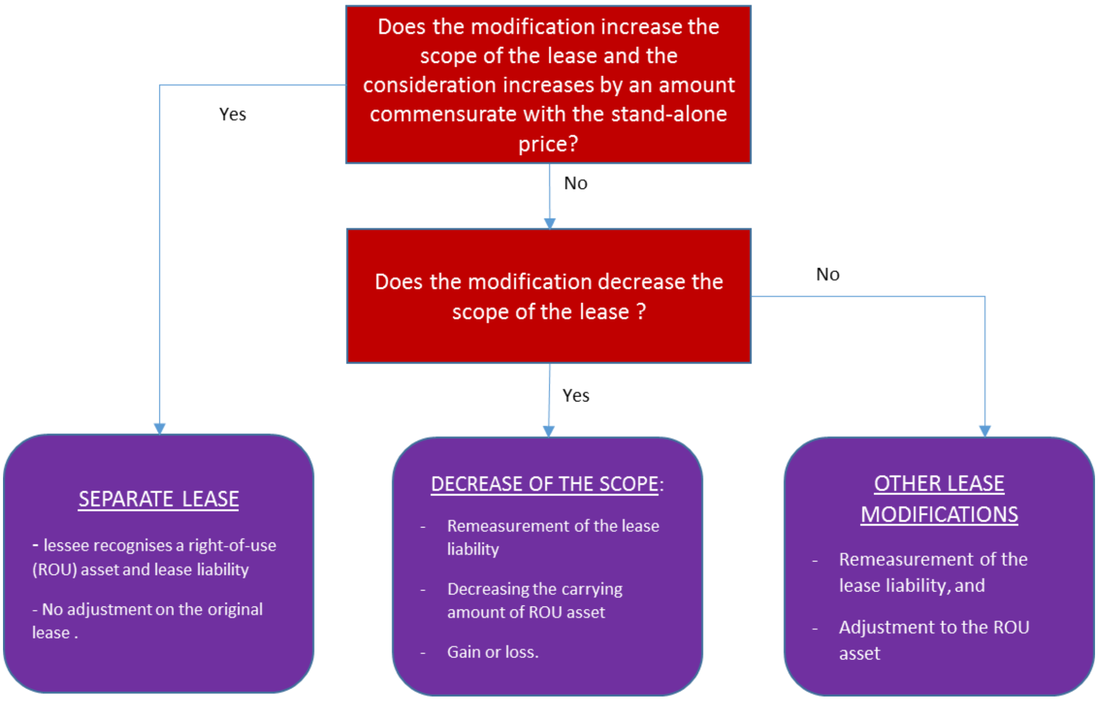
- the lease modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the increase in the consideration is commensurate with the additional right of use and its stand-alone price.

If the lease modification does not meet these criteria, the lessee shall remeasure the lease liability, using a revised discount rate determined at the date of the modification:

- If the lease modification decreases the scope of the lease, the lessee shall remeasure the lease liability and decrease the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, recognising a proportionate gain or loss;
- If the lease modification does not decrease the scope of the lease, the lessee shall remeasure the lease liability and make a corresponding adjustment to the right-of-use asset.

For example, a lease modification that increases the scope of the lease (or the amount of the consideration) results in an increase in the carrying amount of the right-of-use asset commensurate with the remeasurement of the lease liability.

The diagram below shows the process to be followed, and the accounting outcome for each scenario:



What disclosures should the lessee present in the notes?

The standard clearly states the key objective for lessees, namely to "give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows".

In addition to qualitative information that will help to meet this disclosure objective, the standard requires lessees to disclose various quantitative data on their leases. These should be presented in a tabular format (unless another format is more appropriate):

- The depreciation charge for right-of-use assets, presented by class of underlying asset;
- The interest expense on lease liabilities;
- Lease payments relating to short-term leases;
- Lease payments relating to leases of low-value assets;
- Variable lease payments;
- Income from subleases (cf. section 8, below);
- The total cash outflow for leases;
- Gains or losses on sale and leaseback transactions (cf. section 9, below);
- The carrying amount of right-of-use assets at the end of the reporting period, by class of underlying assets.

Lessees are also required to disclose a maturity analysis of lease liabilities in accordance with IFRS 7. This shall be presented separately from the maturity analyses of other financial liabilities.

In addition to the quantitative disclosures listed above, lessees must disclose any additional qualitative and quantitative information that is necessary to meet the key objective of understandability for users of financial statements.

Key points to remember

– The lessee shall recognise a right-of-use asset and a lease liability at the commencement date of the lease.

– The initial measurement of the right-of-use asset is based largely on the initial measurement of the lease liability.

– The lease liability is measured as:
  - the minimum payments to be made over the lease term; and
  - a discount rate, specified as the interest rate implicit in the lease or, if this is not readily available, the lessee's incremental borrowing rate.

– Variable lease payments that are linked to the use of an asset are excluded from the initial measurement of the lease liability and are recognised as an expense when they are incurred, unless they are in-substance fixed lease payments.

– Remeasurements of the lease liability, due to a change in the lease term or a reassessment of lease payments, shall result in a corresponding adjustment to the carrying amount of the right-of-use asset.

7. Lessor accounting

As noted previously, the IASB has opted for the approach that is least onerous for lessors. It has retained the approach used currently under IAS 17, which distinguishes between finance leases and operating leases.

Classification of leases as finance leases or operating leases

As with the current IAS 17 approach, lessors must classify their leases as either finance leases or operating leases.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee. If it does not do this, it is classified as an operating lease.

IFRS 16 states that the classification of a lease depends on the substance of a transaction rather than the form of the contract. The standard reiterates the indicators listed in IAS 17 to help preparers identify situations in which a lease should be classified as a finance lease.

These eight indicators are listed below:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;
- The lease provides the lessee with the option to purchase the asset at a price which is sufficiently attractive for it to be reasonably certain that the option will be exercised;
- The lease term covers the major part of the economic life of the asset;

- The present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset;
- The underlying asset is of such a specialised nature that only the lessee can use it without major modifications;
- The lessor's losses associated with cancellation of the contract are borne by the lessee;
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee; and
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than the market rate.

The classification of the lease is made at the inception date, and is only reassessed in the event of a lease modification.

Recognition of finance leases

At the commencement date, the lessor shall recognise an asset at an amount equal to the net investment in the lease, i.e. the present value of:

- the lease payments; and
- any unguaranteed residual value

plus the initial direct costs of the lessor.

What discount rate should be used?

The standard states that the lessor should use the interest rate implicit in the lease, i.e. the rate that the lessor charges to the lessee. This is the discount rate that, at the commencement date, causes the present value of the lease payments (see below) and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

The lessor will always know what this rate is, as it is essential to calculating the price.

What payments should be included when measuring the net investment in the lease?

The lease payments comprise the following:

- fixed payments (including in-substance fixed payments), less any lease incentives payable to the lessee;
- variable lease payments that depend on an index or a rate (the index or rate at the commencement date is used for the initial measurement of these payments);
- any residual value guarantees provided to the lessor by the lessee (or a related party or a third party);
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option;
- payments of penalties for terminating the lease, if the lessee is reasonably certain at the commencement date to exercise the option to terminate the lease.

How should a manufacturer (or dealer) lessor account for a finance lease?

IFRS 16 retains the key principles of IAS 17 on lessor accounting for finance leases, where the lessor is a manufacturer (or dealer). Manufacturer lessors shall recognise the selling profit or loss at the commencement of the lease. This profit or loss is calculated as the difference between:

- Revenue from the sale, being the fair value of the asset or, if lower, the present value of the lease payments; and
- The cost of sale, less the present value of the unguaranteed residual value.

Subsequent remeasurement

The lessor in a finance lease shall apply the derecognition and impairment requirements in IFRS 9.

The lessor shall also regularly review estimated unguaranteed residual values and revise the income allocation over the lease term accordingly. Any reduction shall be recognised immediately.

Modifications to finance leases

Under IFRS 16, a lessor shall account for a modification to a finance lease as a new lease (separate from the original lease) if both the following conditions are met:

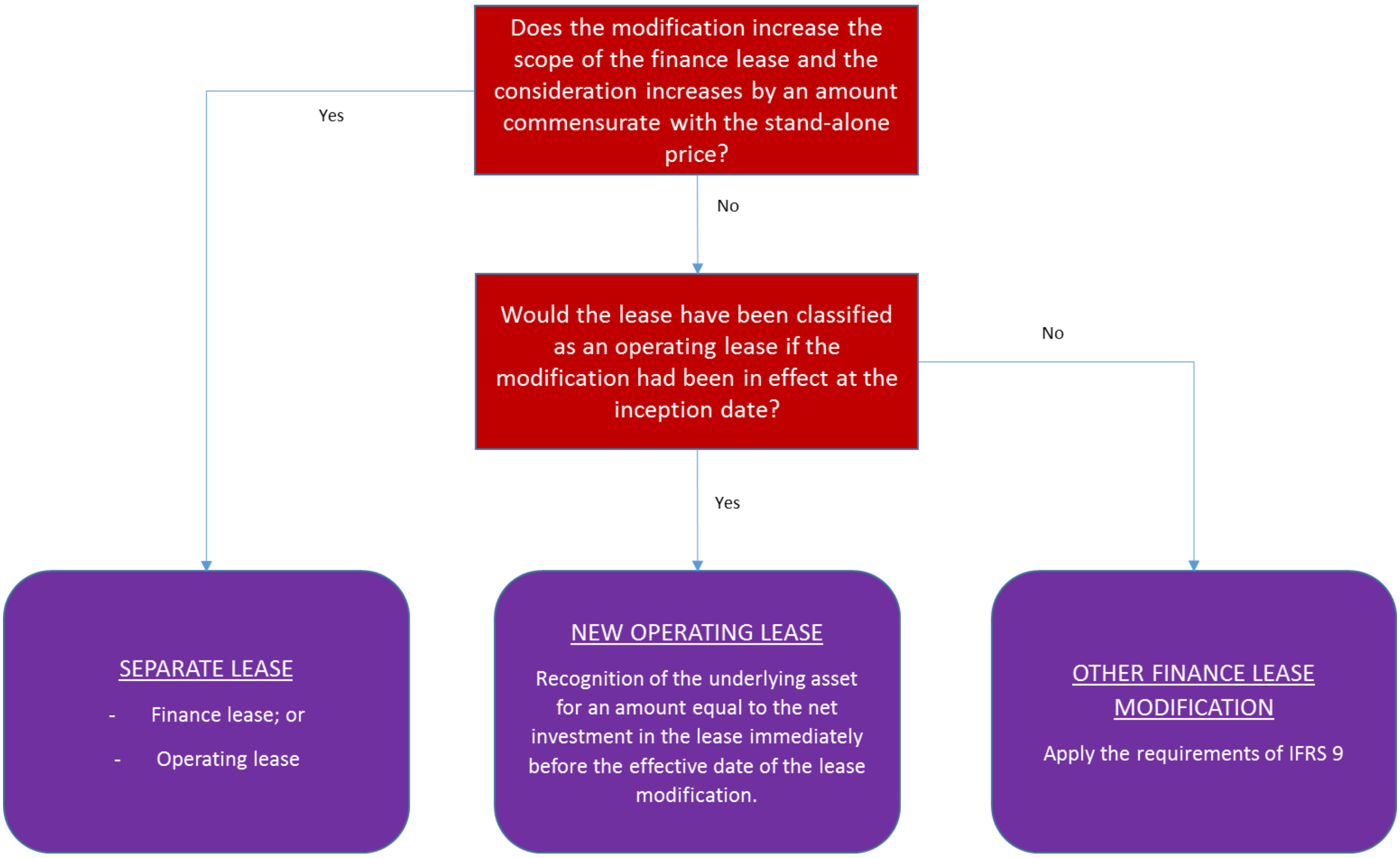
- the lease modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the increase in the consideration is commensurate with the price of the additional rights of use.

The accounting treatment of other modifications to finance leases depends on whether or not the lease would have been classified as an operating lease if the modification had been in effect at the inception date.

If the lease would have been classified as an operating lease, taking into account the modification, the lessor shall account for the modification as a new operating lease. The underlying asset is recognised as an asset at the carrying amount of the net investment in the lease immediately before the lease modification.

Otherwise, the impact of the modification shall be accounted for in accordance with IFRS 9.

The diagram below shows the process to be followed, and the accounting outcome for each scenario:



Recognition of operating leases

As in the current accounting framework, the lessor in an operating lease shall recognise income throughout the lease term on a straight-line basis (or on another systematic basis if that is more representative of the pattern in which the entity obtains the benefits from the use of the underlying asset).

Initial direct costs incurred by the lessor in obtaining an operating lease are added to the carrying amount of the underlying asset and recognised as an expense over the lease term, on the same basis as the lease income.

What disclosures should the lessor present in the notes?

IFRS 16 states the same objective for lessors as for lessees, i.e. to "give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows".

In addition to qualitative information that will help to meet this primary disclosure objective, the standard requires lessors to disclose the following information, in tabular format:

- For finance leases:
  - selling profit or loss;
  - finance income on the net investment in the lease; and
  - the amount of variable lease payments not included in the measurement of the net investment in the lease.
- For operating leases: lease income, distinguishing between variable lease payments that depend on an index or a rate and those that do not.

In addition to these quantitative disclosures, lessors are also required to disclose qualitative information on:

- The nature of their activities;
- How they manage the risks associated with any rights they retain in underlying assets;

- For finance leases:
  - An explanation of significant changes in the net investment;
  - A maturity analysis showing the undiscounted annual lease payments to be received for the first five years, and the total amounts for the remaining years. The maturity analysis shall be reconciled to the lessor's net investment in finance leases.
- For operating leases: a maturity analysis showing the undiscounted lease payments to be received for the first five years, and the total amounts for the remaining years.

Key points to remember

- The key principles of lessor accounting under IFRS 16 are very similar to the current requirements under IAS 17.
- The lessor shall distinguish between:
  - finance leases, for which the lessor shall derecognise the underlying asset and recognise a "net investment", which comprises the lease payments receivable plus any unguaranteed residual value;
  - and operating leases, for which the lessor shall retain the underlying asset in its balance sheet, and recognise income from lease payments throughout the lease term on a straight-line basis.

8. How are subleases accounted for?

First of all, it is important to note that the intermediate lessor (i.e. an entity which is both a lessee and a lessor of the same underlying asset) shall recognise the head lease (in which it is the lessee) and the sublease (in which it is the lessor) as two separate leases.

The head lease shall be accounted for like any other lease, using the standard lessee accounting approach.

IFRS 16 states that a sublease shall be classified and accounted for as either an operating lease or a finance lease, as follows:

- if the head lease is a short-term lease that the lessee has elected not to recognise (i.e. applying the exemption), the sublease is classified as an operating lease in the accounts of the intermediate lessor;
- in all other situations, the sublease is classified as either an operating lease or a finance lease by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset itself.

If the sublease is classified as an operating lease, the intermediate lessor shall:

- retain the right-of-use asset and the lease liability relating to the head lease in its balance sheet; and
- recognise lease income from the sublease over the lease term when it is received.

If the sublease is classified as a finance lease (for example, because the asset is subleased for all of the remaining term of the head lease), the intermediate lessor shall:

- derecognise the right-of-use asset;
- retain the lease liability relating to the head lease in its balance sheet;
- recognise a sublease receivable at an amount equal to the net investment in the lease; and
- recognise a gain or loss (the difference between the derecognised right-of-use asset and the sublease receivable).

Where the sublease is classified as a finance lease, entities may not offset the lease liability for the head lease against the sublease receivable, unless the offsetting criteria are met.

Key points to remember

- If an intermediate lessor subleases an asset, IFRS 16 requires it to recognise two separate leases:
  - The head lease, for which it is the lessee
  - The sublease, for which it is the lessor.
- The assessment of whether a sublease is a finance lease or an operating lease is based on the transfer of risks and rewards arising from the head lease, rather than on the transfer of risks and rewards relating to the underlying asset itself.

9. How are sale and leaseback transactions accounted for?

To begin with, a quick reminder: a sale and leaseback transaction is one in which an entity sells an asset and then leases it back from the buyer-lessor.

The IFRS 16 Basis for Conclusions states that it is the substance of a transaction, rather than its legal form, which determines whether or not a transaction is a sale and leaseback transaction. For example, a sale and leaseback transaction may take the legal form of a lease and leaseback transaction.

Assessing whether a sale has taken place

The new standard states that the requirements of IFRS 15 shall be applied to determine whether the transfer of an asset in a sale and leaseback transaction qualifies as a sale. The Basis for Conclusions states that:

- the existence of a leaseback does not preclude an entity from concluding that a sale has occurred; and
- if the seller-lessee has a substantive repurchase option, then no sale has occurred (as the seller-lessee retains control of the asset).

The accounting treatment differs according to whether or not a sale is deemed to have occurred.

The transfer is not a sale

If no sale has occurred, the transaction shall be treated as a financing operation.

- The seller-lessee continues to recognise the transferred asset in its financial statements and recognises a financial liability equal to the consideration received from the buyer-lessor, which is accounted for in accordance with IFRS 9;
- The buyer-lessor does not recognise the transferred asset in its financial statements and recognises a financial asset equal to the consideration transferred to the seller-lessee, which is accounted for in accordance with IFRS 9.

The transfer is a sale

If a sale is deemed to have occurred, the seller-lessee shall recognise a gain or loss from the sale, as follows:

- The seller-lessee measures the right-of-use asset arising from the leaseback at the proportion of the carrying amount of the transferred asset that relates to the right of use retained by the seller-lessee (i.e. the right of use it retains through the leaseback);
- The seller-lessee shall recognise only the portion of any gain or loss that relates to the sale of the residual interest in the underlying asset, at the end of the lease term.

It is the residual interest in the underlying asset that is transferred, rather than the entirety of the underlying asset, as the seller-lessee retains the right to use the underlying asset through the lease that it enters into concurrently with the sale.

Therefore, the seller-lessee shall recognise only this portion of the gain or loss. It must not recognise the portion of the gain relating to the right of use that it retains.

The buyer-lessor shall recognise the purchase of the asset and the lease separately.

How shall a sale and leaseback transaction be accounted for if the transaction is not at market rates?

If a sale is deemed to have occurred in a sale and leaseback transaction, the standard requires entities to consider whether the transaction took place at market rates.

To do this, it shall compare the most readily determinable of:

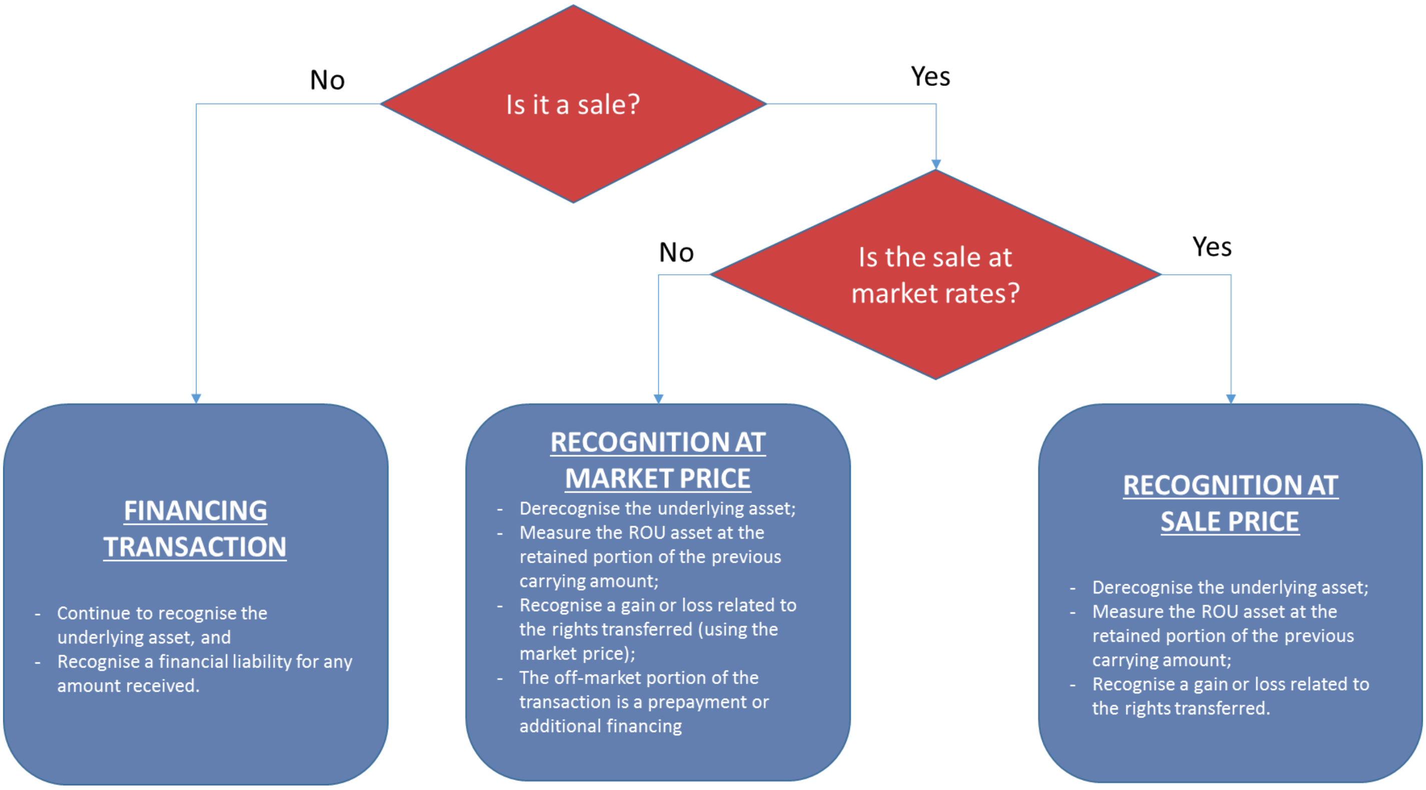
- the fair value of the consideration for the sale and the fair value of the underlying asset; or
- the present value of the contractual payments for the lease and the present value of lease payments at market rates.

The portion of the transaction which is not at market rates is accounted for as follows:

- As a prepayment of lease payments (if below market rates); or
- As additional financing (if above market rates).

Decision tree for sale and leaseback accounting

The decision tree below shows the process to be followed, and the accounting outcome for each scenario.



10. What are the transition requirements?

As we noted in the introduction to this feature, IFRS 16 becomes mandatory for financial periods commencing on or after 1 January 2019 (subject to endorsement by the EU). Early application is permitted, provided that IFRS 15 – *Revenue from Contracts with Customers* is also applied. Readers will remember that IFRS 15 becomes mandatory for financial periods commencing on or after 1 January 2018; early application is permitted.

IFRS 16 will have a substantial impact on the accounting treatment of leases in the financial statements of lessees, as all leases will give rise to the recognition of a right-of-use asset and a lease liability in the balance sheet. In other words, there is no longer any distinction between operating leases and finance leases.

Therefore, in order to avoid the need for full retrospective restatement at the date of initial application, the IASB has introduced various practical expedients. We present these below.

Classification of leases

An entity may opt for a practical expedient, at 1 January 2019, that will exempt it from reassessing whether a contrat is (or contains) a lease at the date of initial application In other words, it will not need to reassess existing contracts in the light of the new IFRS 16 definition, i.e. it will not need to assess whether existing service contracts are (or contain) leases, or vice versa.
Thus, an entity may elect to apply IFRS 16 to contracts that were classified as leases under IAS 17, and not to apply IFRS 16 to other existing contracts.

Initial application for lessees

The standard offers lessees a choice of transition arrangements. They may choose between:

- a full retrospective approach; or
- a modified retrospective approach.

It should be noted that this choice must be applied consistently to the lessee’s entire portfolio of leases, at the transition date.

As lessees will be the most severely affected by the implementation of IFRS 16, the IASB has permitted them various practical expedients.

Some of these practical expedients may be used by all lessees, whether they opt for a full retrospective approach or a modified retrospective approach. Others may only be applied in situations where a lessee has opted for a modified retrospective approach.

What practical expedients are available to all lessees?

All lessees may elect to apply the following practical expedients, irrespective of whether they have opted for a full retrospective approach or a modified retrospective approach:

- a lessee is not required to make any adjustments for leases of low-value assets previously classified as operating leases under IAS 17;
- a lessee is not required to make any adjustments for former IAS 17 operating leases previously accounted for as investment property using the fair value model;
- a lessee may recognise the right-of-use asset at fair value at the date of initial application for leases previously classified as operating leases under IAS 17 that will henceforth be accounted for as investment property under IAS 40.

What does the modified retrospective approach involve?

Under the modified retrospective approach, the lessee:

- shall not restate comparative information. The date of initial application shall be the first day of the financial period in which the standard is first applied;
- shall recognise the cumulative effect of the change in accounting policy as an adjustment to the opening balance of retained earnings at the date of initial application;
- for leases previously classified as operating leases under IAS 17:
  - the lessee shall measure the lease liability at the present value of the remaining lease payments, using the lessee's incremental borrowing rate at the date of initial application as the discount rate;
  - the lessee shall measure the right-of-use asset, for each lease, either:
    - retrospectively as if the new standard had always been applied, using the lessee's incremental borrowing rate at the date of initial application as the discount rate; or
    - at an amount equal to the lease liability (i.e. the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application), adjusted by the amount of any prepaid lease payments made in the past;
- for leases previously classified as finance leases under IAS 17: the lessee shall retain the previous carrying amount of the right-of-use asset and lease liability, measured under IAS 17 immediately before the date of initial application.

What are the practical expedients available to lessees applying the modified retrospective approach?

Lessees that have opted for the modified retrospective approach may apply the following practical expedients (on a lease-by-lease basis) to leases previously classified as operating leases under IAS 17:

- a lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
- instead of performing an impairment test, a lessee may adjust the right-of-use asset by the amount of any provision for onerous leases recognised under IAS 37 immediately before the date of initial application;
- a lessee may elect not to restate leases with a remaining lease term of less than 12 months at the date of initial application. These leases are then accounted for as if they were short-term leases;
- a lessee may exclude initial direct costs from the measurement of the right-of-use asset;
- a lessee may use hindsight at initial application, e.g. in determining the lease term, if the contract contains options to extend or terminate the lease.

Initial application for lessors

IFRS 16 makes only very limited changes to the accounting treatment of leases in the financial statements of lessors. It retains the accounting approach used currently under IAS 17, which distinguishes between finance leases and operating leases.

In consequence, entities are not required to make any adjustments to leases in which they are lessors at the date of initial application.

However, there is one exception to this rule, which applies in the case of subleases for which an entity is an intermediate lessor. In this situation, the entity shall:

- reassess, at the date of initial application, whether leases previously classified as operating leases under IAS 17 should now be classified as operating leases or finance leases, on the basis of the remaining contractual terms of the head lease and sublease;
- and recognise subleases that are now classified as finance leases as if they were new finance leases entered into at the date of initial application.

Key points to remember

- As with IFRS 15, entities may opt for a full retrospective approach on initial application of IFRS 16, or a modified retrospective approach that does not require restatement of comparative information.
- The transition arrangements include a number of optional practical expedients, which entities will need to consider on a case-by-case basis.

11. Conclusion

The new *Leases* standard represents a major change in how leases are conceptualised and accounted for. It will have a substantial impact on the financial statements of lessees, particularly those with large portfolios of operating leases, as the new standard requires virtually all leases to be recognised in the balance sheet.

Figures sometimes speak more loudly than words, and the IASB points out that globally:

- listed companies have off-balance-sheet leases worth around US$2.9 trillion; and
- the four sectors with the highest proportion of off-balance-sheet leases are airlines, retailers, travel and leisure, and transport. The IASB has estimated the present value of future payments to be recognised for off-balance-sheet leases for these four sectors. These leases will account for 22.7% of airlines' total assets, 21.4% for retailers, 20.7% for travel and leisure, and 11.6% for transport.

This will therefore have an impact on the key financial metrics used by entities (debt, ROA, EBITDA, operating margin, etc.), which may in turn require entities to renegotiate some of their financial covenants.

The mandatory effective date of IFRS 16 is not until 1 January 2019, and the standard still has to go through the EU endorsement process. However, in light of the potentially substantial impact of the standard, issuers should start preparing for it now. This may involve:

- collecting as much information as possible on contracts;
- analysing the substance of these contracts (are they leases, or do they contain leases?)
- adapting information and reporting systems;
- etc.

Key points to remember

Lessee accounting

1. For all leases, the lessee shall recognise a right-of-use asset and a lease liability in the balance sheet.
2. The total lease expense will decrease over the lease term (as the interest expense decreases) and is presented below EBITDA.
3. This will have a negative impact on net debt and ROA, but a positive impact on EBITDA.
4. The new definition of a lease redraws the boundary between leases and service contracts. Some contracts may be classified as service contracts, in which case they will not be recognised in the balance sheet. Contracts will have to be examined closely to determine whether they are leases or service contracts.
5. Lease payments that are linked to the use of the underlying asset are not taken into account in the measurement of the lease liability.
6. Key principles are consistent with IFRS 15, e.g. the concept of control, the accounting treatment of lease modifications, and the allocation of consideration to components of the contract.
7. Exemptions are available for short-term leases and leases of low-value assets: an entity may elect not to recognise these in the balance sheet.
8. Portfolio application is permitted in certain circumstances.
9. Additional disclosures are required in the notes.
10. Entities are not obliged to apply the full retrospective approach at transition.

Lessor accounting

1. The accounting treatment remains basically the same.
2. A lease is classified as a finance lease or an operating lease depending on whether or not it transfers substantially all the risks and rewards inherent to ownership of the underlying asset.
3. Additional disclosures are required in the notes.
4. The transition requirements for lessors have, in theory, been simplified.

Events and FAQ

Frequently asked questions

IFRS

- Accounting classification of withholding taxes in the income statement;
- Determining the result on disposal of investments in associates;
- Impact of VAT becoming deductible on the acquisition cost of an installation;
- Accounting treatment by an investor of a subordinated bond redeemable in shares meeting the definition of an equity instrument for the issuer;
- IFRS treatment of marketing costs for the restructuring of a building.

Upcoming meetings of the IASB, the IFRS Interpretations Committee and EFRAG

IFRS		EFRAG	
IASB	**Committee**	**Board**	**TEG**
15-19 February	22-23 March	8 March	24-25 February
14-18 March	10-11 May	13 April	22-24 March
18-22 April	12-13 July	13 May	27-29 March