IFRS 16 OVERVIEW: WHAT DOES THE FUTURE HOLD FOR YOUR LEASE CONTRACTS?

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EDITORIAL

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In January 2016, the IASB published IFRS 16, its new accounting standard on leases. This signals the end of a major and often controversial project, which aimed to provide a **more faithful representation of leases** in IFRS financial statements.

The changes introduced by the standard will primarily affect the financial statements of lessees, as the IASB opted to retain the current accounting principles for lessors. IFRS 16 thus removes the symmetry that existed between the accounting for leases by lessees and lessors.

Companies have until 1st January 2019 to prepare for the change. However, it is a good idea to start thinking about the new definition of a lease and the new accounting model straight away. This will enable companies to **anticipate the accounting impacts of the change of standard, the impacts on financial performance indicators but also the potential implications on renegotiation of existing leases or on an entity's financing strategy**.

THE ESSENTIALS

LESSEES **LESSORS**

1 WHAT EXACTLY IS INVOLVED?

Current operating lease non-cancellable commitments, disclosed as off-balance sheet commitments in the notes to financial statements, amount to close to 3 trillion dollars. IFRS 16 will bring most of these leases onto the balance sheet.

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2 A SINGLE APPROACH TO LEASE ACCOUNTING

The new standard no longer distinguishes between finance and operating leases. Lessees' balance sheets will show, for all contracts which meet the definition of a lease, a right-of-use of the leased asset together with a lease liability.

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3 TWO CRITERIA FOR DISTINGUISHING BETWEEN A LEASE AND A SERVICE CONTRACT

A contract based on the use of an identified asset that transfers to the customer the right to control the use of that asset is a lease, as opposed to a service contract.

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4 THREE APPLICATION PRACTICAL EXPEDIENTS

Practical expedients are available to reduce the operational burden of inventory, analysis and monitoring of significant volumes of short term leases, leases of low value assets or leases with similar characteristics.

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5 VARIOUS TRANSITION PRACTICAL EXPEDIENTS

The standard proposes a simplified approach to measure the right-of-use and the lease liability at the date of first application. Beyond this modified restrospective approach, other simplifications are available for contracts existing at transition date.

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6 AN IN-DEPTH ANALYSIS OF THE CONTRACT TERMS

The contractual terms require careful analysis to determine the lease term, the existence of service components which are to be accounted for separately, or whether some contracts may need to be combined to be accounted for as a single contract.

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7 BALANCE SHEET AMOUNTS SUBJECT TO REASSESSMENTS

Beyond the period-end accounting mechanics required for the different balance sheet items involved, events which imply a reassessment of the contractual terms also affect the amounts recorded on the balance sheet.

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8 MORE GUIDANCE ON THE ACCOUNTING FOR SPECIFIC TRANSACTIONS

Specific sections in the standard are dedicated to the accounting requirements for subleases as well as for sale and lease-back transactions.

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9 LESSOR ACCOUNTING LARGELY UNCHANGED

The accounting model for lessors maintains the distinction between finance and operating leases governed by the transfer of the risks and rewards incidental to the ownership of the underlying asset.

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10 OUR SERVICE OFFERING

Mazars will work with you to effectively and efficiently manage the 3 key phases of your transition to IFRS 16.

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1

WHAT EXACTLY IS INVOLVED?

*Under IFRS 16 and the equivalent US standard, almost **3 trillion dollars*** *of leases will be added to lessees' balance sheets.*

Source: Effects analysis, January 2016, IFRS Foundation

(*)undiscounted, and based on disclosures from over 14,000 listed companies

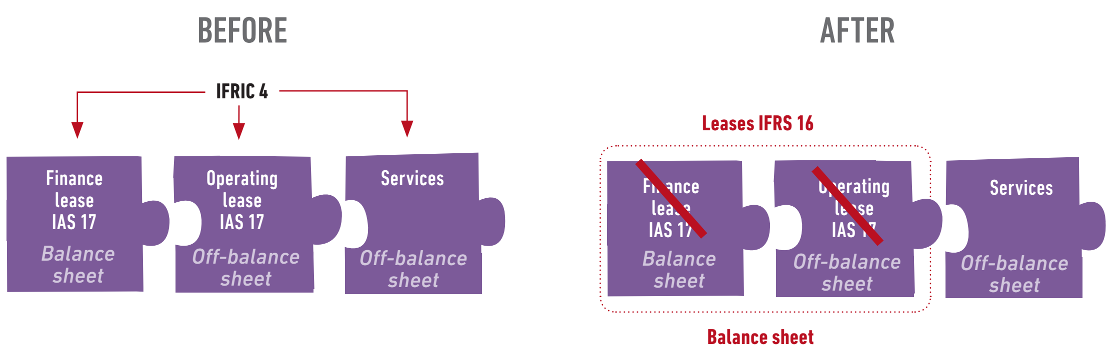
IFRS 16 **replaces IAS 17**, the previous Leases standard, and **interpretation IFRIC 4** – Determining Whether an Arrangement Contains a Lease. It also supersedes the **other related interpretations**, SIC-15 – Operating Leases: Incentives and SIC-27 – Evaluating the Substance of Transactions in the Legal Form of a Lease.

IFRS 16 comprises the **requirements** themselves (the standard and application guidance) and **an explanatory section** (the illustrative examples and Basis for Conclusions).

The IASB has also published an **effects analysis** and set up a dedicated email address for questions relating to implementation.

In total, more than 300 pages of documentation have been published!

The new standard redraws the boundary between leases and service contracts.



The new standard may affect lessees' key financial statement metrics and financial covenants.

+ **Positive impact on EBITDA**

- **Negative impact on net debt**

2

A SINGLE APPROACH TO LEASE ACCOUNTING

General principle: all leases are recognised in the balance sheet

If a contract is a lease, **a right-of-use asset** for the underlying asset is recognised in the **balance sheet, together with a lease liability.**

The right-of-use asset is depreciated over the lease term, usually on a straight-line basis, and impairment is recognised if necessary.

The lease liability is recognised at amortised cost.

A generally decreasing annual lease expense, split into two separate elements in the income statement

The **annual lease expense** is made up of:

- the **depreciation expense** for the right-of-use asset, presented in operating costs; and
- the **interest expense** on the lease liability, presented in finance costs.

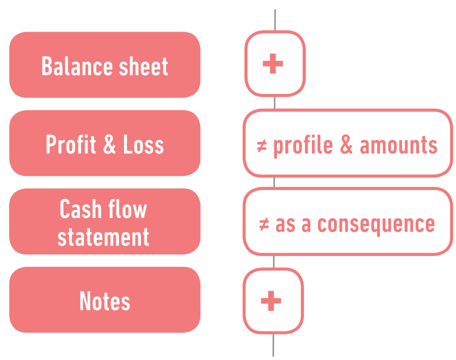
It will therefore generally decrease over the lease term.

Changes to the cash flow statement as a result

Repayments of the principal portion of the lease liability are presented within **financing activities.**

Payments for the interest portion of the lease liability are presented within either operating activities or financing activities, **in line with the entity's presentation of interest paid.**

> “*Under IFRS 16, **more items** will be presented **in the balance sheet, and additional disclosures** will be required **in the notes**.*”



Additional disclosures in the notes

Disclosures in the notes shall give a basis for users of financial statements to **assess the effect that leases** have on the financial position, financial performance and cash flows.

The standard requires **substantial qualitative and quantitative disclosures** on the amounts presented in the financial statements (amounts, flows, maturity of lease liabilities, etc.) and on factors that may have an impact on the financial statements (variable lease payments, whether or not options are taken into account when determining the lease term).

Issuers must also disclose **any additional information if it is necessary** to meet the key objective of usefulness for users of financial statements.

3

TWO CRITERIA FOR DISTINGUISHING BETWEEN A LEASE AND A SERVICE CONTRACT

1st criterion:
The use of an identified asset

An asset is identified if:
- it is **explicitly specified** in the contract or if the **execution** of the contract **implicitly depends on this asset**; and
- **the supplier may not substitute the asset**, as it does not have the substantive right to do so.

A supplier has a substantive substitution right if:
- it has the practical ability to substitute an alternative asset; and
- it has an economic incentive to exercise its substitution right (i.e. the expected benefits outweigh the cost of doing so).

All the facts and circumstances at inception of the contract should be taken into account. Future events that are not considered likely to occur at inception of the contract – such as the introduction of a new technology that is not yet substantially developed – should not be taken into consideration.

If the situation is unclear, it is presumed that the supplier does not have a substantive substitution right.

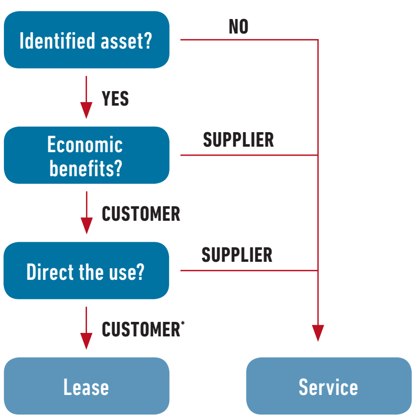
2nd criterion:
The right to control the use of the asset

The customer has the right to control the use of the asset if:
- it receives **substantially all of the economic benefits** from use of the asset during the lease term (e.g. by having exclusive use of the asset); and
- it has the **right to direct the use of the asset** over the lease term.

If the customer makes the relevant decisions regarding how and for what purpose the asset is used, and the supplier cannot change these decisions, the customer has the right to direct the use of the asset.

In situations where the relevant decisions and the use of the asset are predetermined, the customer has the right to direct the use of the asset if the supplier cannot change how the asset is operated, or if the customer has designed the asset in such a way as to predetermine how and for what purpose the asset is used.

The process for determining whether a contract is a lease is similar, yet not identical, to the current process according to IAS 17 and IFRIC 4:



* Complete the analysis if direction of the use is predetermined

Focus on...
(capacity) portions of assets

A portion of an asset is an identified asset if:
- it is physically distinct from the rest of the asset (e.g. a floor of a building); or
- it is not physically distinct but represents substantially all the capacity of the asset.

> “*The **two criteria** for identifying a lease are **cumulative**; if one criterion is not met, the contract does not fall within the scope of the standard.*”

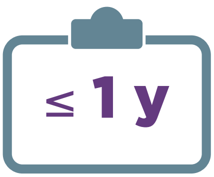
4

THREE APPLICATION PRACTICAL EXPEDIENTS

Exemption for short-term leases

This exemption shall be applied **by asset class**.

It covers leases with a term of 12 months or less, including extensions to the lease term if there is an economic incentive to renew the lease.

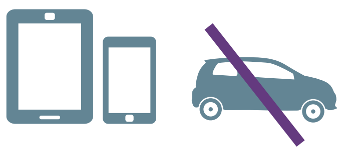


Exemption for leases of low-value assets

This exemption shall be applied on **an asset-by-asset basis**, even if the cumulative amount of low-value assets is material to the entity.

The asset must be usable on its own or together with other resources that are readily available, and must have **a value when new of US$5,000 or less**, irrespective of the size of the company.

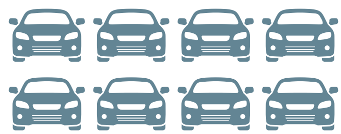
Thus, this exemption would generally apply to small items of electronic or office equipment (telephones, tablets, laptops, etc.) but not to cars.



Portfolio application

If an entity has a **large number of leases with similar characteristics** (e.g. as part of a master lease agreement), these leases can be measured and recognised on a portfolio basis, i.e. through a global computation rather than on an individual lease basis.

This exemption may only be applied if portfolio application would not differ significantly from recognition on an individual basis.



> *“Entities should start* ***reviewing their leases*** *now, to determine whether they will want to apply any of the practical expedients offered by IFRS 16.”*

5

VARIOUS TRANSITION PRACTICAL EXPEDIENTS

An entity may retain the existing classification for all existing contracts

An entity does not necessarily need to reassess whether its existing contracts are service contracts or leases at the date of initial application.

If it opts to retain existing classifications:
- existing leases shall be accounted for in accordance with IFRS 16, and
- existing contracts, assessed to be service contracts, will not need to be reassessed to see whether they meet the definition of a lease under IFRS 16.

In spite of this practical expedient, companies are advised to **reassess some of their contracts**, and especially those that were **complex to analyse under IFRIC 4**. This will help to clarify the appropriate accounting treatment for future contracts of this type under IFRS 16.

An entity may elect not to make adjustments for existing operating leases of low-value assets

If an entity elects to apply this option, the leases in question will be exempt from the requirements set out in the standard at the date of initial application. In practice, this means they will be treated as service contracts and will not be recorded in the balance sheet.

An entity may apply these practical expedients whether or not it has opted for the modified retrospective approach (see opposite).

An entity may apply the modified retrospective approach to all contracts

The full retrospective approach is the default under IFRS 16. However, as it can be difficult to implement in practice, the standard also permits a simplified approach. Under the modified approach, the **cumulative effect of the change in accounting policy** shall be recognised as an **adjustment to the opening balance of retained earnings at the date of initial application** (i.e. January 1st, 2019 in most instances). **Comparative information is not restated.**

The lease liability for existing operating leases shall be measured 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. Meanwhile, the right-of-use asset may be measured either at an amount equal to the lease liability (adjusted by the amount of any prepaid lease payments), or as if the new standard had always been applied, again using the lessee's incremental borrowing rate at the date of initial application as the discount rate.

Entities that use the modified retrospective approach may opt for additional practical expedients.

An entity may elect not to restate leases with a remaining lease term of 12 months or less at the date of initial application

If an entity elects to apply this option, the leases in question shall be accounted for as short-term leases and therefore will not be recorded in the balance sheet.

This option may only be used if an entity has elected to apply the modified retrospective approach. The option may be applied on a lease-by-lease basis.

Other practical expedients relating to measurement are also available.

While these **options** should make the transition process less onerous, particularly in cost terms, they generally require **additional disclosures** regarding transition.

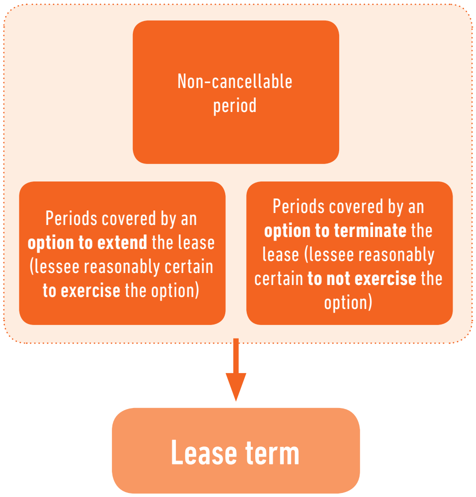
> “ *Companies should start thinking now about the cost/benefit ratio for each of the available* ***practical expedients****, and consider their financial communication* ***on their transition****.* ”

6

AN IN-DEPTH ANALYSIS OF THE CONTRACT TERMS

Lease term

The lease term is the non-cancellable period during which the lessee has the right to use the asset. It is made up of:
- the **non-cancellable period**;
- periods covered by an **option to extend the lease**, if the lessee is reasonably certain to exercise this option;
- periods covered by an **option to terminate the lease**, if the lessee is reasonably certain to not exercise this option.



To determine the lease term, the lessee must therefore carry out a **cost/benefit analysis** to assess whether it is reasonably certain that he will exercise any options or not. Factors to be taken into account include pricing (e.g. extension options at below market rates) and costs incurred (leasehold improvements, termination costs, etc.).

The lease term shall only be reassessed if a **significant event or change in circumstances occurs subsequently that is within the control of the lessee** and that may influence whether or not the lessee is reasonably certain to exercise an option. An example would be a situation in which the lessee subsequently makes substantial improvements to the asset.

Separating or combining components

IFRS 16 is **similar to IFRS 15** – Revenue from Contracts with Customers as regards the rules on **separating** a contract into various (lease and/or service) components – by identifying whether they are distinct, **allocating the consideration** to each component – on the basis of the components' sales prices, and the criteria for **combining** contracts – identity of the contracting party, negotiation mode and dependence of the performance obligations upon another.

If a contract includes both lease and services components, the lessee may elect to treat the contract in its entirety as a lease. This option shall be applied by class of underlying asset.

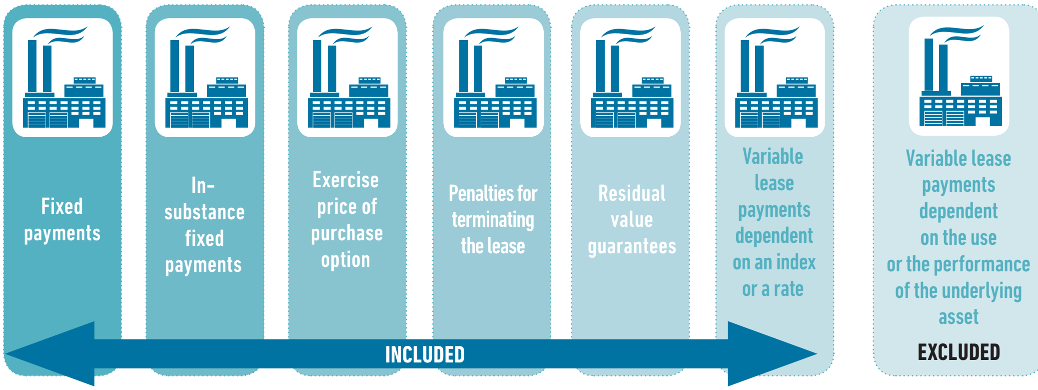
> *"The **single accounting approach** may initially appear simple, but **significant use of judgement** is required when implementing the finer points of the standard."*

7

BALANCE SHEET AMOUNTS SUBJECT TO REASSESSMENTS

At the commencement date

The **initial measurement** of the lease liability is based **on the present value of the lease payments, discounted at the interest rate implicit in the lease** or, if this cannot be readily determined, at the lessee's incremental borrowing rate:



To calculate the initial carrying amount of the right-of-use asset, the following additional elements are added to the amount of the lease liability:

- any payments made by the lessee at or before the commencement date, less any lease incentives received from the lessor;
- any initial direct costs;
- an estimate of any costs to be incurred by the lessee for dismantling the asset, removals, or restoring the asset to a specified condition.

Over the lease term

At each year-end

The right-of-use asset is depreciated over the lease term, usually on a straight-line basis.

The lease payments are deducted from the lease liability, and interests incurred are added to it.

Reassessment of the lease

The amount of the remeasurement of the lease liability due to a change in the lease term or the lease payments is recognised as an adjustment to the right-of-use asset:

- for **changes of the lease term**, the **discount rate** used to calculate the present value of the lease payments is **revised** (at the interest rate implicit in the lease at the date of reassessment, or failing that, at the lessee's incremental borrowing rate at the date of reassessment);
- for **changes in the lease payments** (due to a change in an index or rate or the residual value guarantee), the **discount rate is unchanged.**

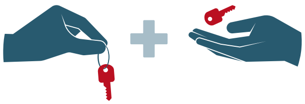
Lease modifications

The rules on contract modifications are similar to those of IFRS 15 – Revenue from Contracts with Customers:

- an increase or a reduction of the **scope of the right-of-use** gives rise to respectively the recognition of a separate contract or to the partial derecognition of the right-of-use;
- other changes are **reassessments** of the right-of-use.

8

MORE GUIDANCE ON THE ACCOUNTING FOR SPECIFIC TRANSACTIONS



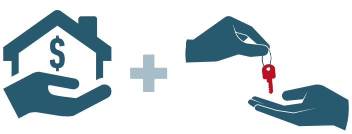
Subleases

In the case of a sublease, the intermediate lessee is the lessee as regards the head lease and the lessor as regards the sublease.

The intermediate lessee accounts for the head lease and the sublease separately.

For the sublease, the intermediate lessee follows the accounting model applicable to lessors (see page 23) which **distinguishes operating leases from finance leases**. In the specific context of the sublease, this distinction is made **by reference to the right-of-use asset arising from the head lease**, rather than by reference to the underlying asset itself – unless the lessee has applied the exemption permitting it to treat the head lease as a short-term lease. In this case, the sublease must be classified as an operating lease, even though the entirety of the right-of-use asset is transferred.

Thus, for example, a sublease shall be classified as a finance lease if it covers the entirety of the remaining term of the head lease.



Sale and leaseback transactions

The qualification as a sale of the underlying asset is determined applying criteria for transfer of control set out in IFRS 15 – Revenue from Contracts with Customers (transfer of the asset to the customer and capacity of the customer to obtain substantially all the benefits from the asset). Therefore, the existence of a substantive repurchase option by the seller-lessee generally indicates that a sale has not occurred.

If **no sale** has occurred, the transaction is, in substance, a **financing operation**.

If a sale is deemed to have occurred, the seller-lessee recognises only the portion of any gain or loss that relates to the rights actually transferred. The right-of-use asset that it retains through the leaseback continues to be recognised in the balance sheet, and is measured at the proportion of the carrying amount of the transferred asset that relates to the retained right-of-use.

If the transaction is **not at market rates, the difference is recognised** as:
- a prepayment of lease payments, if below market rates;
- additional financing, if above market rates.

“ The new IFRS 16 standard brings the accounting principles for recognition of a sale into line with those set out in IFRS 15 – Revenue from Contracts with Customers. ”

9

LESSOR ACCOUNTING LARGELY UNCHANGED

Classification of leases

As in the current approach, the recognition of leases by lessors is governed by **whether the lease is a finance lease or an operating lease**. The distinction is still based on analysis of whether the **risks and rewards incidental to ownership of the underlying asset** are transferred to the lessee. To help lessors assess whether this is the case, IFRS 16 retains the eight indicators currently used under IAS 17.

Finance leases

Recognition

At the commencement date, the lessor recognises the **net investment in the lease** on the asset side at the present value of the lease payments (calculated as for lessee accounting, see p. 19) and any unguaranteed residual value, at the interest rate implicit in the lease, plus the initial direct costs of the lessor.

Subsequent remeasurement

The asset is accounted for in line with the derecognition and impairment requirements set out in IFRS 9.

The unguaranteed residual value must be reviewed on a regular basis.

Lease modifications

If the modification is such that the lease would have been classified as an operating lease at inception date, the lessor recognises the underlying asset on the asset side at the carrying amount of the net investment in the lease immediately before the lease modification.

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

Operating leases

As in the current accounting framework, the lessor recognises 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).

The initial direct costs incurred by the lessor 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.

Focus on... manufacturer/dealer lessors

The principles of finance lease accounting for manufacturer/dealer lessors have not changed.

“Lessors have been spared much disruption to their accounting model under IFRS 16. However, companies should prepare for some ***minor modifications, including the increase of disclosures in the notes.***

Changes to lessee accounting could however have a ***knock-on effect on lessors’ activities.”***

Disclosures in the notes

Disclosures in the notes aim at giving a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows.

Thus, lessors shall present quantitative disclosures that provide further detail on the amounts recognised in the income statement (e.g. a breakdown of variable lease payments depending on their nature); qualitative disclosures explaining the nature of their leasing activities; how they manage the risks associated with any rights they retain in underlying assets; changes in the amounts recognised in the balance sheet; and **a more detailed maturity analysis than was previously required of the undiscounted annual lease payments to be received.**

10

OUR SERVICE OFFERING

Mazars will work with you to effectively and efficiently manage the 3 key phases of your transition to IFRS 16 :

FRAMING THE TRANSITION PROJECT

> Definition of the project organisation (working groups, steering committees, deliverables, etc.)

> Identification and role of stakeholders in:

- Organisation and information systems
- Accounting principles
- Financial communication
- Financing strategy

> Planning

MANAGING THE TRANSITION PROJECT

Project management support, with multi-disciplinary experts assisting you to:

a/ Centralise contracts, analyse information system solutions, adapt approval processes, etc.

b/ Define contract categories, assess accounting impacts, consider transition methods, etc.

c/ Analyse impacts on reporting systems, financial communication, key performance indicators, debt covenants, etc.

d/ Develop models for different financing solutions, analyse varying scenarios, renegotiate specific contracts, etc.

ROLLING OUT THE SOLUTION

Implementation of the chosen solution and follow-up of potential implementation issues (for example relating to categories of contracts, financing, information systems solutions, etc.).

NOTES

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