KPMG

IFRS 16 Leases

ICAI Dubai Chapter

October 2016

Yusuf Hassan

The $3 trillion standard

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

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

Sir David Tweedie
April 2008

Hans Hoogervorst
January 2016

Why is this important?

- Most companies lease assets
- Under IFRS 16, lessees will bring leases on balance sheet.
- New lease definition becomes the new on/off-balance sheet test.
- Changes many financial ratios.
- Your stakeholders/investors will want to understand the impact on your business.

Agenda

KPMG
Insights

Overview and Impact

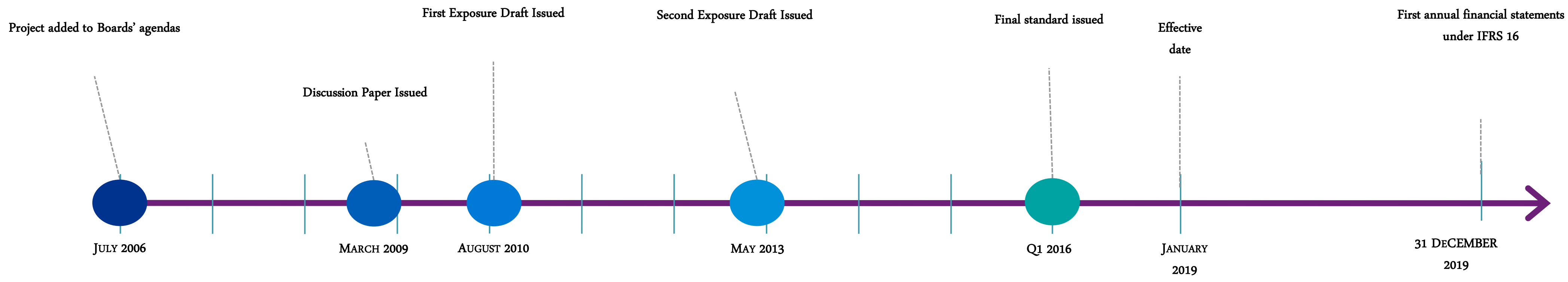
Overview – Project timeline

Objectives:

- Require lessees to recognise all significant leases on-balance sheet
- Eliminate arbitrary accounting distinctions for transactions that are economically similar
- Reduce complexity in lease accounting
- Develop converged lease accounting requirements

…but

Why ?



Lessees face major changes

Leases ‘On Balance Sheet’

Balance sheet

Asset

= ‘Right-of-use’ of underlying asset

Liability

= Obligation to make lease payments

P&L

Lease expense

Depreciation

+ Interest

= Front-loaded total lease expense

Sir David Tweedie's aircraft

Five year lease of an aircraft

CU1,000,000 per annum due at 31 Dec

No renewal no purchase option

Discount rate: 7%

Aircraft useful life: 20 years

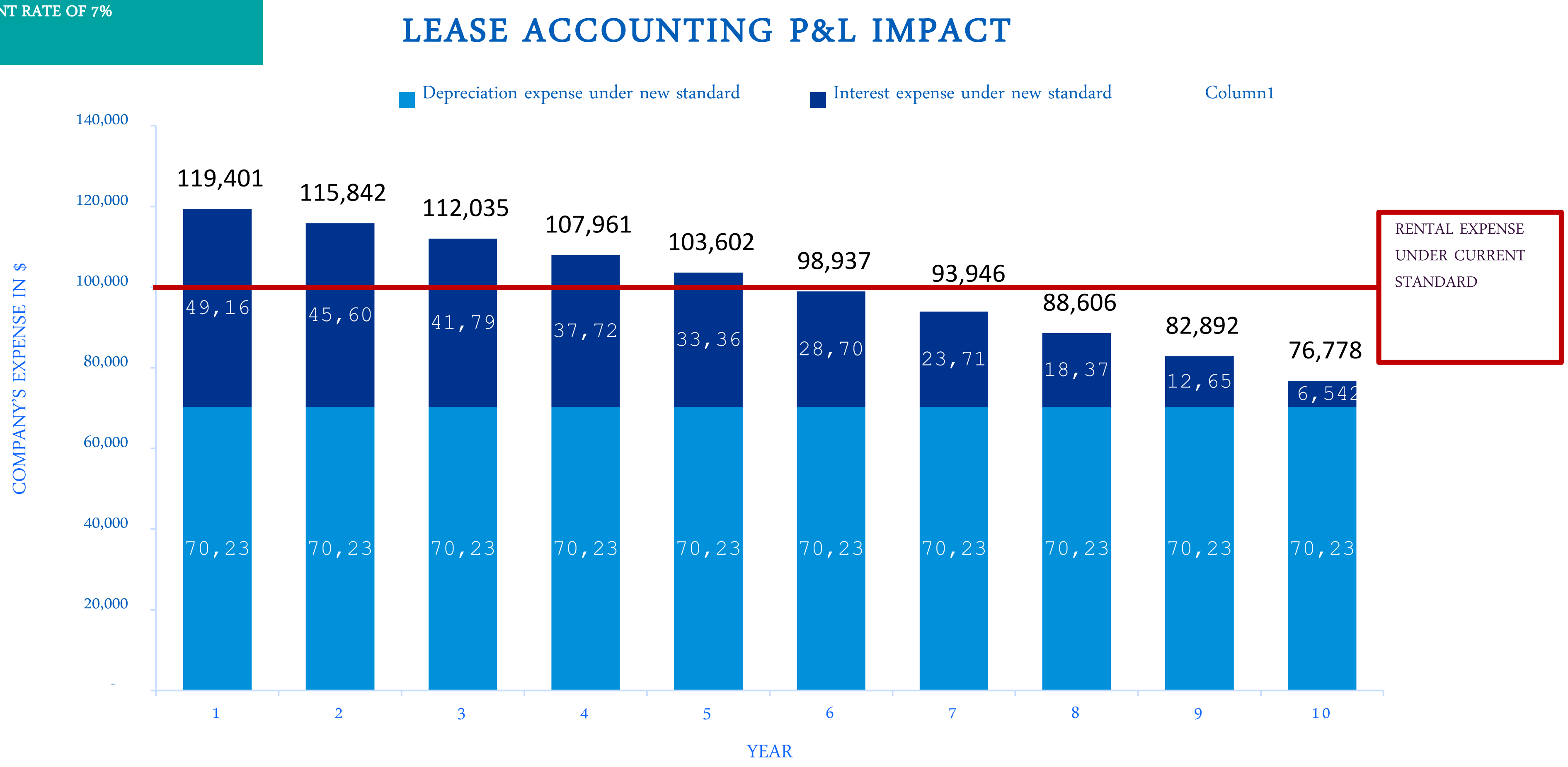
Journal entries

1 January 20X1	Debit (CU)	Credit (CU)
ROU asset (present value of 5 x CU1,000,000 @ 7%)	4,100,000	
Lease liability		4,100,000
31 December 20X1		
Depreciation expense (CU4,100,000/5)	820,000	
ROU asset		820,000
Interest expense (CU4,100,000 * 7%)	287,000	
Total P&L expense	**1,107,000**	
Lease liability	713,000	
Cash		1,000,000

Impact on P&L – IFRS 16 vs IAS 17

ASSUMPTIONS:

1. 10 YEAR LEASE
2. RENT OF $100,000 PER ANNUM
3. DISCOUNT RATE OF 7%



Computation – Right of use

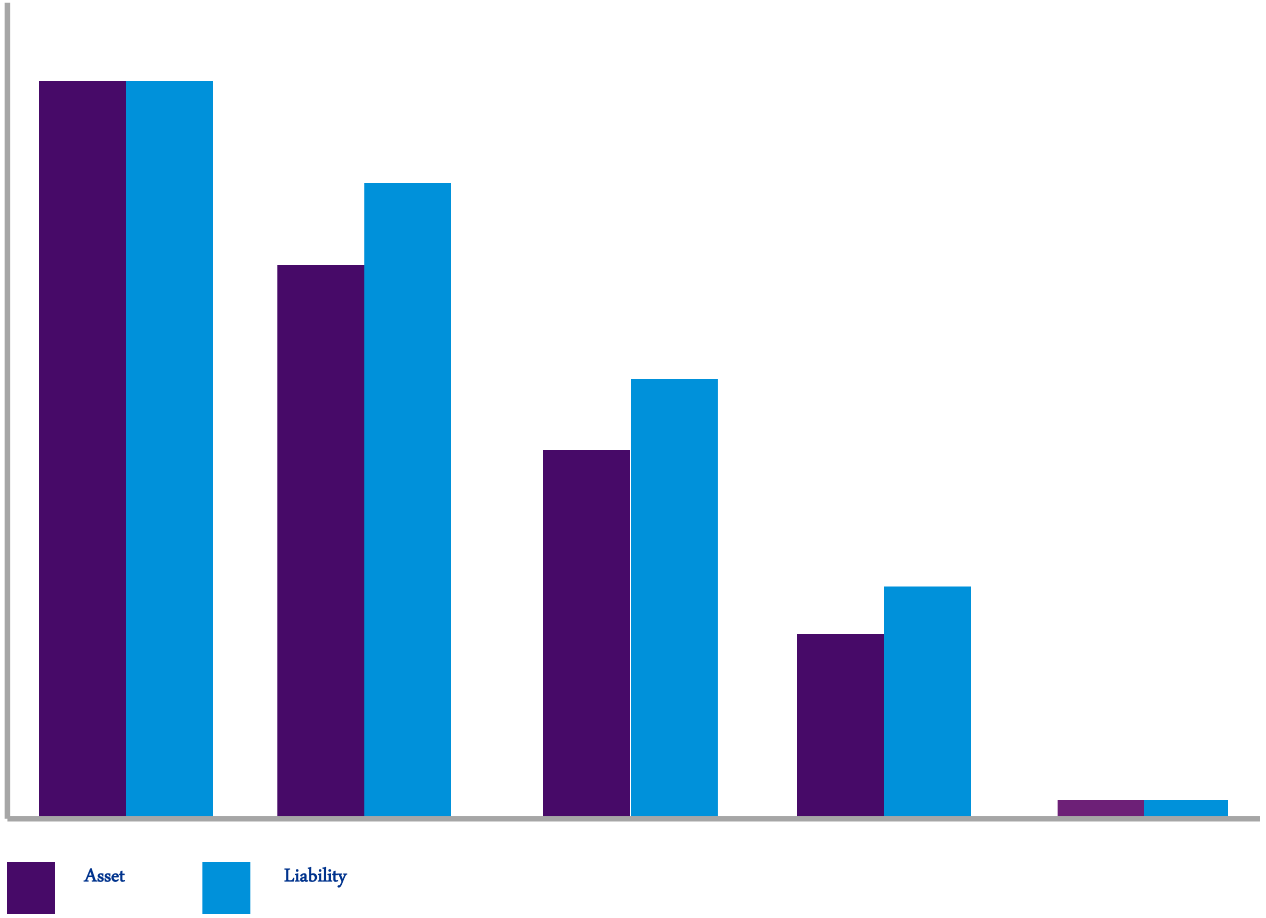
	Balance at beginning of the year	Interest	Payment	Balance at end of the year
T0	$702,358	$0	$0	$702,358
T1	$702,358	$49,165	$100,000	$651,523
T2	$651,523	$45,607	$100,000	$597,130
T3	$597,130	$41,799	$100,000	$538,929
T4	$538,929	$37,725	$100,000	$476,654
T5	$476,654	$33,366	$100,000	$410,020
T6	$410,020	$28,701	$100,000	$338,721
T7	$338,721	$23,710	$100,000	$262,432
T8	$262,432	$18,370	$100,000	$180,802
T9	$180,802	$12,656	$100,000	$93,458
T10	$93,458	$6,542	$100,000	($0)

Presentation

Balance sheet under current IAS 17	Inception	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Assets		-	-	-	-	-	-	-	-	-	-
Liabilities		-	-	-	-	-	-	-	-	-	-
Balance sheet under IFRS 16											
Right of use asset	$702,358	$632,122	$561,887	$491,651	$421,415	$351,179	$280,943	$210,707	$140,472	$70,236	$0
Lease liability	($702,358)	($651,523)	($597,130)	($538,929)	($476,654)	($410,020)	($338,721)	($262,432)	($180,802)	($93,458)	$0
Net equity	$0	($19,401)	($35,243)	($47,278)	($55,239)	($58,841)	($57,778)	($51,724)	($40,330)	($23,222)	$0
		Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Income statement under IAS 17											
Operating lease expense		100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Income statement under IFRS 16											
Amortisation expense		$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236
Interest expense		$49,165	$45,607	$41,799	$37,725	$33,366	$28,701	$23,710	$18,370	$12,656	$6,542
Total expense		$119,401	$115,842	$112,035	$107,961	$103,602	$98,937	$93,946	$88,606	$82,892	$76,778
Difference		(19,401)	(15,842)	(12,035)	(7,961)	(3,602)	1,063	6,054	11,394	17,108	23,222

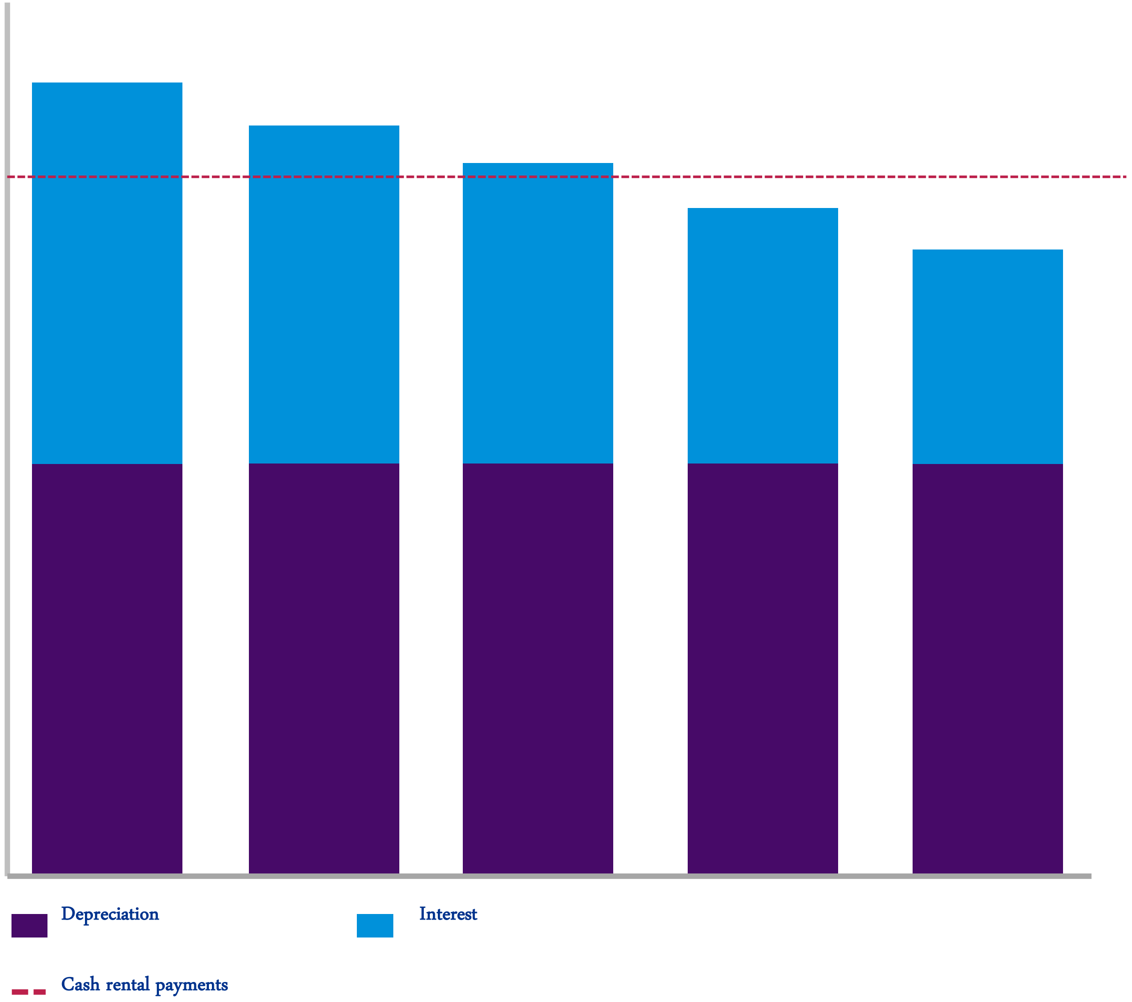
Impact on balance sheet

Companies with operating leases will appear to be more **asset-rich,** but also more **heavily indebted**



Impact on profit/loss

Total lease expense will be **front-loaded** even when cash rentals are constant



Impact on financial ratios

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

Key impacts

Identifying all lease agreements and extracting lease data

New estimates and judgments

Balance sheet volatility

Changes in financial metrics

Communication with stakeholders will require careful consideration

Some impacts cannot yet be quantified

Transition considerations

Changes in contract terms and business practices

New systems and processes

Industry impacts in the UAE

All industries, but especially:

Airlines

Banks

Retail

Schools

Power and Utilities

Shipping & logistics

The critical definition

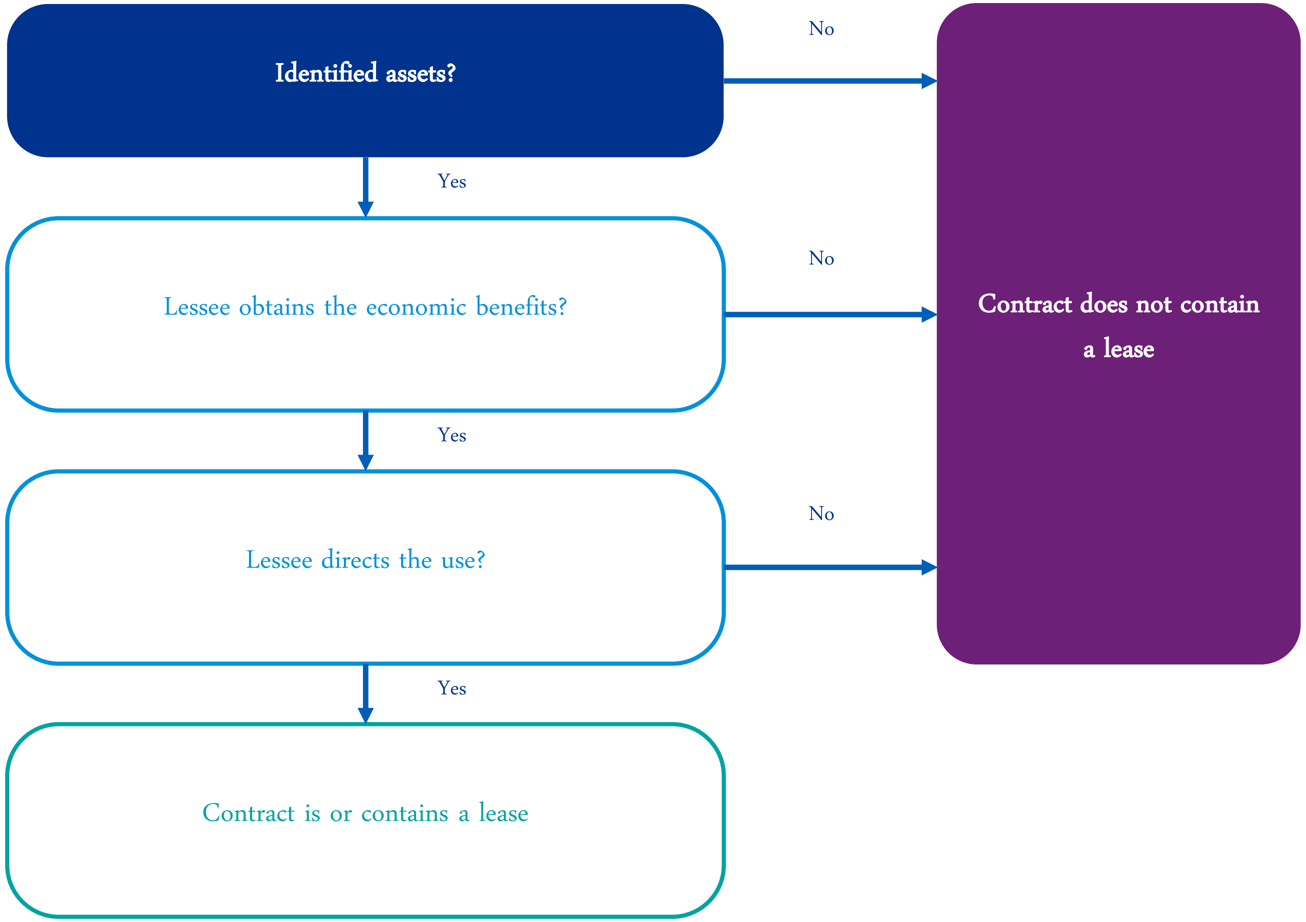
Lease definition [1/2]

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

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

Lease definition [2/2]

A contract is, or contains, a lease if the contract conveys the right to control the use of an identified **asset**



Lease definition – Control

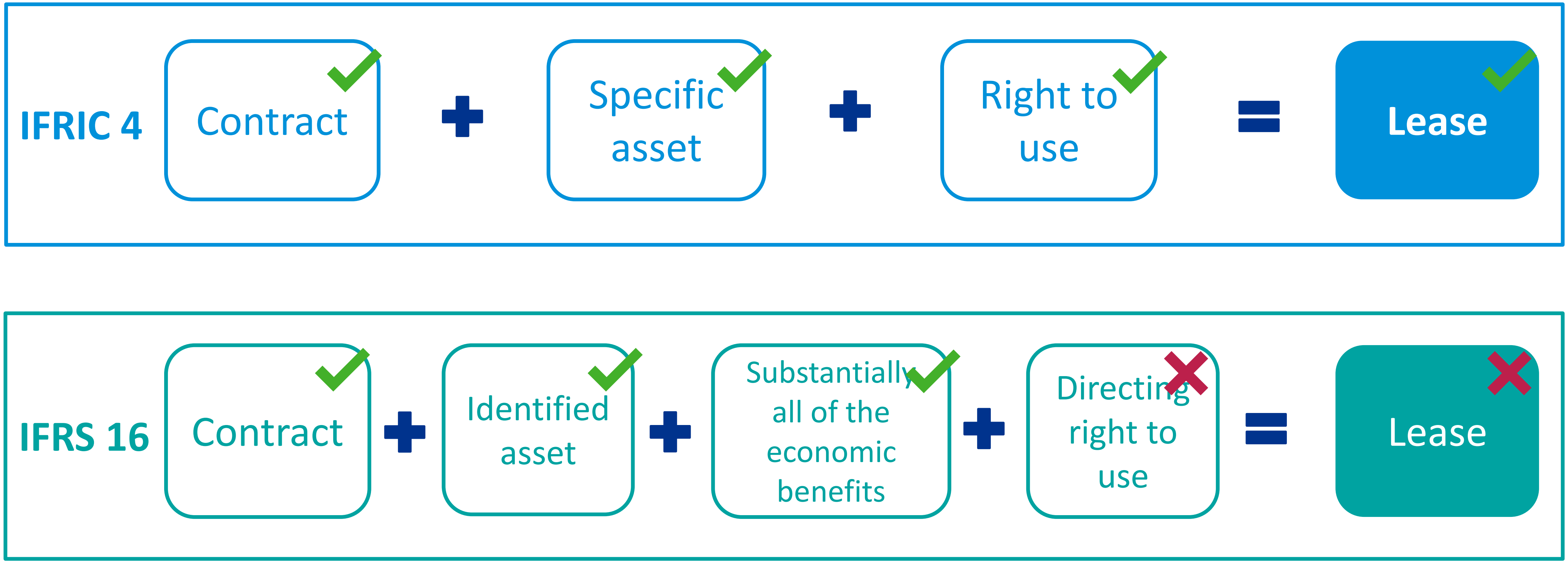
Expect changes in definition from current practice

The new definition increases focus on **who controls the asset** and may change which contracts are leases

Lease

Not a lease

Example: Supply contract solution



 22

Comparing IFRS 16 and IFRIC 4

IFRIC 4

IFRS 16

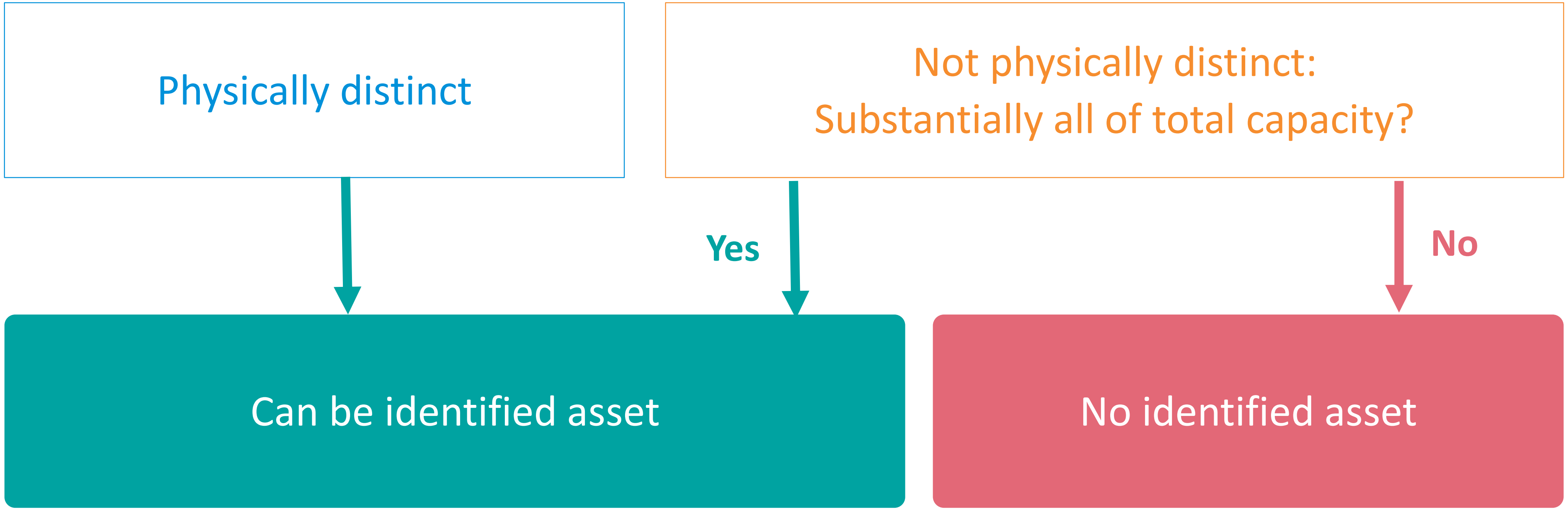
Contract

Asset

Operating asset or controlling access &
> insignificant amount of output
or
substantially all of the output and specific pricing

Substantially all of the economic benefits &
directing the right of use

Capacity portions



Lease definition – Identified assets

Identified assets?

Explicitly specified

or

Implicitly specified

However…

Lessor has practical ability to substitute the asset

and

Lessor benefits economically from substituting the asset

Example

- Kiosk space in a Mall
- Leasing of fiber optic cable
- Reservation of bus seat
- Key tenant

Example - Substantive substitution rights

- Company [illegible], a lessee enters into a five year contract with a freight carrier (Lessor M) to transport a specified quantity of goods.
- M uses rail cars of a particular specification, and has a large pool of similar rail cars that can be used to fulfil the requirements of the contract.
- The rail cars and engines are stored at M's premises when they are not being used to transport goods. Costs associated with substituting the rail cars are minimal for M.

Is there a specific asset?

Are the substitution rights substantive?

- In this case because the rail cars are stored at M's premises, it has a large pool of similar rail cars and substitution costs are minimal, the benefits to M of substituting the rail car would exceed the costs of substituting the cars. Therefore, M's substitution rights are substantive and the arrangement does not contain a lease.

How could this transaction be a lease?

Lease definition – Economic benefits

A company assesses whether it has the rights to:

Identified assets?

Lessee obtains the economic benefits?

Lessee directs the use?

Contract is or contains a lease

obtain substantially all of the economic benefits from use of the identified asset throughout the period of use

and

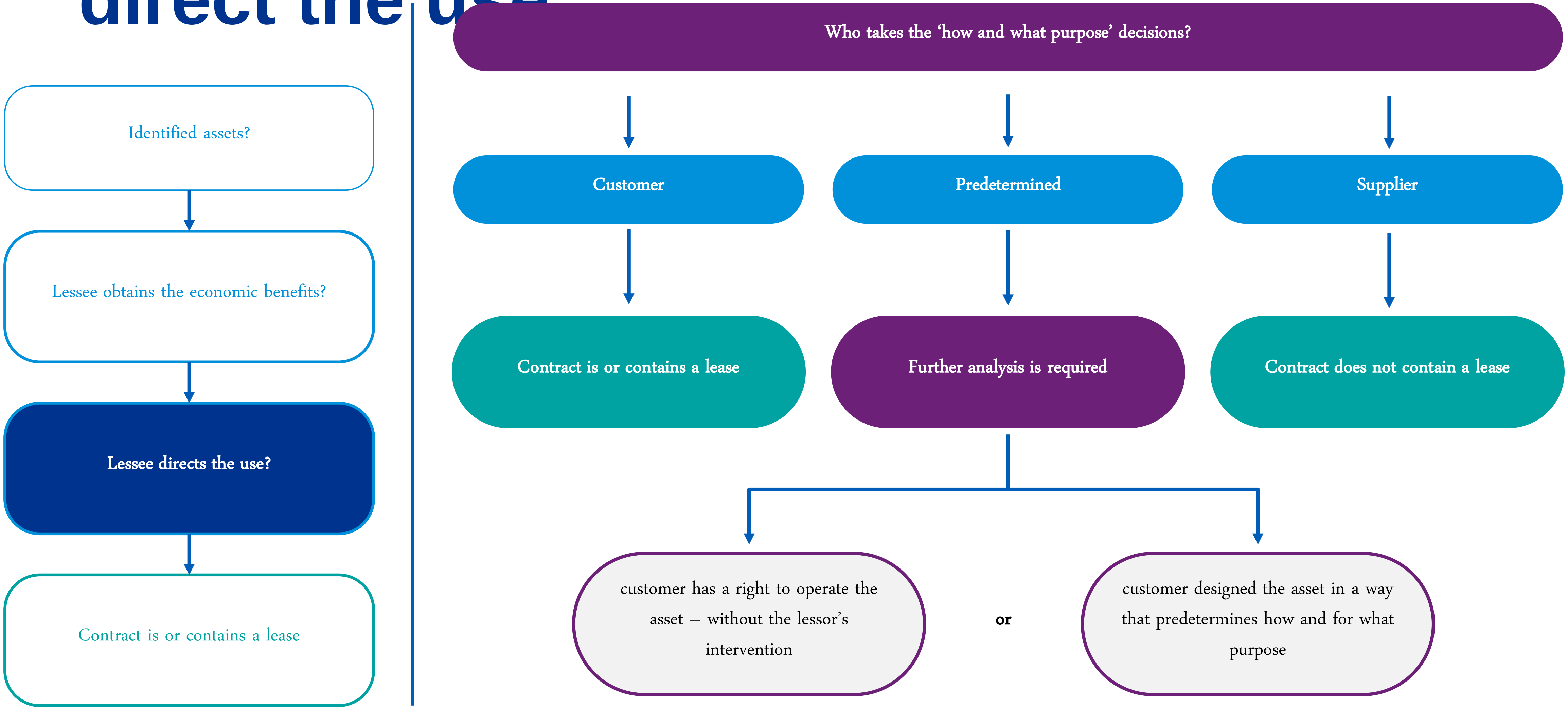
direct the use of the identified asset

'economic benefits' = Primary output, by products and other economic benefits that could be realized commercially

Economic benefits

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

Lease definition – Right to direct the use



Example - Right to direct the use

- Customer (C) enters into a contract with a manufacturer (M) to purchase a particular type, quality and quantity of shirts for a three-year period. The type, quality and quantity of shirts are specified in the contract.
- M has only one factory that can meet the needs of C. M is unable to supply the shirts from another factory or source the shirts from a third party supplier. The capacity of the factory exceeds the output for which C has contracted (ie C has not contracted for substantially all of the capacity of the factory).
- M makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfil with the output of the factory that is not used to fulfil C’s contract.

Is there an identified asset?

Is there a right of control of the use of the factory?

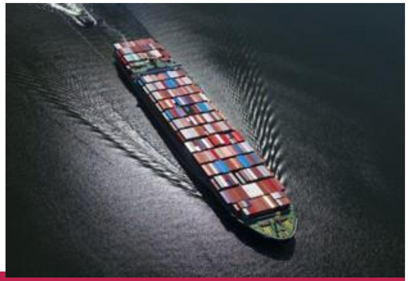
Example - Right to direct the use (cont'd)

- The contract does not contain a lease.
- The factory is an identified asset. The factory is implicitly specified because M can fulfil the contract only through the use of this asset.
- C does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory.
- C also does not control the use of the factory because it does not have the right to direct the use of the factory. C does not have the right to direct how and for what purpose the factory is used during the three-year period of use. C's rights are limited to specifying output from the factory in the contract with M. C has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. M has the right to direct the use of the factory because M can decide how and for what purpose the factory is used (ie M has the right to decide the production level at which to run the factory and which customer contracts to fulfil with the output produced).
- Either the fact that C does not have the right to obtain substantially all of the economic benefits from use of the factory, or that C does not have the right to direct the use of the factory, would be sufficient in isolation to conclude that C does not control the use of the factory.

KPMG

Example - Right to direct the use

- R contracts with S, a ship owner, for the transport of cargo from Dubai to Jeddah on an identified ship.
- The contract details the cargo to be transported on the ship and the dates of pick-up and delivery.
- The cargo will occupy substantially all of the capacity of the ship.
- S operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship.
- R is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.



Does R direct the right to use the asset?

- R does not have the right to control the use of the ship because it does not have the right to direct its use.
- How and for what purpose the ship is used – i.e. the journey from Dubai to Jeddah transporting specified cargo – is predetermined in the contract.
- R does not have the right to operate the ship and did not design the ship in a way that predetermined how and for what purpose it would be used.
- R has the same rights regarding the use of the ship as if it were only one of many customers.
- **Therefore, the contract does not contain a lease.**

Example - Right to direct the use

- Customer T enters into a five-year contract with Company U, a ship owner, for the use of an identified ship.
- T decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract.
- These restrictions prevent T from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo.
- U operates and maintains the ship, and is responsible for safe passage.

Does T direct the right to use the asset?

- T has the right to direct the use of the ship.
- The contractual restrictions are protective rights that protect U's investment in the ship and its personnel.
- In the scope of its right of use, T determines how and for what purpose the ship is used throughout the five-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport.
- T has the right to change these decisions throughout the period of use.
- **Therefore, the contract contains a lease.**

Example - Protective rights

- Lessee L enters into a two-year contract with Lessor M, an aircraft owner, for the use of an identified aircraft.
- The contract details the interior and exterior specifications for the aircraft. There are contractual and legal restrictions in the contract on where the aircraft can fly.
- Subject to these restrictions, L determines where and when the aircraft will fly, and which passengers and cargo will be transported on the aircraft. M is responsible for operating the aircraft, using its own crew.

Does L direct the right to use the asset?

- The restrictions on where the aircraft can fly define the scope of L's right to use the aircraft. In the scope of its right of use, L determines how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where and when the aircraft travels, as well as the passengers and cargo that it will transport.
- L has the right to change these decisions throughout the period of use.
- The contractual and legal restrictions on where the aircraft can fly are protective rights and do not prevent L from having the right to direct the use of the asset.

Lease definition – Exemptions

Two major optional exemptions make the standard easier to apply

Short term leases

≤ 12 months

Election by class of assets

Leases of low value items

≤ USD 5,000 (suggested)

Election on lease by lease basis

When exemption is applied, recognize the expense on a straight line basis over the lease term.

Example – Exemption

- Lessee L enters into a 10-year lease of a machine to be used in manufacturing parts for a plane that it expects to remain popular with consumers until it completes development and testing of an improved model.
- The cost to install the machine in L's manufacturing facility is not significant. L and Lessor M each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date.

Short-term lease exemption applicable?

- The lease term consists of a one-year non-cancellable period because both L and M have a substantive termination right – both can terminate the lease without penalty – and the cost to install the machine in L's manufacturing facility is not significant.
- As a result, the lease qualifies for the short-term lease exemption.

Example – Exemption

Lessee B is in the pharmaceutical manufacturing and distribution industry and has the following leases:

- leases of real estate: both office building and warehouse;
- leases of office furniture;
- leases of company cars, both for sales personnel and for senior management and of varying quality, specification and value;
- leases of trucks and vans used for delivery; and
- leases of IT equipment such as laptops.

Is low value lease exemption applicable?

- B determines that the leases of office furniture and laptops qualify for the recognition exemption on the basis that the underlying assets, when they are new, are individually of low value.
- B elects to apply the exemption to these leases. As a result, it applies the recognition and measurement requirements in IFRS 16 to its leases of real estate, company cars, trucks and vans.

Lease and non-lease components [1/3]

If a contract is, or contains, a lease, then the company accounts for each separate lease component, separately from non-lease components.

Step1: Identify the components

Step 2: Account for the components

Lease and non-lease components

Step1: Identify the components

A company considers the right to use an underlying asset as a separate lease component if it meets the following criteria:

Can the customer benefit from the using the underlying asset either on its own or together with other resources that are readily available?

+

Is the asset neither highly dependent on, nor highly inter-related with, the other assets in the contract?

Yes → **Separate components**

No → **Combine components**

Lease and non-lease components

Step 2: Account for the components

<table>
<tr><th></th><th>Lessee</th><th>Lessor</th></tr>
<tr><td>Observable stand-alone price for each component</td><td>Unless practical expedient is elected, separate and allocate based on the relative stand-alone price</td><td rowspan="2">Always separate and allocate following the IFRS 15 approach</td></tr>
<tr><td>No observable stand-alone price for some or all components</td><td>Maximize the use of observable information</td></tr>
<tr><td>Taxes, insurance on the property and admin costs</td><td colspan="2">Activities that do not transfer a good or service to the lessee are not components in a contract</td></tr>
<tr><td>Practical expedient</td><td>Combine lease and any associated non-lease components and account for them as lease components</td><td>N/A</td></tr>
</table>

Example - Lease and non lease components

- Lessee L enters into a five-year contract with Lessor M to use an operating oil rig.
- The contract includes maintenance service provided by M and M obtains its own insurance for the oil rig.
- Annual payments are 2,000 (300 relate to maintenance services and 50 to insurance costs).
- L is able to determine that similar maintenance services and insurance costs are offered by third parties for 400 and 50 a year, respectively.
- L is unable to find an observable stand-alone rental amount for a similar oil rig because none is leased without related maintenance services provided by the lessor.

Can you identify lease and non lease components?

In this case:

- the observable stand-alone price for the maintenance services is 400;
- there is no observable stand-alone price for the lease; and
- the insurance cost does not transfer a good or service to the lessee and therefor is not a separate lease component.

Therefore, L allocates 1,600 (2,000 – 400) to the lease component.

Lessee accounting

Lessee accounting

Balance sheet

Asset

= 'Right-of-use' of underlying asset

Liability

= Obligation to make lease payments

P&L

Lease expense

Depreciation

+ Interest

= Front-loaded total lease expense

Measuring the lease liability

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

Key inputs

- Lease term
- Lease payments
- Discount rate

Initial measurement – Lease liability

PV of lease payments over the lease term – includes:

- Fixed payments
- Residual value guarantees
- Term option penalties
- Purchase options
- Some variable lease payments

Discount rate

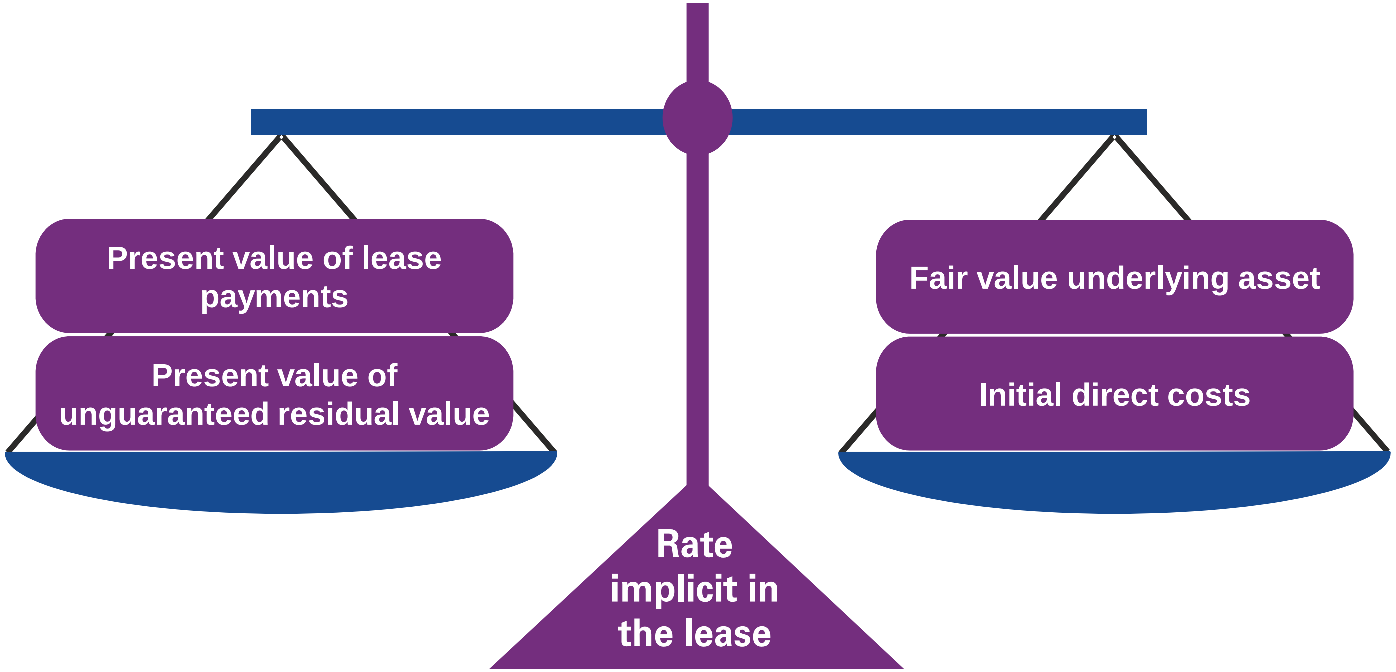
Discount rate

The rate implicit in the lease, if readily available	OR	The lessee's incremental borrowing rate

"Why is the discount rate important?"

Discount rate	Lease liability (5 year lease @ CU10,000 per annum)
3%	CU46,000
5%	CU43,000
7%	CU41,000
10%	CU38,000

Discount rate – rate implicit in the lease



Lease term – example

Five year lease of a machine

CU10,000 annually at 31 Dec (current market rate)

Option to ***terminate*** after 12 months for significant penalty

Option to ***renew*** for two further periods of 5 years, each at market rate

Lessee uses the machine to manufacture car parts, which it must supply for 10 years

Significant installation cost

“Why is the lease term important?”

Lease term?	Lease liability*
1 year	CU9,000
5 years	CU41,000
10 years	CU70,000
15 years	CU91,000

* Based on 7% discount rate

Lease term [1/2]

Non-cancellable period

+

Optional renewal periods if lessee **reasonably certain** to exercise

+

Periods after optional termination date if lessee **reasonably certain not** to exercise

=

Lease Term

Lease term [2/2]

Consider economic factors in estimating lease term

Contractual / Market

- Level of rentals in any secondary period compared to market rates
- Contingent payments
- Renewal and purchase options
- Costs relating to the termination of the lease and the signing of a new replacement lease
- Returning costs of the underlying asset

Asset

- Nature of item (specialised)
- Location
- Availability of suitable alternatives
- Existence of significant leasehold improvements

Lease term – example

Five year lease of a machine

CU10,000 annually at 31 Dec (current market rate)

Option to ***terminate*** after 12 months for significant penalty

Option to ***renew*** for two further periods of 5 years, each at market rate

Lessee uses the machine to manufacture car parts, which it must supply for 10 years

Significant installation cost

Incentive to terminate / renew the lease?

Lease payments – example

15 year lease of a wind farm

Usage payments for expected case of CU1,000,000 per annum

Usage payments for extreme low case of CU700,000 per annum*

Maintenance costs of CU10,000 per annum

Restoration costs of CU100,000 at end of lease

*based on 20 years of climate data: wind has never blown at less than 70% of the wind farm’s capacity.

Variable lease payments

Which variable lease payments are included in the lease liability?

Payments based on an index or rate

Payments based on turnover or usage

Example - Variable payments

Company X leases a store. The lease payments for the store amount to 1% of the store's revenues. There is no minimum rental payment.

Which payments are to be included in the lease liability?

- Lease contains only variable lease payments that do not depend on an index or rate
- Therefore, X measures the lease liability at the commencement of the lease as zero.

Example - Variable payments

- Company Y rents an office building.
- The initial annual rental payment is 2,500,000 and the rent will be reviewed every year and increased by the change in the consumer price index (CPI).

Which payments are to be included in the lease liability?

- This is an example of a variable lease payment that depends on an index.
- The initial measurement of the lease liability is based on the value of CPI on lease commencement - i.e. Y assumes an annual rental of 2,500,000.
- If during the first year of the lease CPI increases by 5%, then at the end of the first year the lease liability is recalculated assuming future annual rentals of 2,625,000 (i.e. 2,500,000 * 1.05).

Example - Residual value guarantees

- Lessee Z has entered into a lease contract with Lessor L to lease a car. The lease term is five years.
- In addition, Z and L agree on a residual value guarantee – if the fair value of the car at the end of the lease term is below 400, then Z will pay to L an amount equal to the difference between 400 and the fair value of the car.

Which payments are to be included in the lease liability?

- At the inception of the lease, Z expects that the fair value of the car at the end of the lease term will be 400.
- Z therefore includes an amount of zero in the lease payments when calculating its lease liability.

Subsequent measurement

Lease liability

Amortised cost using effective interest method

Remeasure to reflect changes in lease payments

Right of use asset

Generally, cost less accumulated depreciation and impairment losses

Adjusted for the remeasurement of lease liability

Alternative measurement basis for right of use asset:

- Fair value in accordance with IAS 40
- Revaluation model under IAS 16

Initial measurement – ROU asset

ROU asset is initially measured as the sum of:

PV of lease payments + Initial direct costs + Prepaid lease payments

Lessee also adjusts the ROU asset for lease incentives

IFRS 16 does not specify whether the ROU asset is tangible or intangible

Subsequent measurement – ROU asset

Amortise over shorter of lease term or economic life, generally on a straight-line basis

Results in front loading of total lease expense

(amortisation expense on ROU asset + interest expense on lease liability)

ROU asset is subject to impairment testing under IAS 36 impairment

IAS 40 applied if the leased property is investment property

IAS 16 depreciation requirements apply including componentisation

Impairment – ROU asset

ROU asset tested is for impairment in accordance with IAS 36. Amortisation following an impairment as follows:

Continue amortising ROU asset pre-impairment basis

At a minimum, must recognise expense from unwinding of the discount

The impairment test replaces the need to test for an onerous contract

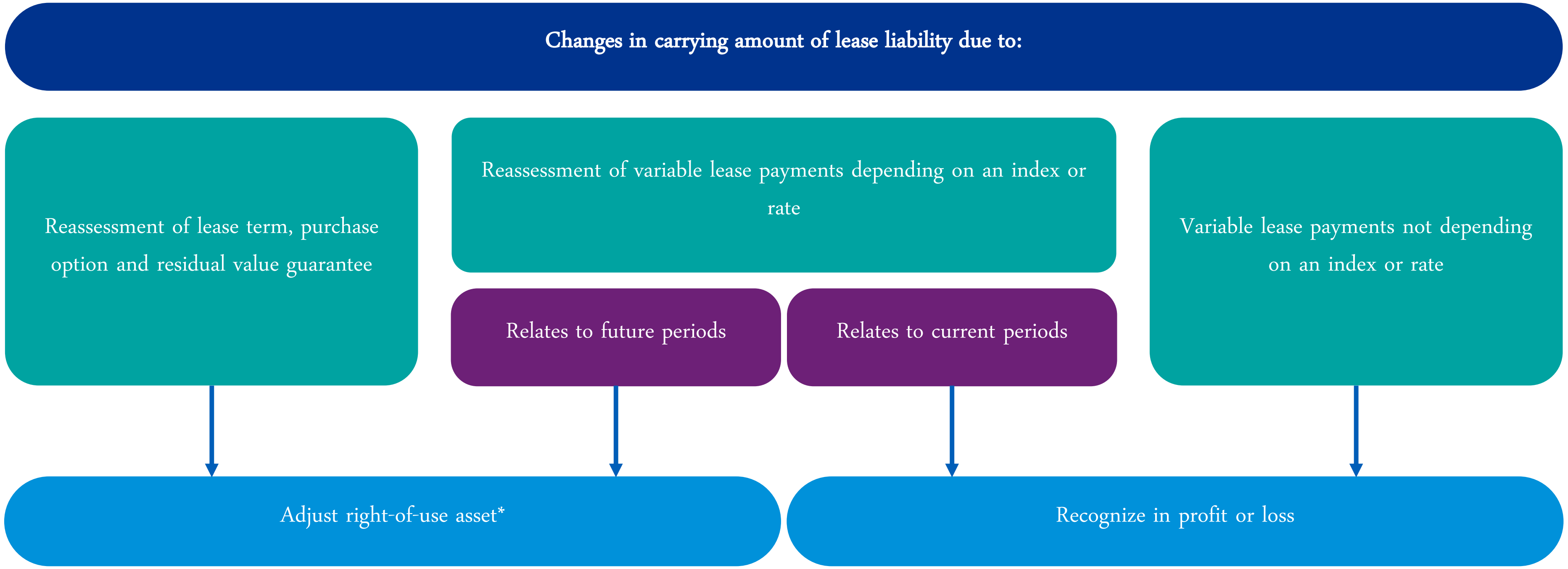
Example - Impairment

- Lessee Y leases a machine for its manufacturing process over a non-cancellable 10-year period.
- The initial carrying amount of the right-of-use asset is 1,000, which is subsequently measured at cost and depreciated on a straight-line basis over a period of 10 years.
- At the end of year 5, the cash-generating unit that includes the right-of use asset is impaired.
- An impairment charge of 200 is allocated to the right-of-use asset.

What will be the carrying amount of the right of use assets ?

- Immediately before the impairment, the carrying amount of the right-of-use asset is 500.
- Following the impairment, the carrying amount is reduced to 300 and the future depreciation charges are reduced to 60 (300/5) per year.

Subsequent measurement



**If the carrying amount of the right-of-use asset is reduced to nil, then any further reductions are recognized in profit or loss*

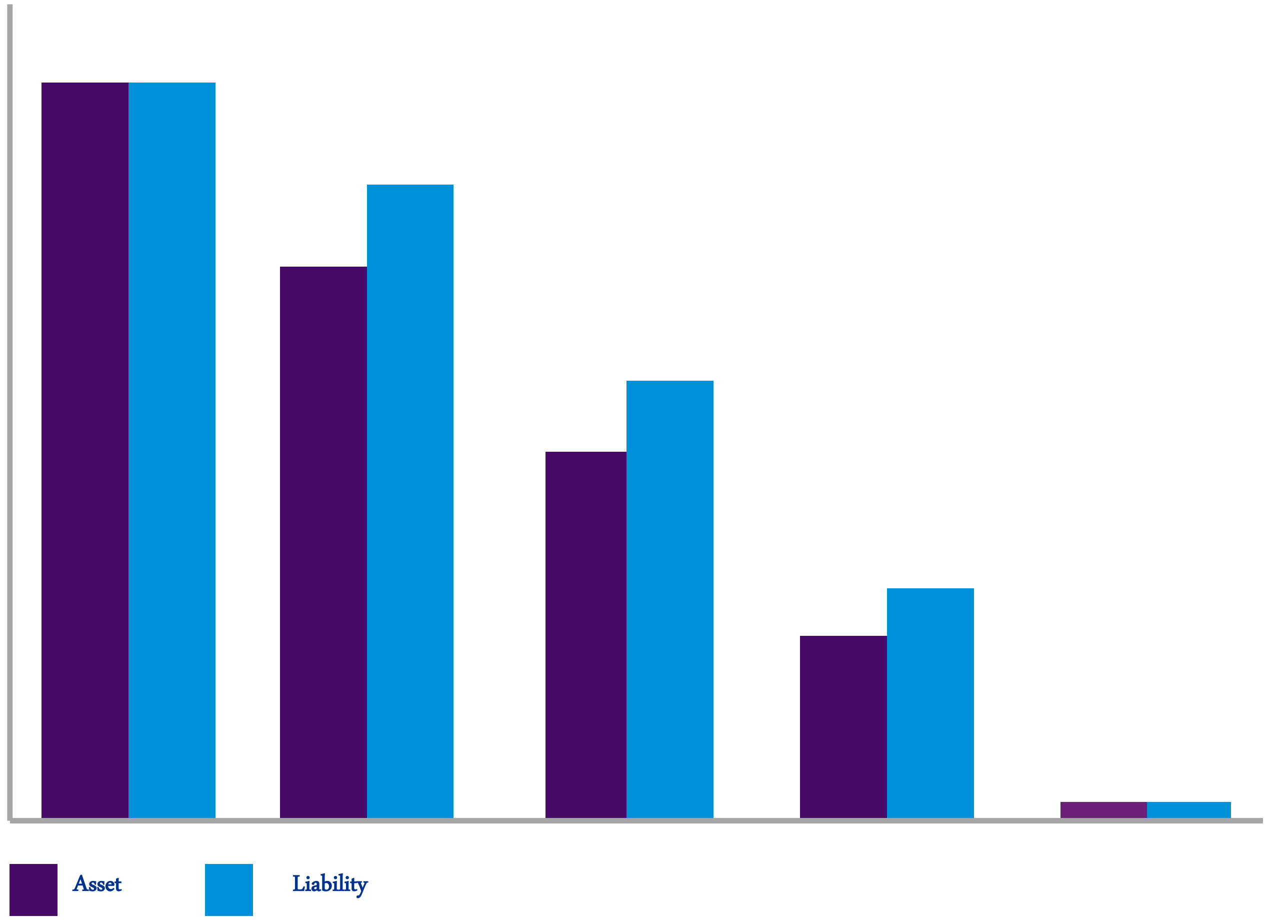
Presentation

Lessees present leases in their financial statements as follows:

Statement of financial position	Statement of profit or loss and other comprehensive income	Statement of cash flows
Right-of-use asset Separate presentation in the statement of financial position or disclosure in the notes to the financial statements **Lease liability** Separate presentation in the statement of financial position or disclosure in the notes	**Lease expenses** Separate presentation of interest expense on the lease liability from depreciation of the right-of-use asset Presentation of interest expenses as a component of finance costs	**Operating activities** Variable lease payments not included in the lease liability Payments for short-term and low-value leases (subject to use of recognition exemption) **Financing activities** Cash payments for principal portion of lease liability **Depending on 'general' allocation** Cash payments for the interest portion are classified in accordance with other interest paid

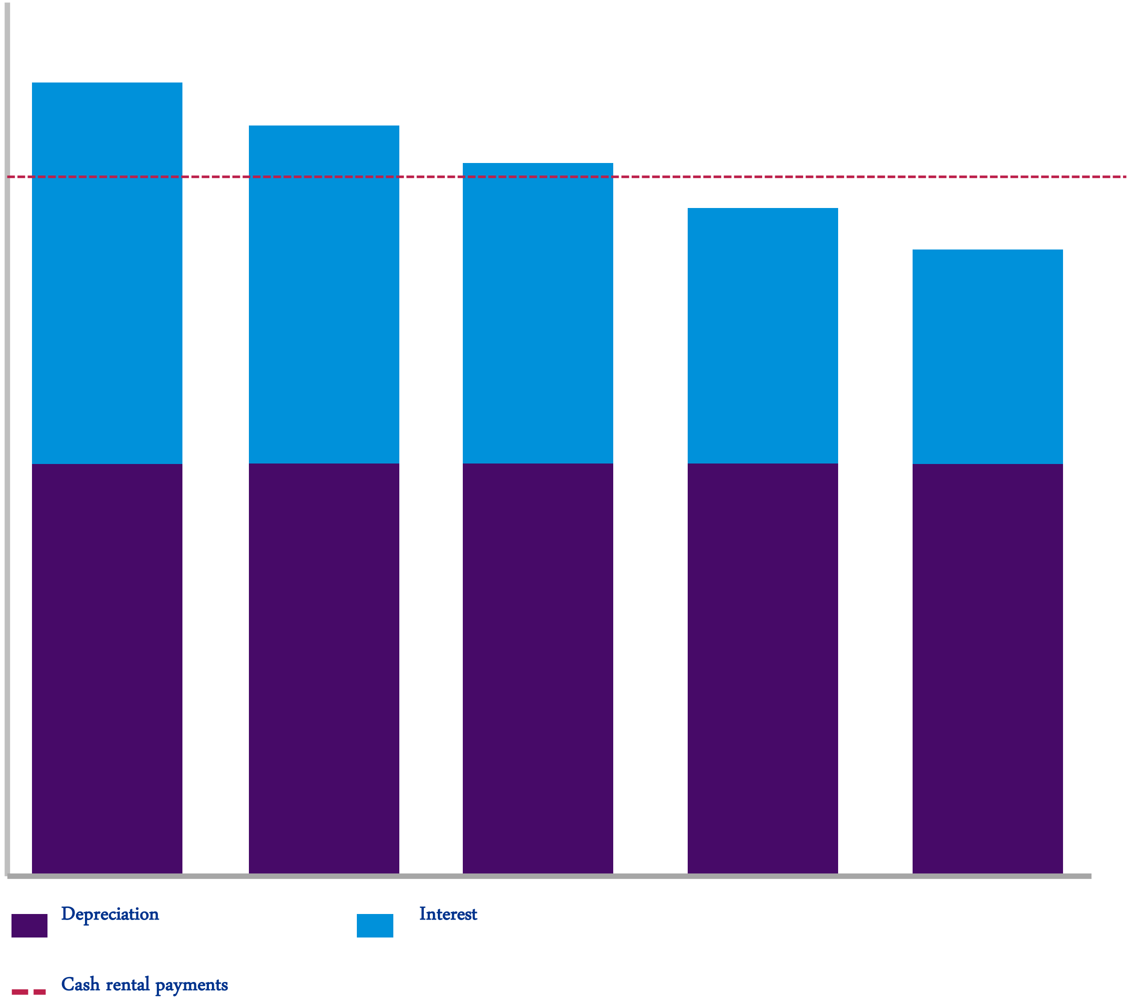
Impact on balance sheet

Companies with operating leases will appear to be more **asset-rich**, but also more **heavily indebted**



Impact on profit/loss

Total lease expense will be **front-loaded** even when cash rentals are constant



Lessor accounting

Lessor accounting

Same as IAS 17

- Lease classification test.
- Finance lease model.
- Operating lease model.

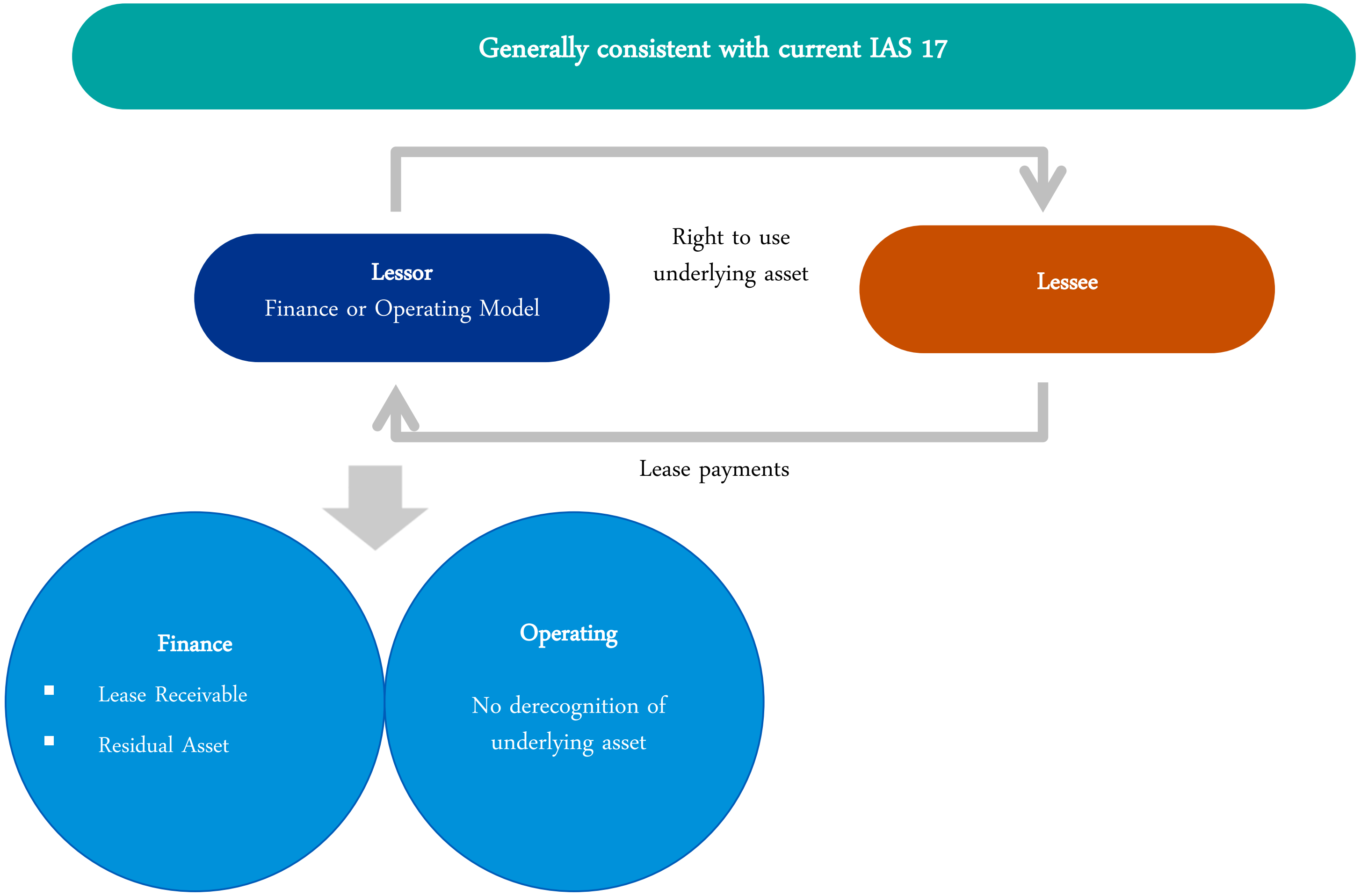
Different to IAS 17

- Definition of a lease.
- Sale-and-leaseback guidance.
- Sub-lease guidance.
- Accounting for lease modifications.
- Disclosure requirements.

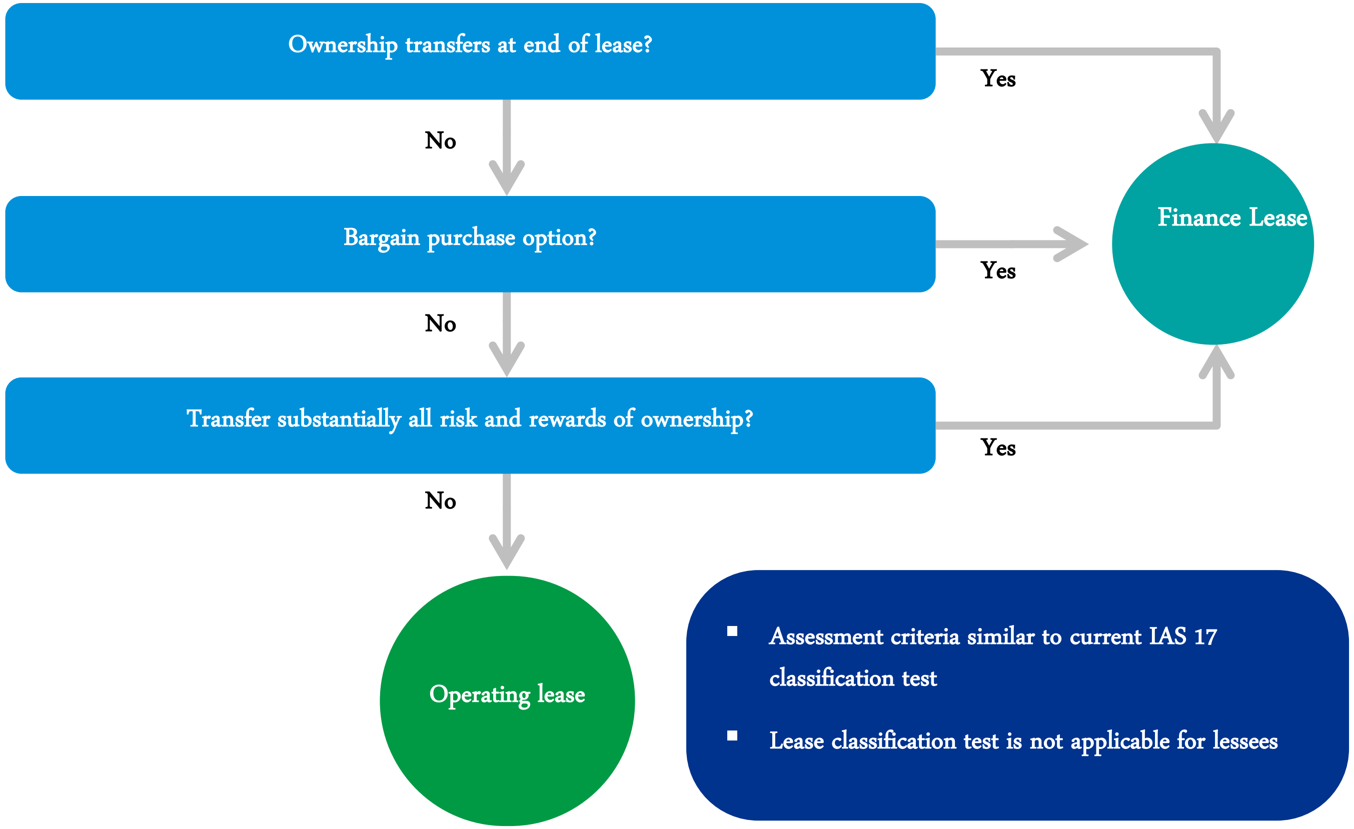
No symmetry between lessee and lessor accounting!

68

Lessor accounting [2/2]



Lessor lease classification test



Lessor accounting [1/2]

Finance lease

Balance sheet

- Derecognize the underlying asset
- Recognize a finance lease receivable

P&L

- Recognize finance income

In addition, manufacturer or dealer lessors recognize for finance leases:

- revenue based on the lower of the fair value of the underlying asset and the present value of the lease payments
- cost of sales based on cost or carrying amount of the underlying asset, less the present value of any unguaranteed residual value
- costs incurred in connection with obtaining the lease as an expense

Lessor accounting [2/2]

Operating lease

Balance sheet

- Continue to present the underlying asset
- Add any initial direct costs incurred in connection with obtaining the lease to the carrying amount of the underlying asset

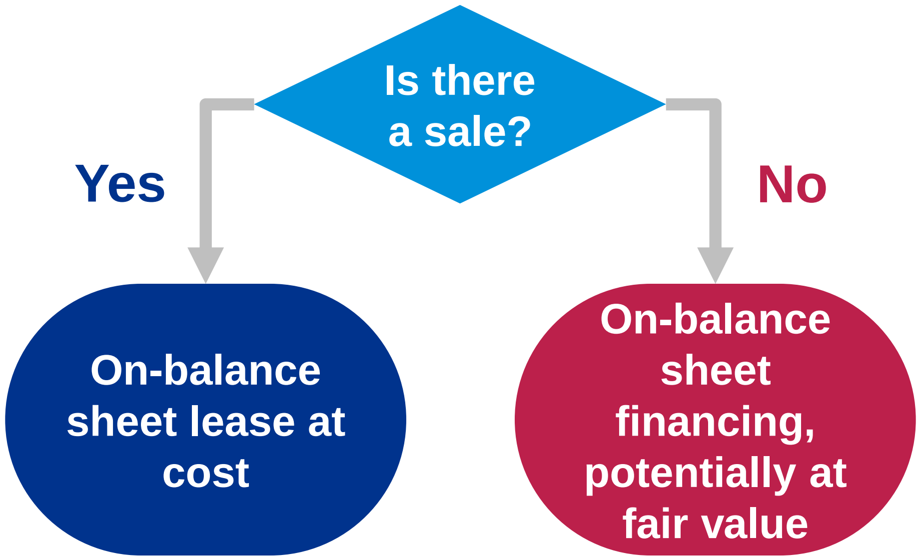
P&L

- Recognize lease income over the lease term, typically on a straight-line basis
- Expense costs related to the underlying asset - e.g. depreciation

Other topics

Sale and leaseback [1/3]

IFRS 16 essentially gets rid of **sale-and-leaseback** as an off-balance sheet financing structure



Sale and leaseback [2/3]

Transfer to buyer-lessor is a sale

Lessee (seller)	Lessor (buyer)
▪ Derecognize the underlying asset and apply the lessee accounting model to the leaseback* ▪ Measure the ROU asset at the retained portion of the previous carrying amount (i.e. at cost)* ▪ Recognize a gain or loss related to the rights transferred to the lessor*	▪ Recognize the underlying asset and apply the lessor accounting model to the leaseback*

* Adjustments are required if the sale is not at fair value or lease payments are off-market.

Sale and leaseback [3/3]

Transfer to buyer-lessor is not a sale

Lessee (seller)	Lessor (buyer)
▪ Continue to recognize the underlying asset ▪ Recognize a financial liability under IFRS 9 for any amount received from the buyer-lessor	▪ Do not recognize the underlying asset ▪ Recognize a financial asset under IFRS 9 for any amount paid to the seller-lessee

* Adjustments are required if the sale is not at fair value or lease payments are off-market.

Sub-leases

The intermediate lessor accounts for the head lease and the sub-lease as two different contracts

Head Lessor

↓

Original lessee / Intermediate lessor

↓

Sub-lessee

The intermediate lessor treats the **right-of-use asset** as the **underlying asset** in the sub-lease, not the item of property, plant or equipment that it leases from the head lessor

Sub-lease

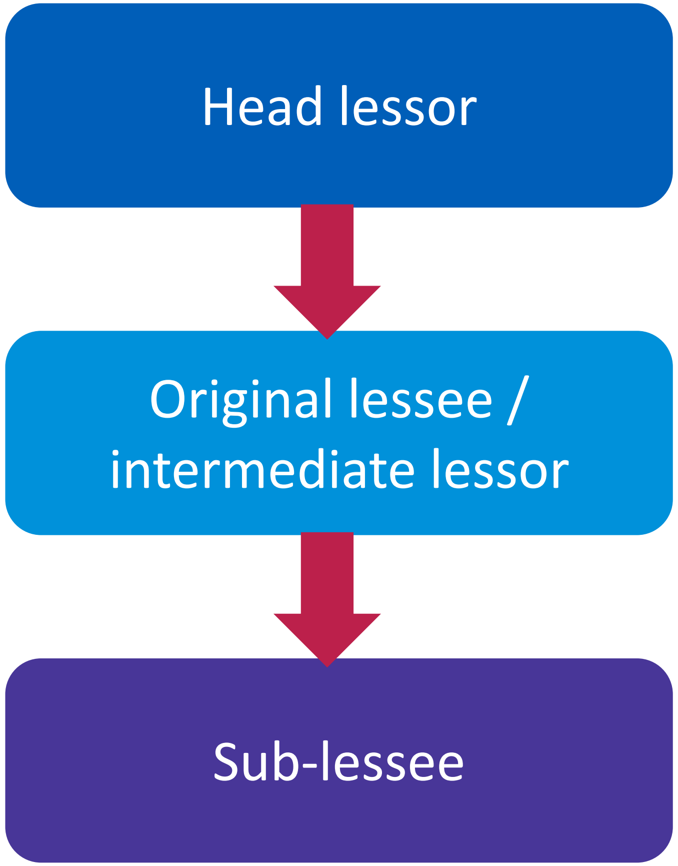
Intermediate lessor:

Accounts for head lease and sublease as two separate contracts.

Classifies the sublease ***based on the ROU asset*** arising from the head lease.

Recognises lease assets and lease liabilities gross – unless offset criteria met.

Recognises lease income and lease expense gross – unless acting as agent.



78

Investment property

A company applies IAS 40 *Investment property* to account for a right-of-use asset if the underlying asset would otherwise meet the definition of investment property

Two key differences in treatment of investment property between IFRS 16 and IAS 17

- The election becomes a requirement
- There is a choice of valuation basis

Disclosures

Disclosures for lessees [1/2]

Normally, a lessee discloses at least the following information.

Quantitative information
Relating to the statement of financial position
▪ Additions to right-of-use assets
▪ Year-end carrying amount of right-of-use assets by class of underlying asset and (if they are not presented separately) the corresponding line items in the statement of financial position
▪ Lease liabilities and the corresponding line items in the statement of financial position if lease liabilities are not presented separately
▪ Maturity analysis for lease liabilities
Relating to the statement of profit or loss and other comprehensive income (including amounts capitalized as part of the cost of another asset)
▪ Depreciation charge for right-of-use assets by class of underlying asset
▪ Interest expense on lease liabilities
▪ Expense relating to short-term leases for which the recognition exemption is applied (leases with a lease term of up to one month can be excluded)
▪ Expense relating to leases of low-value items for which the recognition exemption is applied
▪ Expense relating to variable lease payments not included in lease liabilities
▪ Income from sub-leasing right-of-use assets
▪ Gains or losses arising from sale-and-leaseback transactions

Disclosures for lessees [2/2]

Quantitative information (cont'd)
Relating to the statement of cash flows
▪ Total cash outflow for leases
Other
- Amount of short-term lease commitments if current short-term lease expense is not representative for the following year

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

Additional Disclosure
▪ Disclosures required by IAS 40 for right-of-use assets qualifying as investment property
▪ If the revaluation model of IAS 16 is applied for right-of-use assets, then:
- Effective date of revaluation
- Whether an independent valuer was involved
- Carrying amount that would have been recognized under the cost model
- Revaluation surplus, change for the period and any distribution restrictions

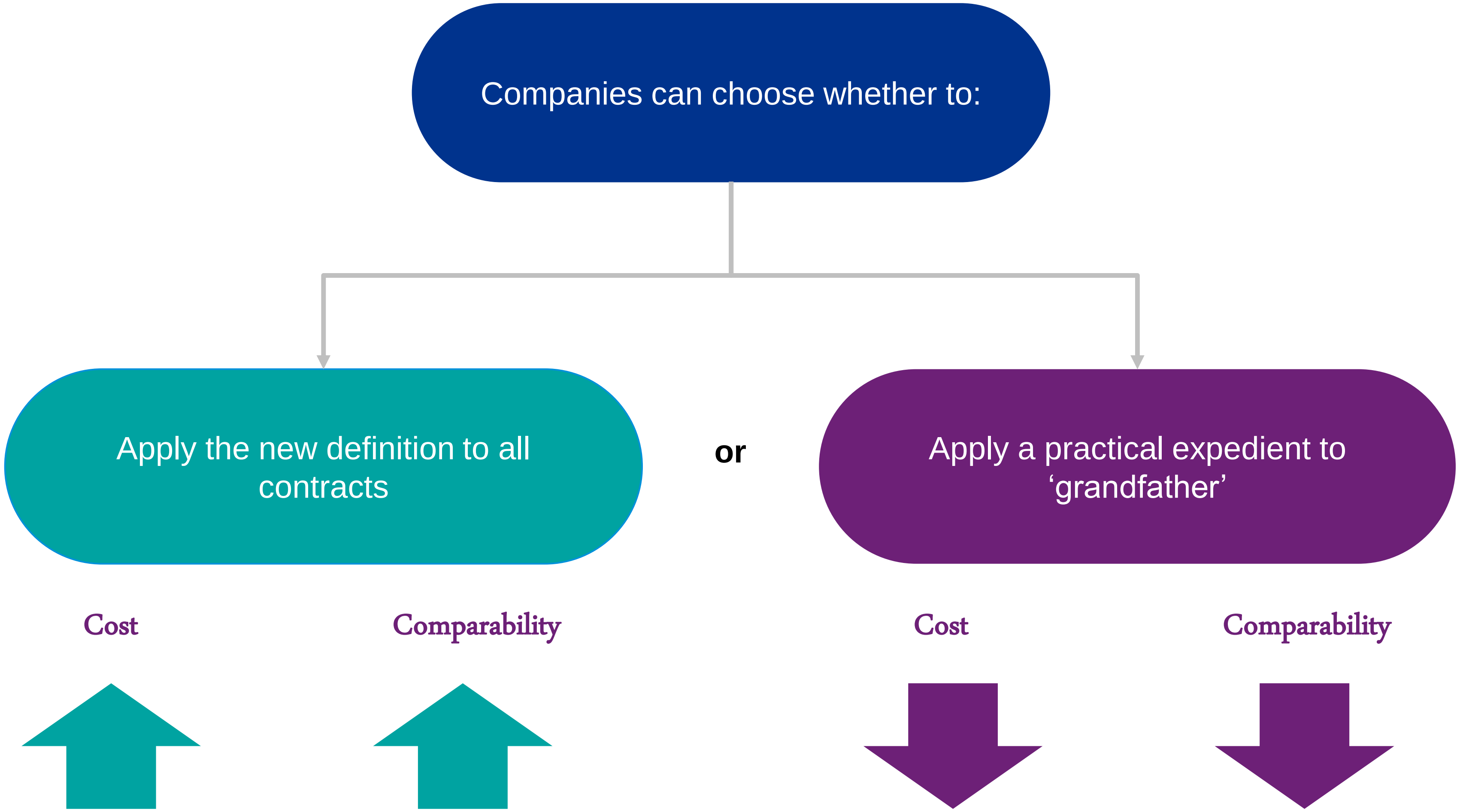
Disclosures for lessors

Normally, a lessor discloses at least the following information.

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

Multiple transition options

Applying the new lease definition



Applying the new standard [1/2]

A lessee is permitted to:

- adopt the standard **retrospectively**; or
- follow a **modified retrospective** approach

Modified retrospective approach

Operating lease

- **ROU asset**
  As if IFRS 16 had always been applied
  OR
  Lease liability
- **Lease liability**
  Present value of remaining lease payments

Finance lease

- **ROU asset**
  Previous carrying amount of finance lease asset
- **ROU asset**
  Previous carrying amount of finance lease liability

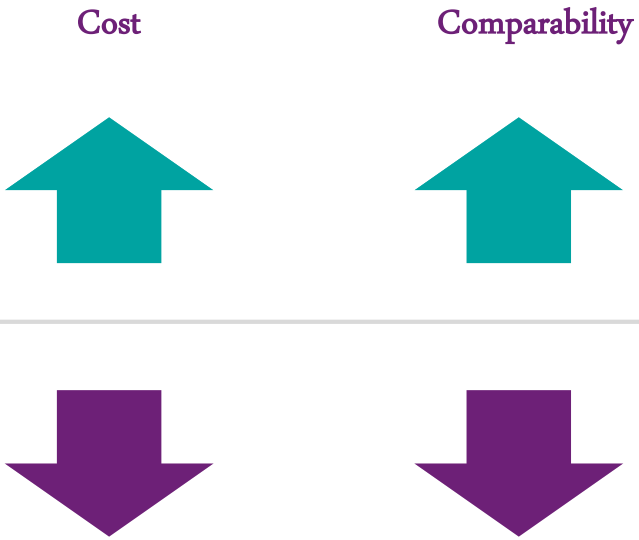
Applying the new standard [2/2]

A lessee can choose to apply the standard…

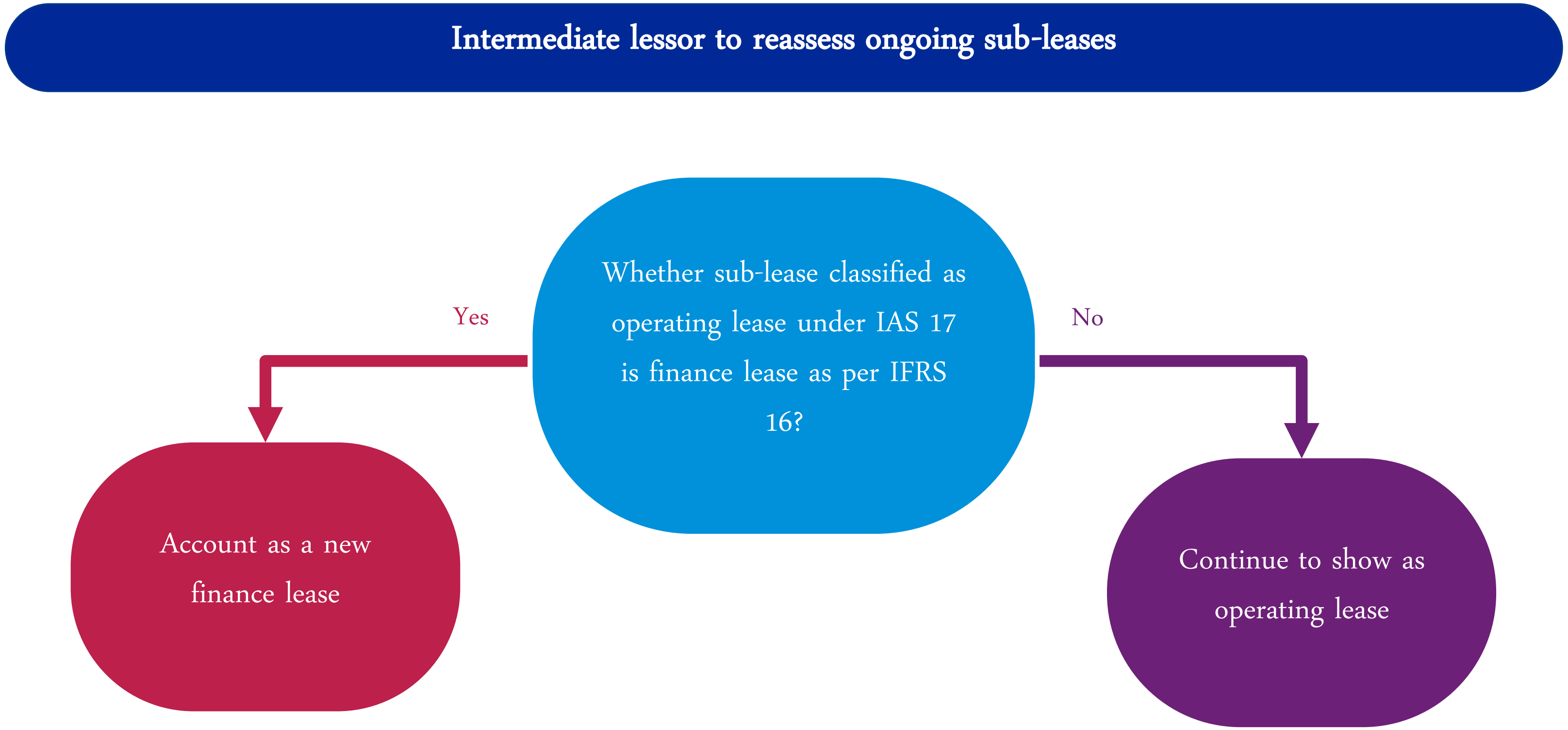
Retrospectively to **all accounting periods**

OR

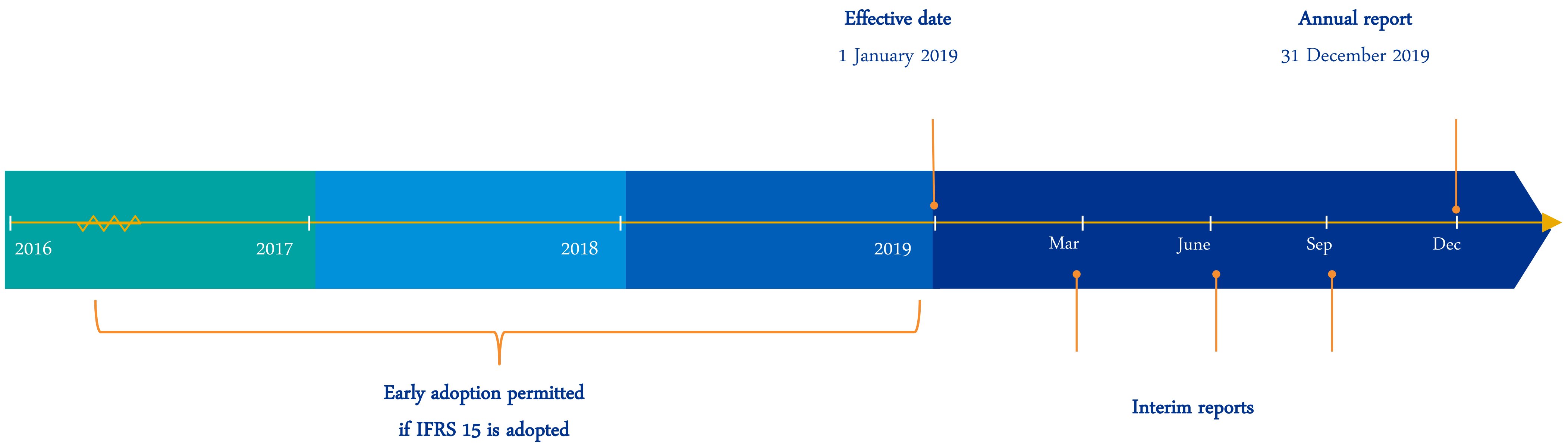
As a ‘big bang’ **at the date of initial application**



Sub-leases on transition



Effective date



IFRS ≠ US GAAP

IFRS vs US GAAP

A joint project but not a joint standard

IFRS and US GAAP standards converged?

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

Next steps

Are you ready for the new standard?

What do you need to do to get ready for 2019? Here are the key questions to help you prepare for implementation:

Lease definition	■ Do you know which of your transactions are, or contain, leases? ■ Will you elect to grandfather the lease definition for existing contracts on transition?
Lease data	■ Do you have a database of all of your assets? ■ Do you have the systems and processes necessary to calculate lease assets and liabilities? ■ Are your current disclosures of operating lease commitments complete and accurate?
Debt covenants	■ Will application of the new standard impact your debt and other covenants?
Sale-and-leaseback transactions	■ Do you understand the impact of the new standard on your sale-and-leaseback transactions?
Financial ratios	■ Do you understand the impact of the new standard on your financial ratios, KPIs, etc? ■ Will optional exemptions, such as those for short-term leases and leases of low-value items, have a material impact on your financial statements?
Transition options	■ Have you thought about how to transition to the new standard?

KPMG

Communications with audit committees

Initial discussion points

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

Next steps

Start impact assessment

Early adoption?

Transition approach?

Disclosure prior to effective date

IAS 8.30 disclosure — known/reasonably estimable possible impact of IFRSs issued but not yet effective.

Considerations

- Pre-adoption disclosures progressing in level of detail as your application date approaches?
- Pre-adoption disclosures meeting external stakeholder expectations?

Next steps – Resources

Reading
First Impressions
Transition options
Sector-specific publications
Go to: http://www.kpmg.com/ifrs http://www.kpmg.com/ae/en/kba/pages/default.aspx http://www.kpmg.com/ae/en/pages/default.aspx

Key points to remember

Key points to remember

New leases standard will impact most companies.

Process of assessing impact should start now.

Other impacts

Restructuring

- Resetting or recalculation of financial covenants in order to not be exposed to an event of default under a loan agreement
- Important to clearly define Accounting Standards in loan agreements (for instance “frozen IFRS”)
- Financing arrangements to achieve off-balance treatment needs to be revisited form a cost/benefit perspective

Tax

- In most cases, operating leases may be tax deductible
- Deferred tax impact may arise similar to any other finance leases

kpmg.com/socialmedia

kpmg.com/app