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SHIPPING AND THE LAW 7[^] Edition
25 - 26 October 2016 NAPLES

**The evolutions of leases'
accounting under IFRS 16**

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Preface

Leasing arrangements address a wide variety of business needs, from short-term asset lease to long-term asset financing. **IFRS 16**, significantly changes the lease accounting model for lessees, and the impact on them may be considerable.

The implementation of IFRS 16 will affect not just the accounting model for new lease contracts in the future, but also entities' business strategy and even the ability to obtain financing.

This presentation is designed to provide you with an overview of IFRS 16, the new standard which sets out the principles for the recognition, measurement, presentation, and disclosure of leases.

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IFRS 16

Overview

Scope of IFRS 16

IFRS 16 is applicable to all leases, including leases of right-of-use assets in a sublease, except for:



Leases to explore for or use **natural resources**, minerals, oil , natural gas



Leases of **biological assets within the scope of IAS 41**,



Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*,



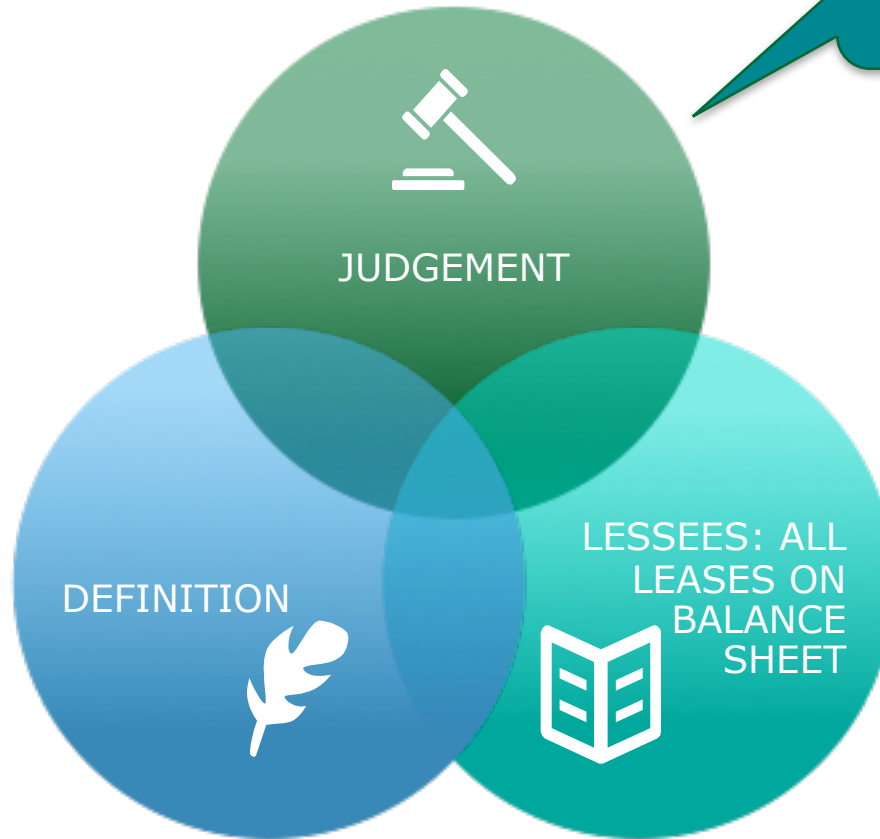
Licences of Intellectual property granted by a lessor within the scope of IFRS 15 *Revenue from Contracts with Customers*, and



Rights held by lessee under the licensing arrangements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Overview

Key changes



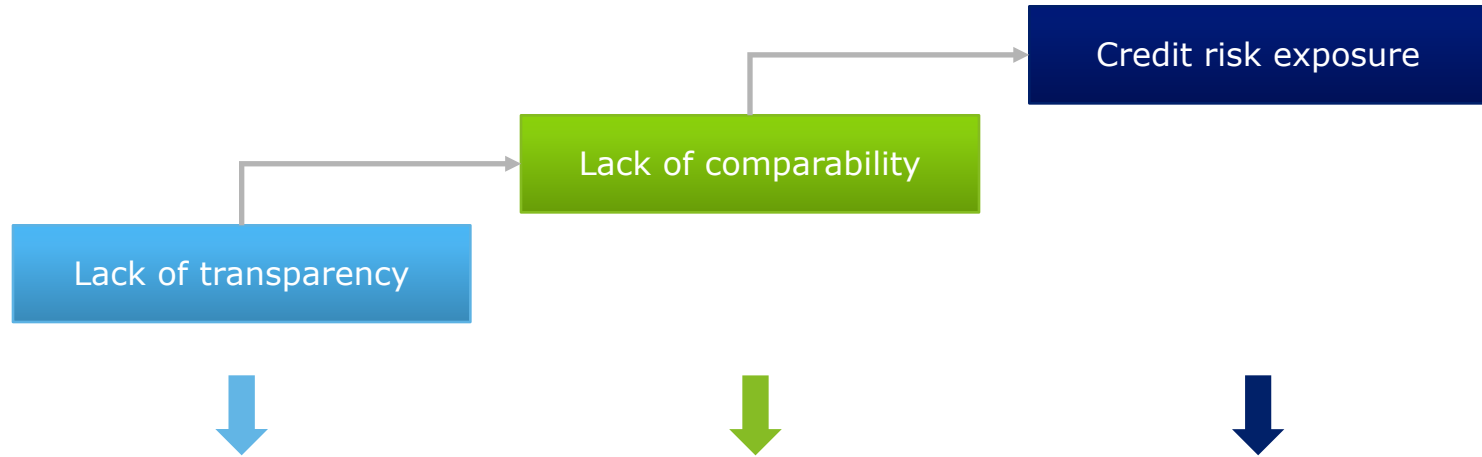
A higher number of judgement areas

New guidance to apply the definition of a lease

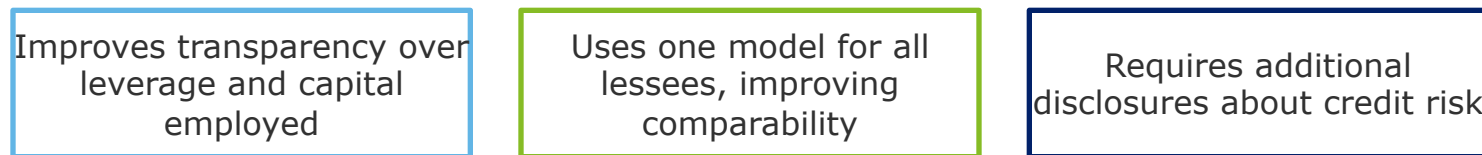
A single recognition and measurement model for lessees

The drivers of change...

IAS 17 had certain shortcomings:

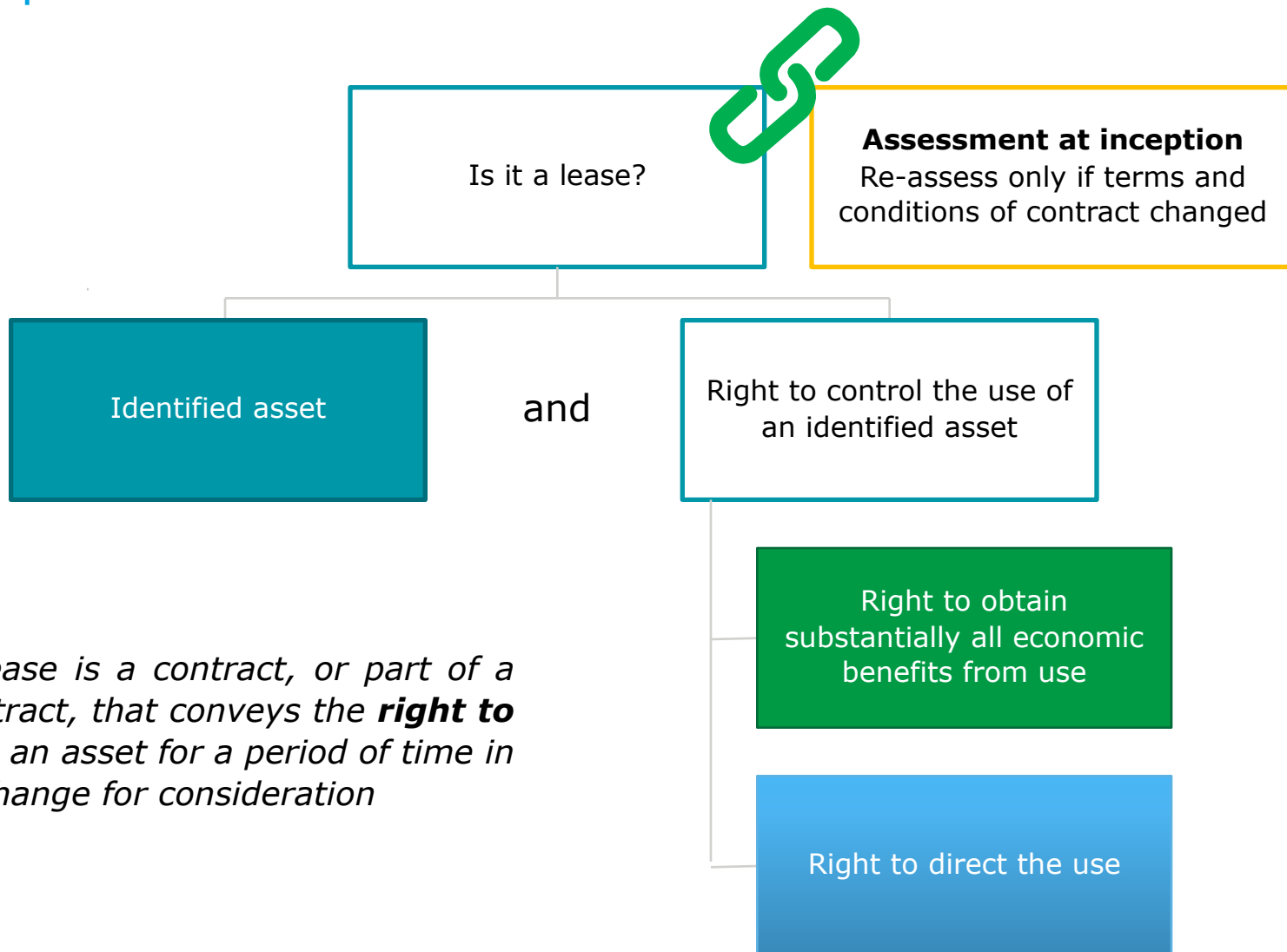


IFRS 16:



Identifying a lease

The requirements



*A lease is a contract, or part of a contract, that conveys the **right to use** an asset for a period of time in exchange for consideration*

Identifying a lease

A decision tree

Fulfilment of the contract depends on the use of an identified asset

Identified asset?

No

Yes

The contract conveys the right to control the use of the identified asset

Substantially all economic benefits?

No

Yes

'How and for what purpose'
predetermined?

Yes No

Customer can operate the asset without the supplier having the right to change operating instructions?
Or
Customer designed asset to predetermine how and for what purpose the asset is used?

Customer has right to direct how and for what purpose the asset is used throughout the period of use?

Yes No

Lease

Not a lease

Yes No

Lease

Not a lease

Identifying a lease

Example

Facts:

- Customer enters into a contract with Supplier for the use of a specified ship for a five-year period.
- The ship is explicitly specified in the contract and Supplier does not have substitution rights.
- Customer decides what cargo will be transported, and whether, when and to which ports the ship will sail, throughout the five-year period of use, subject to restrictions specified in the contract.
- Restrictions prevent Customer from sailing the ship into waters at a high risk of piracy or carrying hazardous materials as cargo.
- Supplier operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. Customer is prohibited from hiring another operator for the ship of the contract or operating the ship itself during the term of the contract.






Does the contract contain a lease?



Identifying a lease

Example: Does the contract contain a lease?

Concept	Considerations
1 <i>Use of an identified asset</i>	 <ul style="list-style-type: none">• The ship is explicitly specified in the contract;• No right to substitute.
2 <i>Right to obtain economic benefits from use of the identified asset</i>	 <ul style="list-style-type: none">• Customer has exclusive use of the ship for the five-year period of use
3 <i>Right to direct the use of the identified asset</i>	 <ul style="list-style-type: none">• Customer decides whether, where and when the ship sails, as well as the cargo it will transport, such decisions are subject to change over the period of use.

A

The contract contains a lease.

Key changes to lessor accounting

Key changes to lessor accounting

Lessor accounting model in IAS 17 retained

- Classify leases as financing or operating lease depending on whether substantially all of the risks and rewards of the asset are transferred to the lessee.

Key changes

- Definition of a lease
- Initial direct costs - *consistent with incremental costs under IFRS 15*
- Lease term – *options to extend or terminate*
- Lease payment – *includes variable lease payments based on index or rate*
- Subleases – *head-leases and subleases should be accounted separately*
- Modifications – *IFRS 16 provides specific guidance as to when a modification should, and should not, be treated as a separate lease*
- Disclosures

New disclosure requirements

- Lease income recognised during the reporting period
- Lease income relating to lease payments of operating leases
- The nature of the lessor's leasing activities
- Exposure to residual asset risks
- Qualitative and quantitative explanation of the significant changes in the net investment in finance leases
- Maturity analysis of the lease payments receivable
- Additional qualitative and quantitative information so that financial statements users can assess the impact of leases on the financial statement.

Overview of lessee accounting

Overview of lessee accounting

Initial and subsequent measurement

Initial

Right of use assets

••Cost (Amount of lease liability + initial direct cost + prepaid lease payments)

Lease liability

••PV of lease payments using interest rate implicit in the lease

Subsequent

Right of use assets

••Cost less accumulated depreciation and impairment

Lease liability

••Amortized cost
••No revision of rate (except in case of change of lease term or change in the circumstances within the control of lessee)

Lease payments:

- *Fixed payments, less lease incentives*
- *Variable lease payments based on index or rate*
- *Residual value guarantees*
- *Exercise price of purchase option if reasonably certain that it will be exercised*
- *Payments of termination penalties*

Overview of lessee accounting

Practical expedients – Recognition exemption

Lessee can make an accounting policy election by underlying asset class for **leases with a lease term of 12 months or less**, with no purchase option.




<12




Lessee can make an accounting policy election on a lease-by-lease basis for **leases of low-value assets**, accounting policy



Overview of lessee accounting

Visual impact on financial statements of lessee accounting

Balance Sheet	IAS 17		IFRS 16
	Finance leases	Operating leases	All leases
Assets		...	
Liabilities	\$\$...	\$\$\$\$\$\$
Off balance sheet rights/ obligations	...	 \$\$\$\$\$...

Income statement	IAS 17		IFRS 16
	Finance leases	Operating leases	All leases
Revenue	X	X	X
Operating costs (excluding depreciation and amortisation)	...	Single expense	...
EBITDA			
Depreciation and amortisation	Depreciation	...	Depreciation
Operating profit			
Finance costs	Interest	...	Interest
Profit before tax			

Overview of lessee accounting

Impact on financial statements

Balance sheet

↑ Assets and liabilities

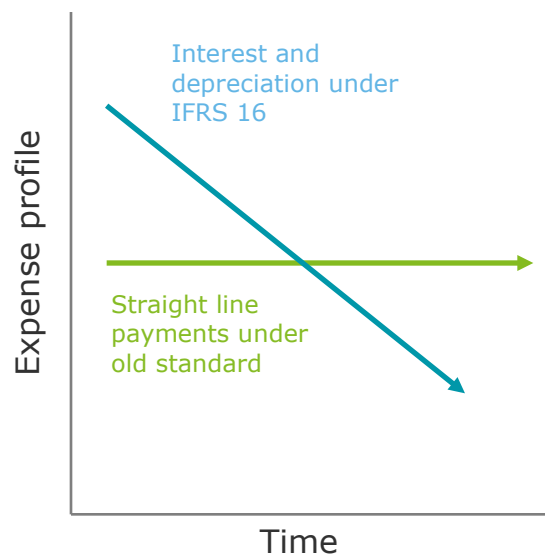
⚙️ Impact on gearing

- Recognise lease assets and liabilities on balance sheet
- Initially measured at the present value of unavoidable lease payments

Income statement

↑ EBITDA

🔄 Profit profile (lower in earlier years of lease)



Cash flow statement

↑ Operating cash inflows

↓ Financing cash outflows

- Repayment of principal: **finance activities**
- Repayment of interest: **Finance or operating activities** (depends on accounting policy for interests)
- Some variable payments, payments from short-term leases and from assets of low value: **operating activities**

Overview of lessee accounting

Effects on the cash flow statement



Cash from operating activities



Cash from financing activities



Total cash flow

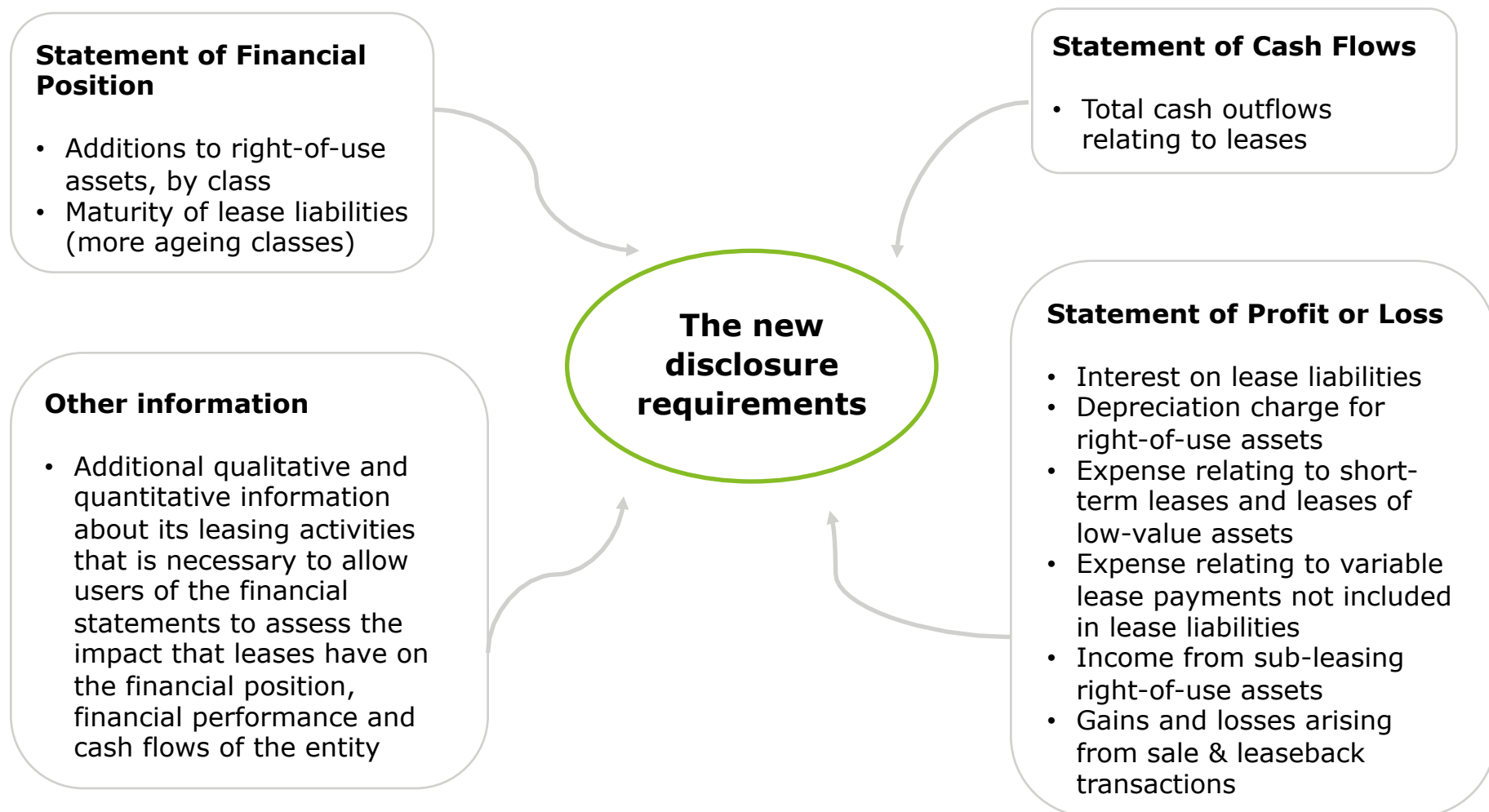
IFRS 16 is expected to reduce operating cash outflows, with a corresponding increase in financing cash outflows, compared to the amounts reported applying IAS 17.

This is because, applying IAS 17, companies presented cash outflows on former off balance sheet leases as operating activities.

In contrast, applying IFRS 16, principal repayments on all lease liabilities are included within financing activities. Interest can also be included within financing activities applying IFRS.

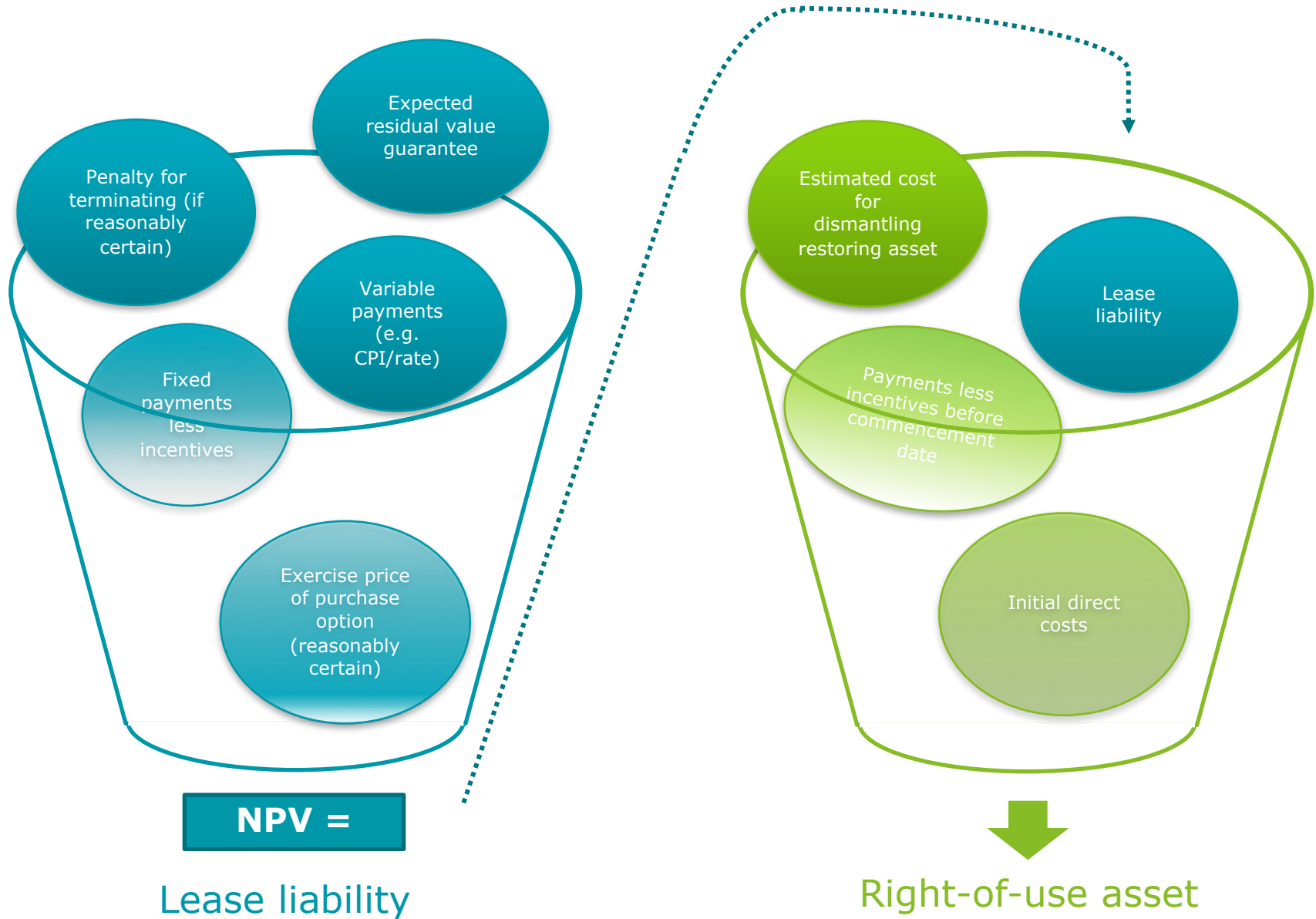
Overview of lessee accounting

New disclosures requirements



Overview of lessee accounting – visual example

Initial and subsequent measurement



Transition

Transition

Effective date

- Effective for annual periods beginning on or after January 1, 2019

Retrospective application

- Full retrospective approach – restatement of comparatives, or
- Modified retrospective approach – no restatement of comparatives and adjust for the cumulative effect in opening retained earnings




Practical expedients

- Not required to reassess contracts at the date of initial application
- Relief from full retrospective measurement of right-of-use assets and lease liabilities
- Sale and leaseback contracts are measured at the date of initial application based on conclusions reached under IAS 17

Overview

Key judgements, policy choices and exemptions

Judgement:

-  Identifying a lease will sometimes require a significant amount of judgement based on the elements of the definition of a lease;
-  Determining whether it is reasonably certain that an extension or termination option will be exercised;
-  Identifying the appropriate rate to discount the lease payments may involve significant judgement.

Exemption may be taken for short-term leases (by class of asset) or low-value asset leases (lease-by-lease basis)

Policy choice:

- Requirements of IFRS 16 can be applied to a portfolio of similar leases provided that such aggregation is not expected to have a material effect;
- Lessee may elect not to separate non-lease components from lease components by class of asset;
- Lessee may, but is not required to, apply IFRS 16 to leases of intangible assets;
- The transition choices available are:
 - Full retrospective approach or Cumulative catch-up approach;
 - Definition of a lease – choice to grandfather all or none;
 - Initial direct costs in measurement of right-of-use assets;
 - Choice lease-by-lease;
 - Other practical expedients on transition.



Industry considerations

Industry considerations

1 Commercial impact

- Impact on financial ratios
- Covenants not adjusted for off balance sheet leases
- Impact on cost of borrowing
- Impact on compensation
- Impact on buy versus lease decisions

The implementation of IFRS 16 will affect not just the accounting model for new lease contracts in the future, but also entities' business strategy and even the ability to obtain financing.





2 Operational impact

- Implementation plan
- Training requirements
- Impact on departments other than finance
- Impact on IT systems
- Revisit lease terms
- Robust accounting policies
- Tax and regulatory implications

Industry considerations


How to plan for the implementation of the new standard?

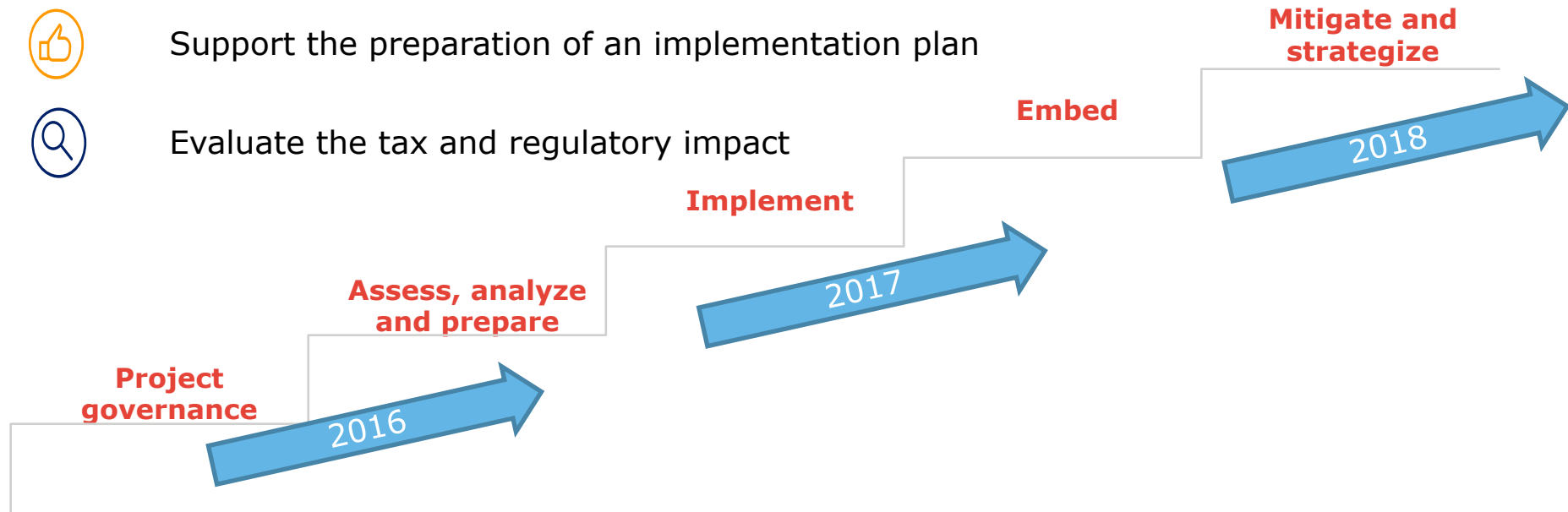
1 January 2019

-  Performing contract reviews
-  Reviewing and assessing IT systems
-  Providing training to staff
-  Assisting with pro-forma financial statement disclosures

4:3 Evaluate the impact on key financial ratios

 Support the preparation of an implementation plan

 Evaluate the tax and regulatory impact

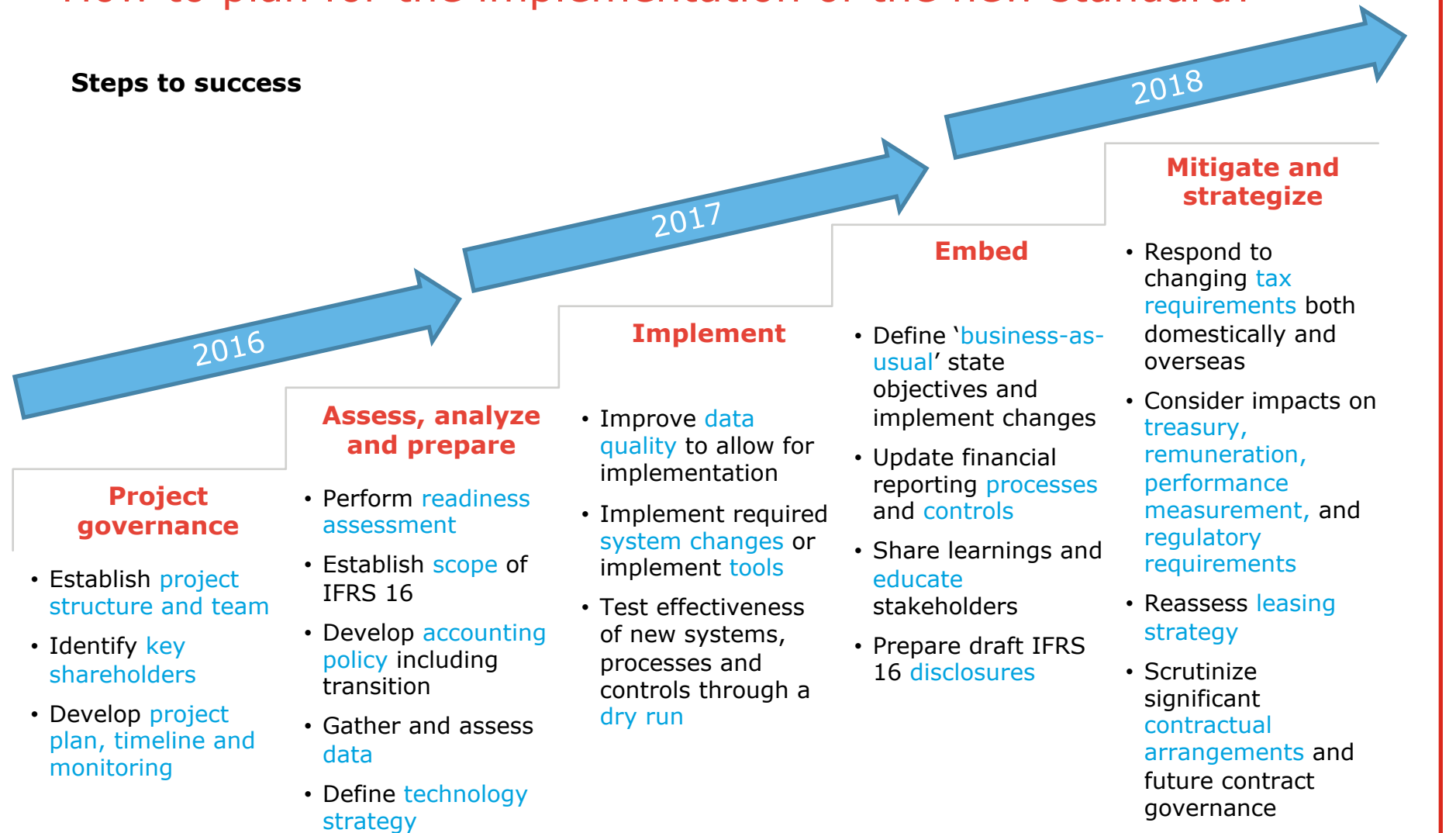


Industry considerations

1 January 2019

How to plan for the implementation of the new standard?

Steps to success



APPENDIX

Other consideration

Other consideration

Though there have not been any changes in the treatment of the initial direct costs from IAS 17, determining whether initial costs are direct can be judgmental.

Initial direct costs

A seller-lessee uses the definition of a sale from IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. IFRS 16 introduced this new principle, so that if the lessee controls (or obtains control) the underlying asset before the asset is transferred to the lessor, the transaction is a sale and leaseback transaction.

Sale and leaseback transactions

Variable lease payments

Lease modifications

Variable lease payments to consider:

1. those that depend on an index or a rate, such as CPI – are included in the lease payments calculation. Reassessment will be necessary when there is a change in the underlying index, and
2. those that are based on usage or performance, such as a percentage of sales or the number of units of inventory produced – are recognized in profit or loss when they are incurred (lessee) or earned (lessor).

- A lease modification is accounted for as a separate lease if certain conditions exist.
- A lease modification that is not a separate lease is accounted for by re-measuring the lease liability using a discount rate determined at that date and an adjustment to the right-of-use asset depending on the scope of the modification

Overview

Key questions for management

1. Do you know which of the entity's contracts are, or contain, leases?
2. Are your systems and processes capturing all of the required information?
3. Are your systems and processes capable of monitoring leases and keeping track of the required ongoing assessments?
4. Have you considered the potential use of IFRS 16's recognition exemptions and practical expedients?
5. Do you know which transition reliefs are available, and whether you will apply any of them?
6. Do you know what discount rates you will be using for your different leases?
7. Have you considered the impact of the changes on financial results and position?
8. How will you communicate the impact to affected stakeholders?
9. Have you planned when you will consider the tax impacts?
10. Have you considered whether your leasing strategy requires revision?