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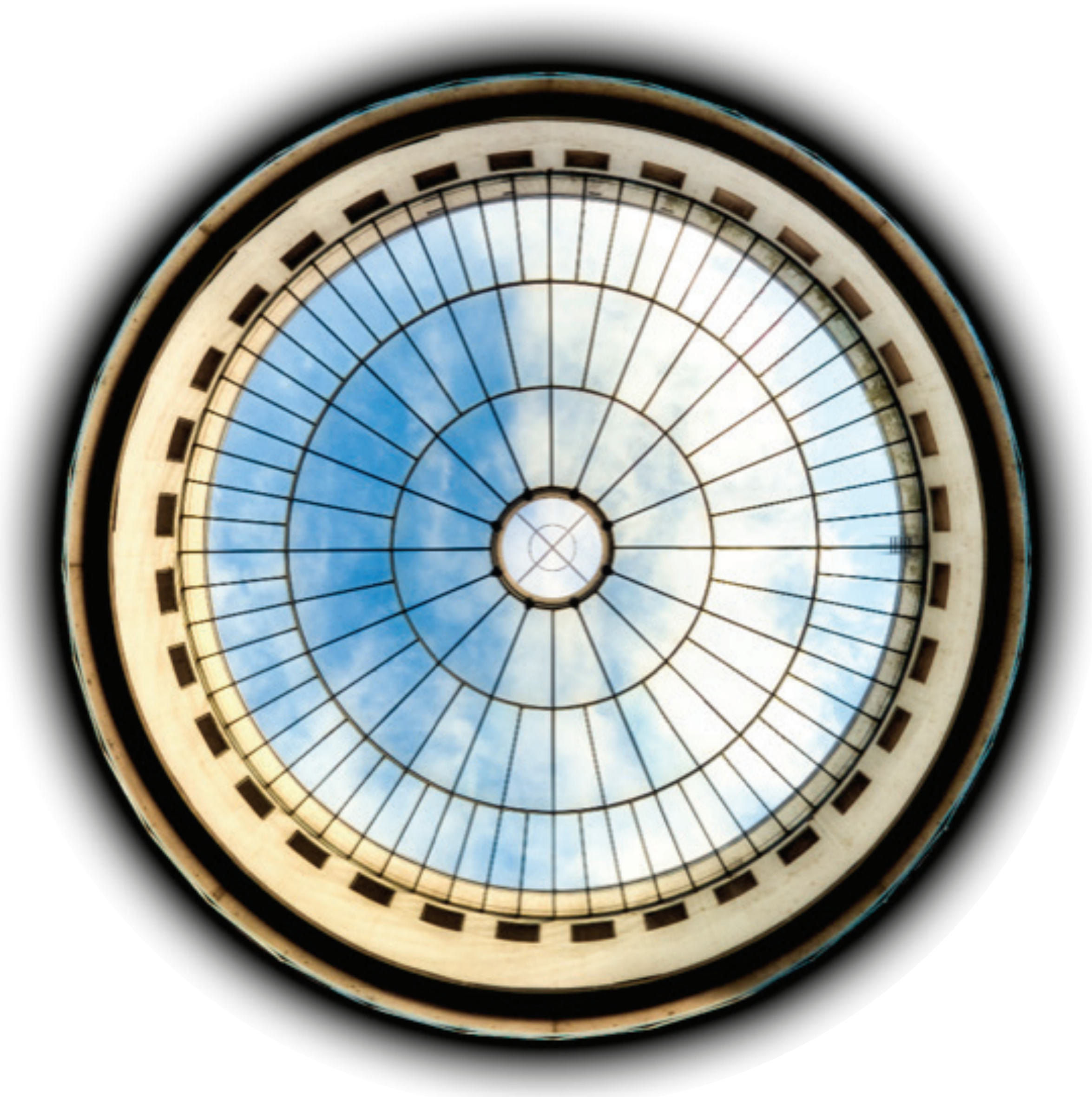


Deloitte Insights:

IFRS 16 - Leasing

Introduction

Leasing is an important financing activity for large corporate and financial institutions with the majority not reported on balance sheet. That is because leases to date have been categorised as either 'finance leases' (which are reported on balance sheet) or 'operating leases' (which are disclosed only in the Income statement and Notes to the financial statements).

Historically, Lease accounting (IAS17) focused on lease classification:

A) Finance Lease - where a lease is economically similar to purchasing the underlying asset and reporting the asset (& liability) on balance sheet

B) Operating Lease - where a lease gives rise to an:

- Asset: "A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity"
- Liability: "A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."

  Neither of which are reported on the balance sheet nor are disclosed only in the notes to the financial statements (as an **Operating Lease**).

This, somewhat arbitrary distinction, made it difficult for investors to compare companies. There was also criticism from investors that reported balance sheets provide a misleading picture about leverage and leased assets used. This meant that investors (and others) had to estimate the effects of a company's off balance sheet lease obligations, which in practice often led to overestimating the liabilities arising from those obligations.

To manage the criticism received for IAS 17 accounting treatment of leases, the International Accounting Standards Board (IASB) is introducing a new Leasing standard: IFRS16.

Timings

Effective date and transition

An entity shall apply IFRS 16 retrospectively for annual periods beginning on or after **January 1, 2019**

The purpose of this publication is to:

- Provide an overview of the definition and scope of IFRS 16 and a comparison against IAS 17
- Explain IFRS 16 impact on corporates, banks and financial institutions
- Inform clients how they can best prepare themselves for the new classification requirements under IFRS 16 and what information with regards to classification of lease contracts they will need to prepare for audit purposes
- Provide an overview of how Deloitte can help clients in Cyprus address the challenges of IFRS 16 implementation

IFRS 16

Definition and scoping: IFRS 16 defines a lease as a contract that conveys to the customer ("lessee") the right to use an asset for a period of time in exchange for consideration. Fulfilment of the contract depends on the use of an identified asset and control of the use of the asset during the lease period.

A Lease involves the use of an identified asset:

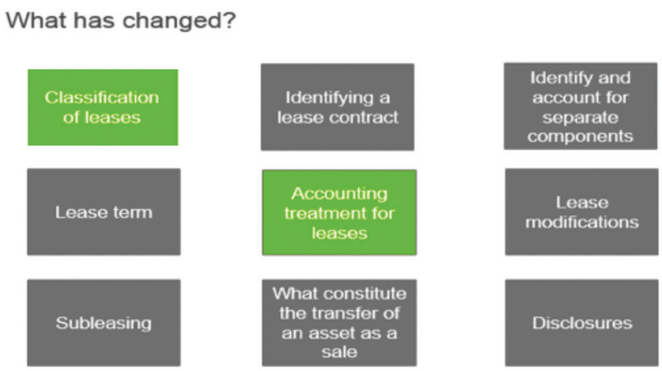
- Explicitly or implicitly specified (can also be a physically defined smaller part of bigger asset)
- No identified asset exists if supplier has a substantive right to substitute the asset
- A supplier's right to substitute an asset is substantive if both:

  - The supplier has the practical ability to substitute the asset, and
  - The supplier can benefit from substituting the asset

A Lease exists when a customer controls the asset:

- Ability to direct the use of the asset
- Right to obtain substantially all of the economic benefit from the use of the asset
- Direction of asset - if the customer can decide how and for what purpose an asset is used and can change its use during the lease period

Comparing IAS 17 and IFRS 16



- The new leasing standard removes the distinction between finance and operating leases for lessees
- Enhanced guidance is introduced on identifying whether a contract contains a lease
- A completely **new lease accounting model for lessees that requires lessees** to recognise all leases on balance sheet, except for short term leases and leases of low value assets is introduced
- Lessor accounting will not change significantly

New lessee model:

- *Balance sheet:*
  - Initially recognises lease assets and liabilities on the balance sheet at Present Value of future lease payments.

- *Income statement:*
  - Rent expense will be replaced with depreciation and interest expenses
  - Recognises amortisation of lease assets and interest on the lease liabilities over the lease term
  - The overall effect on profit will depend on the portfolio of leases an entity holds

- *Cash flow statement:*
  - Separates the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities)

Classifying lease contracts in transition

- At the date of initial application, an entity is not required to reassess whether a contract is, or contains, a lease. The expedient must be applied to all contracts. This is however subject to conditions
- For contracts previously assessed under IAS 17 and IFRIC 4: *Determining Whether an Arrangement Contains a Lease as containing a lease*, IFRS 16 should, automatically, be applied to the contract

Implications for Corporates

Overview

The IASB expects that companies with immaterial or minimal off balance sheet leases transitioning from IAS 17 will not be significantly affected by IFRS 16, regardless of the terms and conditions of their debt covenants.

For those with substantial off balance sheet items the expected implications include:

- The assets and liabilities on their balance sheets will increase significantly, with a potentially material impact on covenant calculations (please refer to section below)
- The cost profile of their income statements will change, with costs skewed towards the early years of leases and greater volatility due to the frequency of recalculation
- The nature of costs in the income statements will change, with a positive impact on EBITDA, but a greater weighting to finance costs and depreciation, again potentially impacting calculations of covenants. Depending on the wording of finance documents, this could also have an impact on cash sweeps, management bonuses etc.
- The accounting benefits of sale and leaseback transactions could be negatively impacted
- Companies should consider whether they need to renegotiate any loan or other agreements due to changes in their financial metrics

How will it impact financial metrics?

There may be some significant changes to a company's key financial metrics, including the following:

	Expected change	Why?
Current ratio	↓	Decrease because current lease liabilities will increase whereas current assets will not
Debt to equity ratios	↑	Increase because lease liabilities will increase total liabilities on an entity's balance sheet, thereby increasing the reported debt load
Asset turnover (e.g. sales to total assets)	↓	Decrease because leased assets will increase an entity's reported asset base with no change in sales
EBIT	↑	Rent expense will be replaced with depreciation and interest expenses. As rent is currently reported as an operating expense, whilst neither depreciation nor interest are taken into account when measuring EBITDA, reported levels of EBITDA could be materially increased. EBIT will increase because the operating lease expense will be eliminated and replaced by a smaller amortization expense. This will have a bearing on banking covenants (both absolute measures of EBITDA/EBIT, and also ratios such as gearing and interest cover), and also any other items such as bonuses, which may be linked to these measures of profitability. In the initial years of a lease, the new standard will result in an income statement expense which is higher than the straight-line rent expense typically recognized under the current standards, falling to a lower cost mid-way through the lease as the interest cost reduces. On implementation, existing leases will be treated in a similar fashion, resulting in increases in assets and liabilities of lessees of large estates.
EBITDA	↑	Increase because operating lease expense is no longer included, and depreciation and amortization are excluded from this profit measure

*Source: **www.iasplus.com***

Debt covenants

Most sophisticated users of financial statements (including credit rating agencies and lenders) already estimate the effect of off balance sheet leases on financial leverage, particularly when a company has a significant amount of off balance sheet leases.

Banks set interest rates based in part on credit ratings when credit ratings are available. Because the credit rating agencies adjust for off balance sheet leases, the interest rates charged on loans granted to rated borrowers are not expected to change as a result of the implementation of IFRS 16.

Capital requirements for Financial Institutions

The IASB expects companies that have material off balance sheet leases to report higher assets and lower equity when applying IFRS 16. This is driven mainly by the fact that IFRS 16 requires a company to present lease assets arising from leases of property, plant and equipment as tangible assets, if they are not presented within their own line item on the balance sheet. *This could affect the regulatory capital of lessees that are financial institutions.*

The IASB has estimated the effect of IFRS 16 on reported equity by considering a sample of 20 European banks. On the basis of this testing, the IASB does not expect the changes to lessee accounting to have a significant effect on the regulatory capital of most financial institutions.

The effect of any new accounting requirements on regulatory capital depends on the actions of prudential regulators which is yet unclear both locally, in Cyprus, and across Europe.

Preparing for IFRS 16 – things to focus on

- **Assessing and Preparing** information to analyse the impact of IFRS 16, analysing the data and preparing for the longer term actions and decisions required
- **Implementing** and embedding system changes and making necessary changes to related processes and controls; developing in house tools to implement the calculations necessary for IFRS 16
- **Mitigating and strategising** impacts on treasury, remuneration targets, covenants, regulatory matters and responding to changing tax requirements both in Cyprus and overseas

How should you be prepared for the new classification requirements under IFRS 16?

- Identify available and accessible information
- Assess the relevance, completeness and accuracy of the identified information
- Review accounting and operating systems: data extractions and compliance with new requirements
- Train relevant members of the finance team
- Communicate with members of other departments for the changes and impact

Key implementation considerations

Accounting

- Transition approach: Elect to use practical expedients for classification and measurement?
- Classifying contracts: Identify contracts not previously assessed in accordance with IAS 17 and IFRIC 4.
- Identify key contract features: Determine lease terms, value of lease payments, the implicit interest rate.
- Contracts with multiple components: Identify stand-alone selling prices and determine whether to apply the practical expedients.
- Deferred tax: Impact on deferred tax
- Disclosures: Determine the required disclosures and to what extent the disclosures aggregated.
- Documentation: New accounting policies. Documentation for key judgments applied
- Application of exemptions: Determine the threshold for low-value assets and whether to apply low-value assets and short-term leases exemption.

Operational

- Training of finance teams and other relevant departments.
- Review of IT systems.
- Determining what information is readily available.
- Review of the completeness and accuracy of the contract data.
- Review control procedures and lease approval processes.
- Internal controls over lease processes and accounting.
- Communication of changes and ensure project plan in place

Commercial

- Impact on future financing: Greater financial transparency
- Impact on tax payments and deferred tax: Timing of profit recognition
- Bonus schemes: Are targets based on EBITDA
- Changes to KPIs
- Compliance with loan covenants
- Compensation arrangements
- Procurement strategy: Lease or buy

What information re: classification of lease contracts you will need to prepare for audit purposes?

- Access to contracts.
- Documentation of the classification assessment.
- Documentation of the exemptions and practical exemptions applied.
- Justification of the low asset value threshold.

How can Deloitte help?

Review of lease contracts

- Taking inventory of all lease agreements and gathering the necessary data, including, among others, lease terms, renewal options and payment terms
- Prioritizing the analysis of those lease arrangements that are significant and/or have complex elements
- Identification of internal stakeholders- Discussing changes with relevant stakeholders, such as the company's board of directors, creditors, analysts, key management personnel, etc.
- Interpretation of key judgmental areas.
- Determining whether any changes need to be made to debt covenants, loan agreements, bonus or compensation agreements

Business and accounting advice

- Identifying "data gaps" including information required from subsidiaries and affiliates operating in foreign jurisdictions
- Transition and ongoing impact analysis
- Changes in internal control and processes
- Asset procurement (lease or buy).
- Preparing pro-forma financial information to assess the impact of the changes to the financial statements
- Perform capital implication reviews and capital gap analysis for Financial institutions applying IFRS 16
- Review debt covenants included in contracts offered to customers by financial institutions and assess impact on capital and provisioning

IT systems and data

- Advise on existing accounting and operating systems.
- Assess the accuracy, relevance and completeness of databases.
- Assist with installation and maintenance of software.

Training

- Role specific training
- Finance or non-finance staff
- Business or accounting oriented

Human resources

- Assessment of the impact of IFRS 16 on bonuses and profit – sharing arrangements.
- Communication of any changes to contracts.

Contacts

If you require any further information on any of the issues mentioned in this material and on how Deloitte can help you address the challenges ahead, please do not hesitate to contact

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