The leases lab

IFRS 16 gives rise to a multitude of intriguing questions inspiring Professor Lee Singh to start a new experiment – this time with his assistant Doctor Holger Meurer.

Hypothesis

Lease contracts denominated in a foreign currency under IFRS 16 will create a lot of additional volatility in profit or loss for lessees.

Testing and analysis

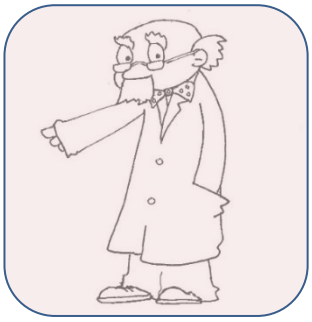
Lease contracts might be denominated in a currency which is different from the functional currency of the lessee (for example, contracts might be denominated in USD and the functional currency is EUR). A lease liability has to be translated into the functional currency of the lessee at every reporting date using the closing rate. Any exchange differences are recognised in profit or loss which can impact a company's KPIs. The airline and shipping industries, amongst others, are likely to be affected.

Can volatility in profit or loss be avoided? Let's experiment further!

An entity can designate the lease liability as a hedged item in a hedge of foreign exchange risk. The retranslation of the lease liability is compensated by opposite changes in the fair value of the hedging instrument (typically a FX forward). This approach can be challenging because of differences in the timing of lease payments and cash flows under the forward contract(s). Furthermore, FX forwards with a long term maturity may often only be available at high cost.

The lease liability could be designated as a hedging instrument in a hedge of highly probable future USD revenues (cash flow hedge). Changes in the value of the lease liability due to changes in foreign exchange rates would be recognised in other comprehensive income (OCI) until the USD revenue occurs (to the extent the hedge is effective). However, this approach only works if:

- the entity has sufficient future USD revenues that are highly probable and
- the entity is able to identify and document the time period(s) during which the revenue is expected to occur within a reasonably specific and generally narrow range of time from a most probable date.



A different approach is to use a subsidiary with a USD functional currency (that is, a foreign operation) to enter the USD lease contracts on behalf of the group. The foreign operation as a whole is translated into EUR. Exchange differences that result from the translation of a foreign operation into the presentation currency of the reporting entity are recognised in OCI. Changes in the USD/EUR exchange rate would affect equity but not profit or loss. This approach only works if the functional currency of the subsidiary is genuinely USD. A subsidiary that is only a structured entity set up to enter into lease contracts with third parties and sub-lease the leased assets to other group entities is unlikely to have a different functional currency than its immediate parent. The primary indicators of IAS 21 do not apply to structured entities that have no operations and do not provide any services, but only carry out activities as an extension of the reporting entity without any significant degree of autonomy. Instead, those entities must have the same functional currency as the reporting entity.

Conclusion

Lease contracts denominated in a currency different from the lessee's functional currency could result in more volatility in profit or loss. There are some ways to mitigate this effect.

Practical application

Lessees should analyse how they deal with the additional volatility in profit or loss triggered by lease contracts denominated in a foreign currency. There are several solutions available, however, each has its challenges and a company should assess carefully which approach fits its particular needs.

*See more of the Professor's analysis of the impact of **IFRS 16 Leases** on the airline and shipping industries in our*

Industry Spotlight:

Airlines and **Shipping**

*For our full range of **Leases** content, visit:*

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