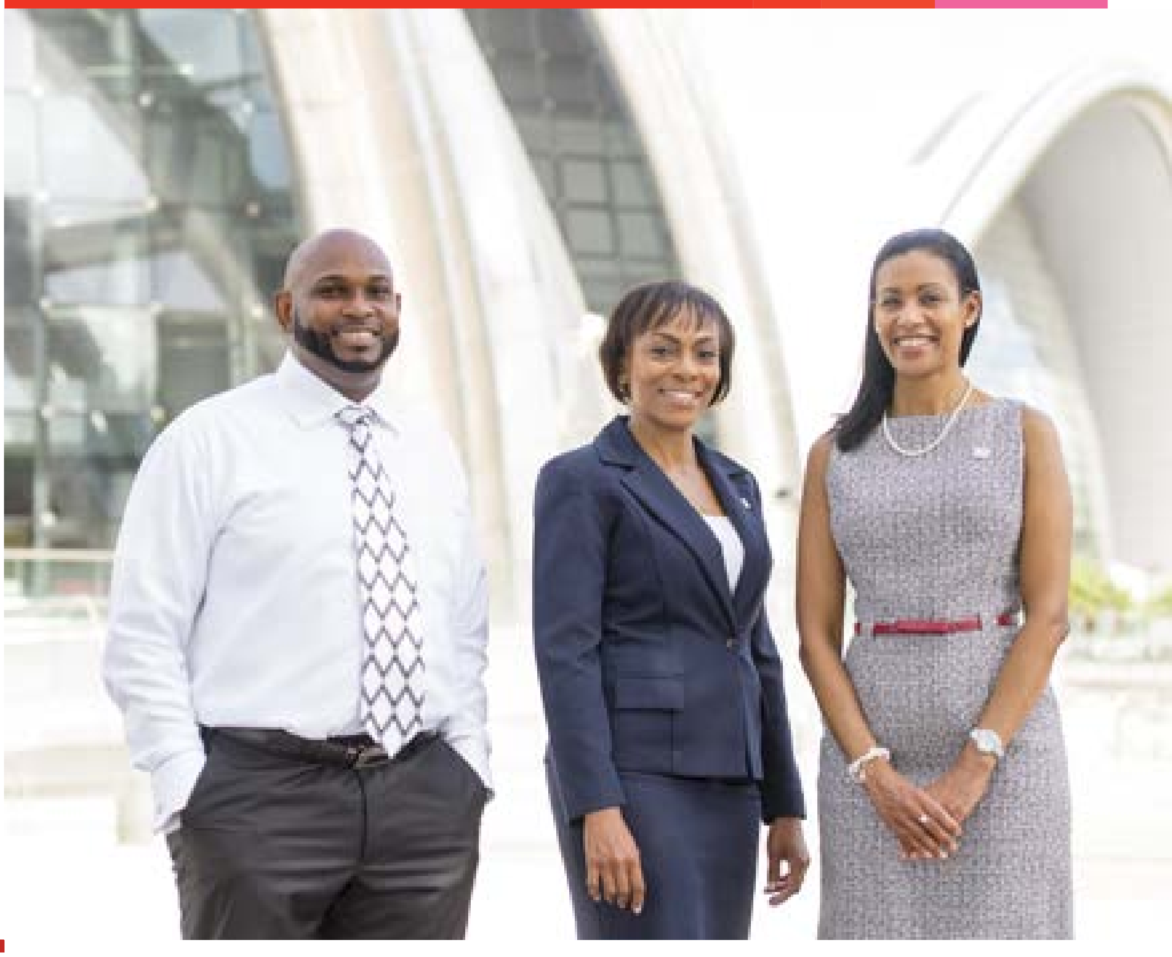
IFRS 16: The leases standard is changing

Are you ready?

IFRS 16 – The new leases standard



New standard

The IASB has published IFRS 16 – the new leases standard. It comes into effect on 1 January 2019. Virtually every company uses rentals or leasing as a means to obtain access to assets and will therefore be affected by the new standard.

Redefines commonly used financial metrics

The new requirements eliminate nearly all off balance sheet accounting for lessees and redefine many commonly used financial metrics such as the gearing ratio and EBITDA. This will increase comparability, but may also affect covenants, credit ratings, borrowing costs and your stakeholders' perception of you.

Business model

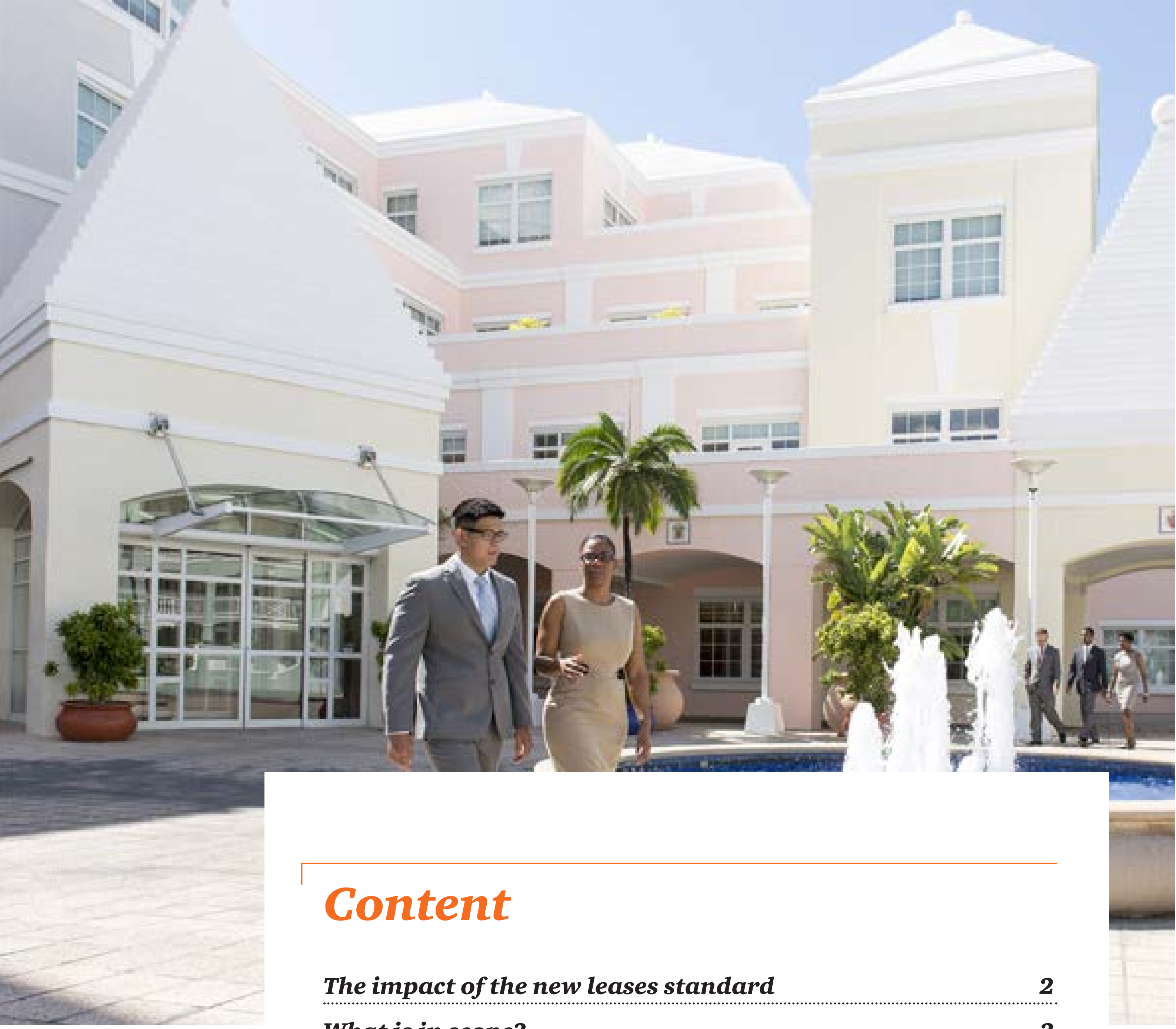
The new standard may affect lessors' business models and offerings, as lease needs and behaviours of lessees change. It may also accelerate existing market developments in leasing such as an increased focus on services rather than physical assets.

Business data and processes

Changes to the lease accounting standard have a far-reaching impact on lessees' business processes, systems and controls. Lessees will require significantly more data around their leases than before given the on balance sheet accounting for almost all leases. Companies will need to take a cross-functional approach to implementation, not just accounting.

Prepare now

The earlier you begin to understand what impact the new standard may have on your organisation the better prepared you will be to iron out potential issues and reduce implementation costs and compliance risk.



Content

The impact of the new leases standard

The IASB published IFRS 16 Leases in January 2016 with an effective date of 1 January 2019. The new standard requires lessees to recognise nearly all leases on the balance sheet which will reflect their right to use an asset for a period of time and the associated liability for payments.

Leasing is an important and widely used financing solution. It enables companies to access and use property and equipment without incurring large cash outflows at the start.

It also provides flexibility and enables lessees to address the issue of obsolescence and residual value risk. In fact sometimes, leasing is the only way to obtain the use of a physical asset that is not available for purchase.

Under existing rules, lessees account for lease transactions either as operating or as finance leases, depending on complex rules and tests which, in practice, use 'bright-lines' resulting in all or nothing being recognised on balance sheet for sometimes economically similar lease transactions.

The impact on a lessee's financial reporting, asset financing, IT, systems, processes and controls is expected to be substantial. Many companies lease a vast number of big-ticket items, including cars, offices, power plants, retail stores, cell towers and aircraft.

Therefore, lessees will be greatly affected by the new leases standard. The lessors' accounting largely remains unchanged. However they might see an impact to their business model and lease products due to changes in needs and behaviours.

Lessees

- The new standard will affect virtually all commonly used financial ratios and performance metrics such as gearing, current ratio, asset turnover, interest cover, EBITDA, EBIT, operating profit, net income, EPS, ROCE, ROE and operating cash flows. These changes may affect loan covenants, credit ratings and borrowing costs, and could result in other behavioural changes. These impacts may compel many organisations to reassess certain 'lease versus buy' decisions.
- Balance sheets will grow, gearing ratios will increase, and capital ratios will decrease. There will also be a change to both the expense character (rent expenses replaced with depreciation and interest expense) and recognition pattern (acceleration of lease expense relative to the recognition pattern for operating leases today).
- Entities leasing 'big-ticket' assets – including real estate, manufacturing equipment, aircraft, trains, ships, and technology – are expected to be greatly affected. The impact for entities with numerous small leases, such as tablets and personal computers, small items of office furniture and telephones might be less as the IASB offers an exemption for low value assets (assets with a value of $5,000 or less when new). Low value assets meeting this exemption do not have to be recognised on the balance sheet.
- The cost to implement and continue to comply with the new leases standard could be significant for most lessees. Particularly if they do not already have an in-house lease information system.

Lessors

- Lessees and lessors may need to consider renegotiating or restructuring existing and future leases.
- Business and legal structures supporting leases should also be reassessed to evaluate whether these continue to be effective (for example, joint ventures and special purpose entities).
- Lessor accounting remains largely unchanged from IAS 17 however, lessors are expected to be affected due to the changed needs and behaviours from customers which impacts their business model and lease products.

The pervasive impact of these rules requires companies to transform their business processes in many areas, including finance and accounting, IT, procurement, tax, treasury, legal, operations, corporate real estate and HR.

What is in scope?

The scope of IFRS 16 is generally similar to IAS 17 and includes all contracts that convey the right to use an asset for a period of time in exchange for consideration, except for licences of intellectual property granted by a lessor, rights held by a lessee under licensing agreements (such as motion picture films, video recordings, plays, manuscripts, patents and copyrights), leases of biological assets, service concession agreements and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. There is an optional scope exemption for lessees of intangible assets other than the licences mentioned above.

However, the definition of a lease is different from the current IFRIC 4 guidance and might result in some contracts being treated differently in the future. IFRS 16 includes detailed guidance to help companies assess whether a contract contains a lease or a service, or both. Under current guidance and practice, there is not a lot of emphasis on the distinction between a service or an operating lease, as this often does not change the accounting treatment.

The analysis starts by determining if a contract meets the definition of a lease. This means that the customer has the right to control the use of an identifiable asset for a period of time in exchange for consideration.

Example: Lease vs. service

Company A enters into a fixed three-year contract with a stadium operator (Supplier) to use a space in a stadium to sell its goods. The contract states the amount of space and that the space may be located at any one of several entrances of the stadium. The Supplier has the right to change the location of the space allocated to Company A at any time. There are minimal costs to the Supplier associated with changing the space. Company A uses a kiosk (that Company A owns) to sell its goods that can be moved easily. There are many areas in the stadium that are available and would meet the specification for the space in the contract.

The contract does not contain a lease because there is no identified asset. Company A controls its own kiosk. The contract is for space in the stadium, and this space can be changed at the discretion of the Supplier. The Supplier has the substantive right to substitute the space Company A used because:

a) The Supplier has the practical ability to change the space used at any time without Company A’s approval.

b) The Supplier would benefit economically from substituting the space.

How to separate lease and non-lease components

Currently, many arrangements embed an operating lease into the contract or operating lease contracts include non-lease (e.g. service) components. However, many entities do not separate the operating lease component in the contracts because the accounting for an operating lease and for a service/supply arrangement generally have a similar impact on the financial statements today.

Under the new leases standard, lessee accounting for the two elements of the contract will change because leases will have to be recognised on the balance sheet*.

Both lessees and lessors are required to separate lease components from non-lease components in their contracts if both of the following criteria are met:

a. The lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and
b. The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

After the identification of lease and non-lease components, payments should be allocated as follows:

- Lessors should apply the guidance in IFRS 15 Revenue from Contracts with Customers when allocating the transaction price to separate components. Allocation is based on the relative standalone selling prices (SSP). If no observable information is available, entities are required to estimate the SSP. IFRS 15 distinguishes three methods of estimation: adjusted market assessment approach, expected cost plus margin approach and residual approach. Entities may want to combine the adoption of the new leases standard with the new revenue recognition standard (effective 1 January 2018), considering the interdependencies between the two standards. This may prove to be the most cost-efficient.
- Lessees should separate lease components from non-lease components unless they apply the accounting policy election described below. Activities that do not transfer a good or service to the lessee are not components in a contract. Allocation of payments should be similar to lessors as described above. The standard gives the policy election for lessees to not separate non-lease components from a lease component for a class of an underlying asset. In such cases, the whole contract is accounted for as a lease.

Example: Separating lease components

Company A enters into a 15-year contract for the right to use three specified, physically distinct dark fibers within a larger cable connecting Hong Kong to Tokyo and maintenance services. The entity makes all of the decisions about the use of the fibers by connecting each end of the fibers to its electronics equipment (i.e. Company A 'lights' the fibers). The entity concluded that the contract contains a lease.

The agreement consist of the lease of three dark fibers and maintenance services. The observable standalone prices can be determined based on the amounts for similar lease contracts and maintenance contracts entered into separately. If no observable inputs are available, Company A has to estimate the standalone prices of both components.

The requirements of IFRS 16 for separating lease and non-lease components and allocating the consideration to separate components will require management judgement when identifying those components and applying estimates to determine the observable standalone prices. Lessees may not currently have the data to separate lease and non-lease components. i.e. Hence, lessors might need to provide the information to separate lease and non-lease components to their customers. In the past they might not have priced these elements separately to customers.

* Except for the exempted short term leases and low value asset leases, see page 7

What is the new model?

The distinction between operating and finance leases is eliminated for lessees, and a new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) are recognised for all leases*.

Lessees should initially recognise a right-of-use asset and lease liability based on the discounted payments required under the lease, taking into account the lease term as determined under the new standard. Determining the lease term will require judgment which was often not needed before for an operating lease as this did not change the expense recognition. Initial direct costs and restoration costs are also included.

Lessor accounting does not change and lessors continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating. For financing arrangements or sales, the balance sheet reflects a lease receivable and the lessor's residual interest, if any.

The key elements of the new standard and the effect on financial statements are as follows:

- A 'right-of-use' model replaces the 'risks and rewards' model. Lessees are required to recognise an asset and liability at the inception of a lease.
- All lease liabilities are to be measured with reference to an estimate of the lease term, which includes optional lease periods when an entity is reasonably certain to exercise an option to extend (or not to terminate) a lease.
- Contingent rentals or variable lease payments will need to be included in the measurement of lease assets and liabilities when these depend on an index or a rate or where in substance they are fixed payments. A lessee should reassess variable lease payments that depend on an index or a rate when the lessee remeasures the lease liability for other reasons (for example, because of a reassessment of the lease term) and when there is a change in the cash flows resulting from a change in the reference index or rate (that is, when an adjustment to the lease payments takes effect).
- Lessees should reassess the lease term only upon the occurrence of a significant event or a significant change in circumstances that are within the control of the lessee.

* Except for the exempted short term leases and low value asset leases, see page 7

Example: Car lease

Company A leases a car for a period of four years starting on 1 Jan 20x9. The investment value is CU35,845. The lease requires payments of CU668 on a monthly basis for the duration of the lease term (i.e., CU8,016 pa). The annual lease component of the lease payments is CU6,672 and the service component is CU1,344. The residual value of the car at the end of the lease term is CU14,168. There is no option to renew the lease or purchase the car, and there is no residual value guarantee. The rate implicit in the lease is 5%.

The net present value of the lease payments using a 5% discount rate is CU24,192.

The overall impact on the net profit is the same under IFRS 16 and IAS 17, however, with the application of the right-of-use model the presentation of lease payments in the statement of comprehensive income will change. Lease payments of an operating lease under IAS 17 are presented within operating expenses, while under the right-of-use model, depreciation and interest expense will be recognised separately, having a positive impact on EBITDA. The overall cumulative effect on the net profit is the same under IFRS 16 and IAS 17, however, with the application of the right-of-use model the lease expense recognition pattern during the lease term and presentation of lease payments in the statement of comprehensive income will change. Also a right-of-use asset and lease liability is recognised in the financial statements of the lessee.

IFRS 16 – Impact on financial position and income

	Jan 20x9	Dec 20x9	Dec 20y0	Dec 20y1	Dec 20y2	Total
Right-of-use asset	24,192	18,144	12,096	6,048	0	
Lease liability	(24,192)	(18,580)	(12,687)	(6,498)	0	
Operating expense – service	0	1,344	1,344	1,344	1,344	**5,376**
Depreciation	0	6,048	6,048	6,048	6,048	**24,192**
Interest expense	0	1,083	797	496	120	**2,496**
Net Income	0	(8,475)	(8,189)	(7,888)	(7,512)	**(32,064)**

IAS 17 – Impact on financial position and income

	Jan 20x9	Dec 20x9	Dec 20y0	Dec 20y1	Dec 20y2	Total
Right-of-use asset	0	0	0	0	0	
Lease liability	0	0	0	0	0	
Operating expense – lease and service	0	8,016	8,016	8,016	8,016	**32,064**
Net Income	0	(8,016)	(8,016)	(8,016)	(8,016)	**(32,064)**

Examples of practical implications

The short-term lease exemption aims to limit the costs related to implementation of the new leases standard without significantly impairing the quality of the information provided in the financial statements.

Determining the lease term

IFRS 16 defines a lease term as the noncancellable period for which the lessee has the right to use an underlying asset including optional periods when an entity is reasonably certain to exercise an option to extend (or not to terminate) a lease.

Entities need to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option when determining the lease term. The option to extend the lease term should be included in the lease term if it is reasonably certain that the lessee will exercise the option. Lessees are required to reassess the option when significant events or changes in circumstances occur that are within the control of the lessee. A lessor would not be permitted to reassess the lease term.

Short-term leases

Under IFRS 16 lessees may elect not to recognise assets and liabilities for leases with a lease term of 12 months or less. In such cases a lessee recognises the lease payments in profit or loss on a straight-line basis over the lease term. The exemption is required to be applied by class of underlying assets.

To be able to apply this exemption, entities need to determine the lease term. The determination of short-term lease is consistent with the definition of a lease term i.e. the options to extend should be taken into account if an entity is reasonably certain to exercise an option to extend (or not to terminate) a lease. Any lease that contains a purchase option is not a short-term lease.

Upon implementation, entities also need to find a way to capture and scope out short-term leases and introduce a different process to account for this election available within the new model which may have process and systems implications aside from the new model itself.

Leases of low value assets

Based on feedback provided to the IASB on cost and benefits, the Board included another exemption in the new standard to reduce the costs and complexity of IFRS 16. Lessees are not required to recognise assets or liabilities for leases of low value assets such as tablets and personal computers, small items of office furniture and telephones. The IASB has included in the Basis of Conclusions an indicative amount of less than $5,000 when new as the value of assets that would normally qualify for the exemption.

Upon implementation, entities also need to find a way to scope out low value assets and introduce a different process to account for this exception to the new model which may have process and systems implications aside from the new model itself.

Example: Extension option

Company A leases a building from a real estate company which provides the right of use of the asset for five years with an option to extend it for another five years. The option to extend is at market conditions and there are no specific economic incentives for Company A to exercise the option at the commencement of the contract.

The lease period at the commencement of the contract is 5 years.

What if… Company A undertook a significant investment for a leasehold improvement prior to the commencement of the lease. The economic life of the leasehold improvement is estimated at ten years.

Company A should consider if the leasehold improvement has a significant economic value at the end of the initial five year lease period. If the improvements result in the underlying asset having greater utility to the lessee than alternative assets that could be leased for a similar amount, Company A concludes that it has a significant economic incentive to exercise the option to extend the lease.

The impact on industries

Although virtually every industry uses leasing as a means to obtain access to assets, the type and volume of assets that they lease, and the terms and structures of these lease agreements differ significantly.

For example, a professional services firm leases cars and corporate offices; a utilities company leases power plants; a retailer leases retail stores; a telecoms entity leases fibre optic cables and cell towers; and an airline leases aircraft – all with very different characteristics, terms, regulatory frameworks, pricing, risks and economics. As a result, different implications may arise for different industries when adopting the new leases standard.

PwC has conducted a global lease capitalisation study to assess the impact of the new leases standard on reported debt, leverage, solvency, and EBITDA for a sample of more than 3,000 listed entities reporting under IFRS across a range of industries and countries (excluding the US). The research identifies the minimum impact of capitalising existing off balance sheet operating leases based on commitments disclosures in entities' published financial statements in 2014. The research does not take into account any transitional reliefs that may be available on adoption of the new standard.

The median increase in debt and EBITDA for some of the most impacted industries can be summarised as follows.

Industry	Median increase in debt	Median increase in EBITDA
All companies	**22%**	**13%**
Retailers	98%	41%
Airlines	47%	33%
Professional services	42%	15%
Health care	36%	24%
Wholesale	28%	17%
Transport & logistics	24%	20%
Entertainment	23%	15%
Telecommunication	21%	8%

Source: PwC global lease capitalisation study

Here are a few examples of industry specific implications that may arise:

Retailers

Retailers are heavy users of real estate leases for their stores. They are likely to experience major impacts when implementing the new leases standard:

- *Renewal options* – leasing real estate is retailers' core business and determining and reassessing when a retailer has an economic incentive to renew a retail lease location may require substantial judgement.
- *Variable payments linked to index or rate* – retailers need to put systems in place to estimate and remeasure variable payments linked to an index at the spot rate for each reporting period (e.g. CPI).
- *Separating lease and non-lease elements* – retailers will need to separate service charges (e.g. administrative/utilities/marketing) from lease elements with many landlords – for example, with shop-in-shop leases and large retail outlets.

Telecommunication

Some telecoms entities lease a vast number of big-ticket items, including network equipment, cell towers, satellite transponders and fibre optic cables.

- *Identification of a lease* – determining when an arrangement is a lease can be complex and judgemental for a telecoms entity. The new standard discusses an example of capacity/service versus lease for a fibre optic cable and an example of network services. Telecoms entities need to determine whether their leases provide control over a physically distinct portion of an asset or provide capacity.
- *Separating lease and non-lease elements* – telecoms entities will need to unbundle multiple-element arrangements provided to customers. As a result, they may want to combine the adoption of the new leases standard with the new revenue recognition standard (effective 1 January 2018), considering the interdependencies between the two standards for telecoms entities. This may prove to be most cost-efficient.

Transport and logistics

Entities in the Transport and Logistics sector often lease big-ticket items, including aircraft, trains, ships and real estate, but also leases such as trucks and other vehicles.

- *Renewal options* – entities in this industry often use leases in their revenue-generating activities. When does such an entity have economic incentive to renew a lease (e.g. airline, shipping, trucks)? This may require substantial judgement.
- *Identification of a lease* – determining when an arrangement is a lease can be complex and judgemental. For example, does a shipping entity have control over an identified asset when considering a time charter or bareboat charter? Under current guidance, there is not a lot of emphasis on the distinction between a service or an operating lease, as this often did not change the accounting.
- *Separating lease and non-lease elements* – Entities in this industry often lease assets combined with other services (e.g. maintenance, insurance, etc.). Sometimes lessors have bundled products, and lessees will need unbundled lease information to account for leases separate from service elements.

Real estate and equipment lessors

The real estate and equipment lessor industry may not be significantly affected in their own accounting as lessors. However, they may be impacted in their business model due to changes in lessees' behaviours.

- *Changing lessee needs* – lessees' changing behaviours may result in requests for shorter lease terms and more variable lease payments, which increases risk for lessors. This also changes the economics of leases and puts pressure on pricing. Real estate and equipment lessors may find it challenging to ask for higher lease rates in the current economic environment. This could influence the performance of real estate funds and equipment lessors, and increase cash flow volatility and risk. In turn, this could impact lessors' own ability to obtain favourable financing for their investments.
- *New service opportunities* – commercially, the changing needs of lessees may be more important to equipment and vehicle lessors rather than real estate. However, this depends on common terms of real estate leases which may differ by country. These changes may create a greater workload for lessors but also provide a catalyst for change in the industry. These new dynamics offer opportunities for new services and products. Various developments in the market may be accelerated by the new leases standard such as the increased focus on services. This may require a shift in some lessors' traditional business models.

Effects of the new standard will be felt across all industries, although the impacts may differ significantly.

Financial, operational and business impacts

The accounting change for leases is just the tip of the iceberg. Entities will need to undertake an in-depth review of the proposed changes and assess the impact on financial ratios and performance metrics (including debt covenants), business operations, systems and data, business processes and controls to understand the implementation issues and costs of complying with the new lease standard.

Financial information

The new standard will gross up balance sheets and change income statement and cash flow presentation. Rent expense will be replaced by depreciation and interest expense in the income statement (similar to finance leases today). This results in a front-loaded lease expense, which for some might decrease earnings and equity immediately after entering into a lease compared to an operating lease today.

Financial ratios and performance metrics redefined

Most commonly used financial ratios and performance metrics will be impacted, such as gearing, current ratio, asset turnover, interest cover, EBIT, operating profit, net income, EPS, ROCE, ROE, and operating cash flows. However, some performance measures such as operating profit, EBIT, EBITDA and operating cash flows reported would improve, with no change in the underlying cash flows or business activity.

The effect on financial ratios (such as gearing or leverage) may trigger breaches of loan covenants unless an entity has included ‘frozen’ GAAP clauses in its financing arrangements. An increase of interest expenses might also trigger covenants based on interest. These changes may also affect credit ratings and possibly result in other behavioural changes of stakeholders. Financial institutions should consider any impacts on regulatory capital needs, as the new leases standard might lead to an increase in risk-weighted assets. Lastly, entities need to consider the effect of these changes to their remuneration schemes and staff bonuses. Entities often operate in a complex environment, and these redefined metrics will affect many existing arrangements and stakeholders.

Entities anticipating capital market transactions shortly before or after the effective date of the new leases standard should consider the effects on their leverage/gearing ratios, how this benchmarks with peers and consider any specific regulatory requirements to present three to five years of historical financial information and track record.

Stakeholder awareness and communication

We anticipate that internal and external stakeholders will want to understand the impact of the new leases standard well before the effective date of 1 January 2019. Timely assessment of which arrangements and stakeholders are affected by these redefined financial ratios and metrics enables an entity to proactively revise its arrangements if needed and engage its stakeholders. Entities should also check whether they have agreed on 'frozen' GAAP clauses in their existing and future financing arrangements to avoid surprises and difficult negotiations with lenders.

Implementation can be cumbersome and costly

An entity should carefully assess the effects at an early stage, perform an inventory of contracts involved and understand the impact of the new standard and develop an early communication strategy to manage its stakeholders (and their perceptions). This includes extracting, gathering and validating lease data, assessing the impact and preparing for the re-design of its IT systems and process impacted by the new standard.

Lease data requirements will increase given that operating leases have historically been off-balance sheet. In addition, increased disclosure requirements for leases will also require additional data collection. Extracting lease data from lease contracts that currently is not systematised, and/or collecting lease data from different operational or other 'systems', may prove difficult and time-consuming. Once data is gathered and migrated from various sources it will need to be validated, standardised and analysed. The practical implications in gathering, validating and standardising lease data across the group can be time-consuming – for example, consider foreign locations and their lease data which require language translations. Then, cataloging existing leases, identifying lease data gaps and ensuring completeness can be a major effort. This requires significant resources and supporting (automated) lease extraction, validation and analysis tools during the implementation process.

New IT systems and robust processes and controls needed

Many lessees today use spreadsheets to manage and account for their leases. With the complexity of the new leases standard bringing all leases on balance sheet, using spreadsheets may not be cost-efficient and can lead to errors feeding into financial reporting. Lessees may need to implement contract management modules for lease data and lease engines to perform the lease calculations as required by the new leases standard. Entities need to think about implementing sustainable lease software solutions that are capable of dealing with the new lease accounting requirements. The current limited lease software solutions in the marketplace are based on the existing risks and rewards approach (finance versus operating leases). These will need to be modified to the requirements of the new leases standard. ERP providers have started to think about lease software solutions but they have generally been waiting on the issuance of the lease standard before they can finalise the development of their lease software solutions. Lessees will need to identify system gaps and changes that may be needed to their IT environments on a timely basis. This will support an entity in its selection of software vendors and a lease software solution that can be integrated with existing (accounting) systems and IT environments and best meets its future needs in a cost-efficient way. Timely assessment of the system gaps and business and IT requirements will support the software vendor selection process for a lease software solution. This will help reduce reporting and compliance risks.

Benefits to lessees beyond compliance and new opportunities for lessors

The new standard may result in renegotiations of existing leases to minimise the impact of the new leases standard. The elimination of off balance sheet accounting and increased administrative burden for leases might reduce the attractiveness of leasing. Next to the external transparency over leases, the increased internal transparency within an entity may actually drive more economic lease decisions enable lease portfolio optimisation or provide for potential cost savings. Other changes in lessee needs and behaviours may include a desire to move to shorter lease terms or include more variable lease payments based on usage of an asset. Others may want to move to more service-type agreements rather than leases, a trend that already exists in markets but could be accelerated by the new standard. Lessees may already engage in these renegotiations well before the adoption date to minimise the impacts of the new leases standard. However, entities considering such changes to their leases need to evaluate this carefully and consider all impacts, as these changes will often result in changes in economics, such as pricing and risks absorbed by an entity.

Unexpected tax consequences may arise

The standard may have a broad impact on the tax treatment of leasing transactions, as tax accounting for leasing is often based on accounting principles. Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the tax jurisdiction. In some jurisdictions IFRS principles and/or IFRS financial statements may be relevant for determining certain tax thresholds (e.g. in the Netherlands and UK). Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalisation rules for debt versus equity, percentage of EBITDA rules), and existing transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-border leases). A reassessment of existing and proposed leasing structures should be performed against the new standard to ensure continued tax benefits and/or management of (new) tax risks on the horizon. Where tax does not follow the new lease accounting model, management will be faced with the challenge of deferred tax accounting to account for the newly originated temporary differences in the financial statements.

Transition accounting and effective date

The effective date of IFRS 16 Leases is 1 January 2019

The new leases standard permits early application but it can't be applied before an entity also adopts IFRS 15 *Revenue from Contracts with Customers*.

A lessee has to choose either a full retrospective approach or a modified retrospective approach to transition to the new standard. The selected approach has to be applied to the entire lease portfolio.

A lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying the new standard from the date of initial application (specific provisions apply for intermediate lessors). An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale.

Lessees and lessors are not required to reassess whether an existing contract contains a lease upon transition, i.e. if an entity concluded under IAS 17 Leases that the contract is not a lease, an entity does not have to reassess the contract in accordance with IFRS 16.

The full retrospective approach

The transition accounting under the full retrospective approach requires entities to retrospectively apply the new standard to each prior reporting period presented as required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Under this transition approach, entities need to adjust equity at the beginning of the earliest comparative period presented.

Effective date	Years to be presented in accordance with IFRS 16 in financial statements
1 January 2019	Full retrospective method: FY 2018, FY 2019 Modified retrospective method: FY 2019

The modified retrospective approach

Under this approach, a lessee does not restate comparative information. Consequently, the date of initial application is the first day of the annual reporting period in which a lessee first applies the requirements of the new leases standard. At the date of initial application of the new leases standard, lessees recognise the cumulative effect of initial application as an adjustment to the opening balance of equity as of 1 January 2019.

Lessees with leases previously classified as operating leases:

- Recognise a lease liability, measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.
- There are two options for measuring the right-of-use asset on transition (on a lease-by-lease basis): by measuring the asset as if IFRS 16 had been applied since the commencement date of a lease using a discount rate based on the lessee's incremental borrowing rate at the date of initial application; or by measuring the asset at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments recognised immediately before the date of initial application.

Under the modified retrospective approach lessees are permitted on a lease-by-lease basis to apply the following practical expedients:

- apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
- adjust the asset on transition by the amount of any previously recognised onerous lease provision, as an alternative to performing an impairment review;
- apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or fewer of the date of initial application and account for those leases as short-term leases;
- use hindsight in applying the new leases standard, for example, in determining the lease term if the contract contains options to extend or terminate the lease; and
- exclude initial direct costs in the measurement of the right of use asset.

Lessees with leases previously classified as finance leases:

- The carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying IAS 17.
- Apply subsequent accounting in line with the requirements of IFRS 16.

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