

In-depth

A look at current financial reporting issues

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Retail and consumer ('R&C') industry supplement for IFRS 16 'Leases'

At a glance

The new lease accounting standard, IFRS 16, 'Leases', will fundamentally change the accounting for lease transactions for lessees, and it is likely to have significant business implications. The International Accounting Standards Board (IASB) issued the standard in January 2016.

Almost all leases will be recognised on the balance sheet for a lessee, with a right-of-use asset and a lease liability that recognise more expenses in profit or loss earlier during the life of a lease. This will have an associated impact on key accounting metrics, and clear communication to stakeholders will be required to explain the impact of changes.

'A study on the impact of lease capitalisation', issued by the International Accounting Standards Board in February 2016, identified that the retail industry is one of the most heavily impacted, and that it would see a median increase in debt of almost 100% and in EBITDA of 41%. 35% of entities would have an increase in debt of over 25%. This supplement highlights some of the areas that could create the most significant challenges for lessees in the retail and consumer sector as they transition to the new standard. These include:

- determining whether renewal options should be considered in the initial measurement;
- treatment of variable lease payments; and
- identification of triggering events that might require reassessment of the lease.

Areas of focus for retailers include arrangements with variable lease payments, assessing right of use and perpetual lease contracts, and the treatment of payments to previous lessees ('key money').

The majority of retailers are most significantly impacted by the guidance for lessees. Further guidance for lessors is included in our ['Applying IFRS for the real estate industry'](#) publication.

Overview

Entities in the retail and consumer sectors are generally prolific lessees and, at times, lessors of assets. IFRS 16 requires lessees to capitalise all leases, except for short-term leases and leases of low-value assets. This is a significant change from IAS 17, where operating leases were off balance sheet.

The accounting model for lessors is substantially the same as under existing IFRS. Lessors will classify leases as operating or financing. A lease that transfers substantially all risks and rewards incidental to ownership is classified as a finance lease. All other leases are classified as operating leases.

Effective date and transition

The new standard is effective for annual reporting periods beginning on or after 1 January 2019.

Earlier application is permitted, but only in conjunction with adopting IFRS 15, 'Revenue from contracts with customers'. This means that an entity is not allowed to apply IFRS 16 before applying IFRS 15. The date of initial application is the beginning of the annual reporting period in which an entity first applies IFRS 16.

The new standard is required to be adopted using either a full retrospective approach under IAS 8, 'Accounting policies, changes in accounting estimates and errors', or a simplified approach. Under the simplified approach, lessees do not need to restate comparative information, but they should instead recognise the cumulative effect of applying the standard as an adjustment to the opening retained earnings at the date of initial application. The simplified approach provides various practical expedients, including being allowed to use hindsight.

Impact

The accounting changes are the most obvious impact that the new standard will have on retail and consumer companies. Companies will also need to analyse how the new model will affect current business activities, contract negotiations, budgeting, key metrics, systems and data requirements, and business processes and controls.

For retail and consumer companies with a significant portfolio of leases, the ability to gather the required information on existing leases, and to capture data on new leases at the outset, will be critical to an orderly and smooth transition to the new standard. This might result in the need for new systems, controls and processes, which will take time to identify, design, implement and test. Furthermore, recognition of right-of-use assets and associated liabilities will profoundly change the balance sheet for retail and consumer companies. This, in turn, might affect loan covenants, credit ratings and other external measures of financial performance.

More information

[In depth INT2016-01](#) is a comprehensive analysis of the new standard.

'[In the Spotlight: An industry focus on the impact of IFRS16: Retail and Consumer](#)' also looks at some of the practical issues that lessees and lessors in the industry might face.

Is the contract a lease?

Lease accounting guidance applies to any arrangement that conveys control over an identified asset to another party. Retail and consumer companies often enter into arrangements that might clearly contain leases (for example, high street premises), or they might leave residual elements of control with the landlord (for example, airport coffee shop concessions).

An arrangement is a lease, or contains a lease, if an underlying asset is explicitly or implicitly identified and use of the asset is controlled by the customer.

If an arrangement explicitly identifies the asset to be used, but the supplier has a substantive contractual right to substitute the asset, the arrangement does not contain an identified asset. A substitution right is substantive if (a) the supplier can practically use another asset to fulfil the arrangement throughout the term of the arrangement, and (b) it is economically beneficial for the supplier to do so. The supplier's right or obligation to substitute an asset for repairs, maintenance, malfunction or technical upgrade does not preclude the customer from having the right to use an identified asset.

An identified asset must be physically distinct. A physically distinct asset might be an entire asset or a portion of an asset. For example, a building is generally considered physically distinct, but one floor within the building might also be considered physically distinct if it can be used independently of the other floors (for instance, with its own point of entry or exit, access to lavatories, etc). A capacity portion of an asset is not an identified asset if (1) the asset is not physically distinct (for example, the arrangement permits the lessor to allocate a different space to the lessee), and (2) a customer does not have the right to substantially all of the economic benefits from the use of the asset.

A customer controls the use of the identified asset by possessing the right (1) to obtain substantially all of the economic benefits from the use of such asset ('economics' criterion), and (2) to direct the use of the identified asset throughout the period of use ('power' criterion). A customer meets the 'power' criterion if it holds the right to make decisions that have the most significant impact on the economic benefits derived from the use of the asset. In a retail environment, these decisions would include what is sold, for how much and how it is displayed. If these decisions are predetermined in the contract, the customer must have the right to direct the operations of the asset without the supplier having the right to change those operating instructions, or must have designed the asset in a way that predetermines how, and for what purpose, the asset will be used throughout the period of use, in order for the contract to be a lease.

The new model differs, in certain respects, from today's risks and rewards model, and it might result in the identification of fewer embedded leases compared to current guidance. However, under current lessee guidance, embedded leases are often off-balance sheet operating leases and, as such, application of lease accounting might not have had a material impact on the income statement. Determining whether to apply lease accounting to an arrangement under the new guidance is likely to be far more important, since virtually all leases will result in recognition of a right-of-use asset and lease liability.

PwC observation

Contracts that might contain a lease are often the result of specific negotiations covering a variety of goods and services, and they often involve extensive collaboration between the parties, before and during the term of the arrangement. In some cases, the factors that indicate that control has passed to the customer might not be obvious and might require significant judgement. Careful assessment of the facts and circumstances, considering all relevant rights, will be required.

Example 1 – Retail unit with substitution rights

A customer enters into a contract that conveys the right to use an explicitly specified retail unit for a period of five years. The property owner can require the customer to move into another retail unit; there are several retail units of similar quality and specification available.

Because the property owner has to pay for any relocation costs, it can benefit economically from relocating the customer only if there is a new lessee that wants to occupy a large amount of retail space at a rate that is sufficient to cover the relocation costs. Those circumstances might arise, but they are not considered likely to occur.

The contract requires the customer to sell his goods during the opening hours of the larger retail space. The customer decides on the mix of goods sold, the pricing of the goods sold and the quantities of inventory held. He further controls physical access to the retail unit throughout the five-year period of use.

The rent that the customer has to pay includes a fixed amount plus a percentage of the sales from the retail unit.

Analysis

Is there an identified asset? The retail unit is explicitly specified in the contract. The property owner has a right to substitute the asset; however, the substitution right is not substantive, because the property owner would benefit from the exercise of the right only under certain circumstances that are not considered likely to occur. The retail unit is an identified asset.

Does the customer have the right to obtain substantially all of the economic benefits from the use of the retail unit? The customer has the exclusive use of the retail unit throughout the period of use. The fact that a part of the cash flows received from the use are passed to the property owner as consideration does not prevent the customer from having the right to substantially all of the economic benefits from the use of the retail unit.

Does the customer have the right to direct the use of the retail unit? During the period of use, all decisions on how, and for what purpose, the retail unit is used are made by the customer. The restriction that goods can only be sold during the opening hours of the larger retail space defines the scope of the contract, but it does not limit the customer's right to direct the use of the retail unit.

The contract contains a lease of a retail unit.

Example 2 – Coffee kiosk with substitution rights

A coffee vendor enters into a contract that conveys the right to 10 square metres of retail space within an airport terminal for a period of one year, with an option to renew indefinitely. There is no specific location cited in the contract – it is stipulated by the contract that the airport operator can require the coffee vendor to move to any location next to, or near to, different boarding gates. The coffee vendor can easily move its kiosk, and the airport operator has minimal costs to relocate the coffee vendor. The contract requires the outlet to be open between 5.30am and 10pm.

Analysis

Is there an identified asset? The contract is for 10 square metres of retail space, but the location within the airport is not explicitly specified in the contract and the airport operator has a right to substitute the space at any time. The substitution right is substantive because:

- (a) the airport operator has a practical ability to change the space used – it can choose between alternative locations near different boarding gates; and
- (b) the airport operator would benefit economically from substituting the space – there are minimal costs to move the kiosk and, over time, the operator could benefit from using space differently to meet changing circumstances.

In this instance, there is no lease, because there is no identified asset and the arrangement is an executory contract.

Components, contract consideration and allocation

An arrangement might contain lease and non-lease components that are subject to different accounting models. Components are those items or activities that transfer a good or service to the lessee. Arrangements might also contain multiple lease components. The right to use an underlying asset is a separate lease (from other leases within the contract) where the lessee can benefit from using the underlying asset on its own, or together with resources readily available to the lessee, and the underlying asset is not highly dependent on, or highly interrelated with, other underlying assets in the contract.

Example 3 – Identifying components within an arrangement: rental unit

Facts: A retail company leases a retail unit within a shopping mall together with shop fixtures and a storage bay. The monthly payment to the lessor includes: (a) fixed rent for the retail unit, fixtures and loading/storage bay; (b) a fixed amount for property taxes and insurance; (c) a fixed amount for security and cleaning; and (d) a fixed amount relating to the maintenance of the retail unit.

Question: What are the components in this arrangement?

Discussion: The lease components in the arrangement are the retail unit with the loading/storage bay and the fixtures. The non-lease components are the security and cleaning and the maintenance services.

The fixed payments relating to property taxes and insurance do not transfer a good or service to the lessee, so they cannot be identified as separate components. They are instead considered as part of the total consideration allocated to the separately identified components of the contract.

The fixtures are considered a separate lease component, since they are neither dependent on, nor highly interrelated with, the retail unit or loading/storage bay, because they can be sourced from other providers and be used in other boutiques. Accordingly, the right to use the fixtures is a separate lease component.

Security and cleaning services involve the provision of separate services to the retail company, and they are considered as separate non-lease components. The retail company can either:

- 1) separate the lease from the non-lease components, and allocate consideration to each component; or
- 2) apply the practical expedient, and account for both the lease and the associated non-lease component as a single, combined lease component.

Due to the significance of the maintenance services, the retail company elects not to apply the practical expedient of combining the non-lease components with the associated lease components.

Once the lease and non-lease components are identified, contract consideration is allocated to each component. A lessee should allocate the contract consideration to the separate lease and non-lease components, based on their relative stand-alone prices.

A lessor should allocate contract consideration to the separate lease and non-lease components in accordance with the transaction price allocation guidance in IFRS 15. The practical expedient available to a lessee, for lease and non-lease components, is not available to a lessor.

The guidance specifies that amounts payable by the lessee for activities and costs that do not transfer a good or service to the lessee (for example, property taxes and insurance) are not separate components of the contract, but they are considered as part of the total consideration allocated to the separately identified components of the contract.

PwC observation

A lessee might elect to apply the practical expedient of accounting for a lease and the associated non-lease component as a single lease component. If the practical expedient is applied, the cash flows associated with the non-lease component will increase the liability and right-of-use asset recognised on the balance sheet. This is an election by asset class. Companies are likely to consider the significance of the increase in the right-of-use asset and liability relative to the effort and complexity required to obtain reliable information to separately account for the lease and non-lease components. Retail and consumer lessees with material leases will need additional processes, controls and documentation to ensure appropriate and consistent application of the guidance. For example, the guidance requires an appropriate allocation based on relative stand-alone prices that maximises the use of observable prices.

Initial direct costs

Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been executed. Any costs that would have been incurred even if the lease were not executed are not incremental costs, and they should be excluded from initial direct costs. For example, external legal fees are excluded from initial direct costs, assuming that the lessee would be required to pay its lawyers for preliminary work performed before a potential lessee was found. However, where a lessee and lessor execute a legally binding lease commitment prior to drafting the lease agreement, legal fees for drafting might be incremental costs that can be accounted for as initial direct costs. Initial direct costs are capitalised as part of the right-of-use asset and amortised over the lease term.

Retail and consumer companies often enter into multi-year arrangements, and they might incur significant initial direct costs in the form of payments paid to ensure access to a key location. Some contracts require the lessor, new lessee or old lessee to make payments when entering into a lease contract or during the lease term. Accounting for these payments might differ, depending on the contractual arrangements and on the substance of the transaction. The following table sets out the principles of lease accounting for payments between these parties:

	Lessor	New lessee	Old lessee
Lessor pays sums to:		Payments made to a new lessee at the inception of the lease are accounted for as a lease incentive.	This is a cost associated with cancelling the old lease, so it is generally expensed by the lessor. The old lessee should recognise the receipt as income (assuming that all conditions for receipt have been met).
New lessee pays sums to:	The payment is accounted for as a prepayment of rentals under the lease.		This might be a premium paid by the new lessee to gain access to a property located in a specific location. These payments, often called key money, might qualify as initial direct costs. The old lessee should recognise the receipt as income (assuming that all conditions for receipt have been met).
Old lessee pays sums to:	This is income arising from the old lease, so it should be recognised as income by the lessor. This is a cost of exiting the old lease, and it should be expensed by the old lessee.	This is a cost of exiting the lease for the old lessee, and it should be expensed. From the perspective of the new lessee, it is analogous to a lease incentive.	

Lease classification and initial measurement

Lessees will recognise a right-of-use asset and lease liability for virtually all of their leases (other than short-term leases or leases of low-valued assets for which they elect to apply an exemption). There will be no distinction between finance and operating leases for lessee accounting, as is the case under IAS 17. However, lessors will continue to classify leases as operating or finance leases.

Short-term leases are leases with a lease term of 12 months or less. The lease term also includes periods covered by an option to extend, or an option to terminate, if the lessee is reasonably certain to exercise the extension option, or not to exercise the termination option. A lease that contains a purchase option is not a short-term lease. Short-term leases for retail premises potentially exist in certain jurisdictions where notice periods are less than 12 months and there is no expiry date. In such circumstances, the guidance on lease renewal options should be considered (see below).

The guidance around lease portfolios is available for use by retailers. Both a lessee and a lessor can apply IFRS 16 to a portfolio of leases with similar characteristics if they reasonably expect that the resulting effect is not materially different from applying the standard on a lease-by-lease basis. Care should be taken over judging whether characteristics are similar – boutiques in shopping malls are unlikely to share the same characteristics as luxury high street locations. Similarly, since property leases are often territory-specific, a country-by-country portfolio specification is most likely to be seen in practice.

At the commencement date, the lessee measures the lease liability at an amount equal to the present value of the lease payments during the lease term that are not paid at that date. Lease payments consist of the following components:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- variable lease payments that depend on an index or a rate;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option (if the lessee is reasonably certain to exercise that option); and
- payments of penalties for terminating the lease (if the lease term reflects the lessee exercising the option to terminate the lease).

Variable lease payments which depend on turnover or footfall/passengers, rather than an index or a rate, are a frequent feature of retail leases, and they are recognised in the income statement when the event or condition that triggers those payments occurs.

The lessee might be obliged to return the underlying asset to the lessor in a specific condition or to restore the site on which the underlying asset has been located. The accounting for these obligations is comparable to the current accounting. The lessee continues to recognise a provision in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets', to reflect this obligation. The initial carrying amount of any provision is included in the measurement of the right-of-use asset. Obligations incurred during the term of the lease (such as wear and tear) are recognised as an expense as incurred.

The existence of renewal options or lessee rights to extend are a common feature of leases on retail premises. Periods covered by an option to extend the lease term are included in the lease term if the lessee is reasonably certain to exercise that option. Hence, at initial recognition, retailers should include lease payments in future periods if the lessee is 'reasonably certain' to exercise the extension option.

IFRS 16 lists various factors to consider, but it does not prescribe how to weight the individual factors when determining whether it is 'reasonably certain' that a lessee will exercise an option. For example, consider a flagship store in a prime and much sought-after location. A number of factors should be considered to assess if it is reasonably certain that the lessee will renew the store lease, such as lease term, geographical location of the store, termination penalties and, most importantly, magnitude and expected useful life of leasehold improvements. It is likely that a retailer will be reasonably certain to extend the lease at a flagship store if the initial lease period is relatively short.

Non-monetary aspects are included in the analysis, provided that they reflect economic incentives and not irrational behaviour. Examples of non-monetary aspects include the time and business disruption to find a replacement asset and to enter into a new contract and move locations, and the prestige of the location.

A lessee's past practice might provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. It is, however, key to understand the economic reasons for that past practice. Those economic reasons, if any, must be taken into account in the lease term assessment.

Example 4 – How are lease payments determined if there are extension options at market rates?

On 1 January 20X1, entity A (lessee) enters into a lease of retail space. The non-cancellable lease term is seven years. The annual lease payment is CU10,000 in the first year, with a 5% increase in every following year; and CU10,000 reflects the market rent at the commencement date. Entity A has the option to extend the lease term for another five-year period. At the commencement date, it concludes that it is reasonably certain to exercise the extension option.

How does entity A determine the lease payments that are included in the lease liability in the scenarios below?

Scenario A

The revised rent for the extension period will be agreed by the lessor and the lessee at the date when the option is exercised, based on the market rent at that time. The revised rent will, however, be no more than 105% of the rent at the end of the preceding period.

Since entity A is reasonably certain to exercise the extension option, the lease term is 12 years. All lease payments within that period are included in the lease liability.

Because both lessor and lessee have to agree to the revised rent for the extension period, it can be assumed that the rent will be the market rent at that time. Variable lease payments that depend on an index or a rate, such as payments that vary to reflect changes in market rental rates, are initially measured using the index or rate as at the commencement date. [IFRS 16 para 27]. The lease payments for the extension period that are included in the initial measurement of the lease liability are therefore CU10,000 (market rent at the commencement date) for each year of the renewal period.

	1	2	3	4	5	6	7	8–12
Lease payment [CU]	10,000	10,500	11,025	11,577	12,155	12,763	13,401	10,000

When the entity agrees the amount of the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time.

Scenario B

The revised rent for the extension period will be agreed by the lessor and the lessee at the date when the option is exercised, based on the market rent at that time. There is, however, a cap and a floor such that the revised rent cannot be below 85% or higher than 115% of the rent at the end of the preceding period. The lease payment throughout the extension period is therefore at least $(CU10,000 \times 1.056) \times 0.85 = CU11,391$.

In scenario B, the payments throughout the extension period are not fully variable but floored. Since the floor of CU11,391 is higher than the market rental rate at commencement date (CU10,000), the amount that is included in the initial measurement of the lease liability for years 8–12 is CU11,391.

	1	2	3	4	5	6	7	8–12
Lease payment [CU]	10,000	10,500	11,025	11,577	12,155	12,763	13,401	11,391

When the entity agrees the amount for the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time.

Scenario C

The revised rent for the extension period is the higher of (i) the rent paid in year 7 (CU13,401) and (ii) the current market rent at the date of the commencement of the extension period (either to be agreed by the lessor and the lessee, or determined by an independent surveyor).

Similar to scenario B, the payments throughout the extension period are not fully variable but floored. In scenario C, the floor is the lease payment made in year 7 (CU13,401). Since the floor of CU13,401 is higher than the market rental rate at commencement date (CU10,000), the amount that is included in the initial measurement of the lease liability for years 8–12 is CU13,401.

	1	2	3	4	5	6	7	8–12

Lease payment [CU]	10,000	10,500	11,025	11,577	12,155	12,763	13,401	13,401
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When the entity agrees the amount of the first lease payment of the extension period (that is, the payment for year 8), it remeasures the lease liability to reflect the market rent at that time if that is higher than CU13,401.

Lease modifications and reassessments

Lease modifications

A lease **modification** is any change to the terms and conditions of a contract that results in a change in the scope of, or the consideration for, the use of an underlying asset.

A modification is only accounted for as a separate lease if (i) the modification increases the scope of the lease by adding the right to use one or more assets, and (ii) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

Where a modification is a separate lease, the accounting for the original lease is unchanged, and the new lease component(s) should be accounted for at commencement, like any other new lease.

Lease reassessments

A **reassessment** of the lease liability takes place if the cash flows change based on the original terms and conditions of the lease (that is, there is no change to the lease contract).

If a lessee has an extension option, with unchanged conditions, which it was initially not reasonably certain to extend, so the extension period was not included in the lease term, but it later does exercise the extension option, the lease liability would be reassessed to reflect the extended lease term. The lessee accounts for the remeasurement in a similar way to a modification, but whether or not it revises the discount rate depends on the reason for the reassessment. For example, when the lease term changes it uses a revised discount rate, whereas when the lease payments increase with inflation it does not revise the discount rate.

PwC observation

Reassessment of the likelihood of exercise of extension, termination or purchase options, and consequent reassessment of the lease term, is required when a triggering event occurs which is within the control of the lessee and was not previously included in the determination of the lease term. A change in market-based factors will not, in isolation, trigger a reassessment of options.

For example, a reassessment would not be triggered if a lessee is leasing retail space and current market conditions for the office space location change, resulting in lease payments that the lessee will be required to make in the extension period now being considered below market. A reassessment would be

triggered if a lessee invests in significant lease improvements near the end of the original lease term, because the investment is within the lessee's control.

Retail companies have large portfolios of leased assets, and the likelihood of extending will change over time as a result of changes in general macro-economic conditions or company-specific factors (such as customer trends, store location, etc). It will be important for a company to ensure that it has processes and controls in place to identify and monitor triggering events that would require the remeasurement of a lease.

Lease payments which change with inflation or a rent review, which was foreseen in the original contract, are also situations where the lessee will reassess its liability. The original discount rate is still used, unless the change in payments is due to a change in interest rates.

Transition provisions

Lessees can choose between a full retrospective application in accordance with IAS 8, 'Accounting policies, changes in accounting estimates and errors', and a 'simplified approach'. The approach chosen must be applied consistently to all leases. For more explanation of the two approaches, see [In depth INT2016-01](#).

Comparative information is not restated under the 'simplified approach', which causes a lack of comparability for users of the accounts. This lack of comparability, and the significant magnitude of the change, is causing some retailers to elect the more costly full retrospective application.

If a lessee chooses the 'simplified approach', for its leases that are currently classified as operating leases it can choose whether to recognise the right-of-use assets retrospectively or based on the lease liability on transition. Right-of-use assets based on the lease liability will typically be bigger than those calculated retrospectively, resulting in more depreciation and reduced profitability in future. Retailers with material long-term leases wanting to maximise reported profits are likely to choose right-of-use assets calculated retrospectively.

Lessees calculating right-of-use assets retrospectively under the 'simplified approach' have a choice of using hindsight (which is not available under the full retrospective application). Hindsight relates to areas of estimation and judgement (for example, whether the lessee was reasonably certain to extend a lease). Hindsight should not be applied to areas that do not involve judgement or estimation (for example, leases that have been modified or would have been reassessed – see previous section).

All lessees calculating a right-of-use asset retrospectively (under either transition approach) will have to retrospectively calculate how the right-of-use asset would have changed each time there was a modification (such as a renegotiation) or a reassessment (such as a market rent review or inflationary increase). This will be particularly onerous for retailers with large long-term lease portfolios.

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