

In depth

A look at current financial reporting issues

Corporate treasury industry supplement for IFRS 16 'Leases'

No. 2018-07

What's inside:

Background

Practical issues:

1. *Discount rates for lease liabilities* 2

2. *Hedging lessee interest rate risk under IFRS 9* 4

3. *Hedging foreign currency risk in leases under IFRS 9* 6

Closing remarks 8

At a glance

The new lease accounting standard, IFRS 16, 'Leases', will fundamentally change the accounting for lease transactions for lessees and is likely to have significant business implications. It is effective from 1 January 2019.

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

Treasurers at companies adopting IFRS 16 are likely to be involved in its implementation. This publication highlights some common issues and practical solutions relevant to treasurers. These include:

- determining the appropriate discount rate to use for lease liabilities;
- potential hedging strategies for interest rate risks inherent in leases; and
- potential hedging strategies for leases denominated in foreign currencies.

Background

IFRS 16, the IASB's leasing standard, is almost upon us. Effective from 1 January 2019, IFRS 16 requires most leases to be treated as financing arrangements, and a resulting right-of-use asset and lease liability to be recorded.

In depth INT2016-01 provides a summarised analysis of the new standard. In addition, PwC's Manual of accounting, chapter 15 (Leases), contains a comprehensive overview of the new standard and its related implications.

Practical issues

In this publication, we focus on those issues of most relevance to the treasury function of an organisation. The extent to which treasury is involved in leasing projects varies between organisations. For example, in some organisations the treasury department might take an active role in 'lease versus buy' decisions, and it would need to have a greater understanding of the impact of the standard on those issues. However, this publication covers basic treasury involvement in determining

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

borrowing rates and some of the hedging/financial risk management considerations that relate to leases.

Since the model that is being applied to lessees is the most radically different, we focus on the issues relevant to lessees in this publication.

1. Discount rates for lease liabilities

Lease liabilities need to be recorded at present value, so determining the discount rate to apply to a lease is an important consideration. The discount rate applied will drive the future financing costs that need to be recognised for the lease, as well as the aggregate amount recorded for the liability.

IFRS 16 requires the rate implicit in the lease to be used if it can be readily determined and, if it cannot, the lessee's incremental borrowing rate should be used. In most cases, the implicit rate will not be readily determinable. However, we have seen cases where the lease agreement explicitly gives an implicit rate, or where the rate can be determined through the operation of penalties for early termination or default provisions. Except in the limited cases where the implicit rate is readily determinable, the incremental borrowing rate will need to be estimated.

Generally, the borrowing rate will be determined at the commencement date of a lease and locked in for the term of the contract. However, there might be situations where the borrowing rate is reassessed (for example, contractual modifications or reassessments of whether extension options will be exercised).

On transition, the discount rate for existing leases that need to come on to the books is relevant. We expect that the majority of entities will adopt the standard on a modified retrospective basis, which requires the incremental borrowing rates at the transition date to be computed. Therefore, the interest rates applicable on 1 January 2019 for a calendar year entity will drive the initial recognition of the lease liabilities.

There is an option to adopt the standard on a retrospective basis, which would require consideration of the rates that would have applied historically, using the implicit rate if it was readily determinable.

Example of relevant measurement date for different transition methods

Assume a calendar year entity is adopting the lease standard on 1 January 2019. The entity has one lease arrangement which commenced on 1 January 2015 for a 10-year lease term.

If the entity uses the modified retrospective approach, the incremental borrowing rate at 1 January 2019 will be relevant. The transitional requirements for IFRS 16 do not specify whether the lease term, when determining the incremental borrowing rate, should be the original lease term (10 years) or the remaining lease term (six years). In our view, using either would be appropriate, and the entity has an accounting policy choice.

If the entity uses the full retrospective approach, the discount rate at 1 January 2015 with a 10-year term will be relevant. If the lease was modified before transition on 1 January 2019, the entity will also need to calculate the revised discount rate, to account for the modification.

The question then arises as to how the incremental borrowing rate should be determined. The lessee's incremental borrowing rate is defined as *"the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use*

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

asset in a similar economic environment". The definition is a bit of a mouthful but let's break it down into its components:

'the lessee'

- The lessee is the substantive counterparty to a lease arrangement.
- An organisation will likely have a number of lessees, because different legal entities within a group might enter into contracts. To the extent that a legal entity within a group enters into a contract without an explicit guarantee from other members of the group, the incremental borrowing rate will primarily consider the borrowing rate that would apply to the contracting legal entity. It is likely that such borrowing rates would differ from the borrowing rate of the ultimate parent of the group.
- However, if there are no explicit guarantees, the effect of implicit guarantees on the contracting entity's borrowing rate could also be considered, but only to the extent that these would be taken into account by hypothetical market participants lending to the contracting entity.

'borrow over a similar term'

- The term of the borrowing is generally aligned with the term being used in the assessment of a lease. This would include renewal options that the lessee is reasonably certain to exercise. Most entities have different leases with a range of different terms. Effectively, a discount rate would generally be developed for various maturities.

'similar security and similar value'

- Lease liabilities are considered to be the equivalent of secured loans. This is because, if a lessee defaults, the lessor will typically be able to seize the asset and lease it to another party.
- A secured borrowing rate would generally be lower than an unsecured borrowing rate, so the discount rate curve would be adjusted by a 'security factor'.
- The 'security factor' could vary depending on the nature of the assets. For example, a real estate asset in a major city, where a lessor could easily find a number of other tenants, would likely attract a greater security factor than a real estate asset at a remote industrial site where it would require a significant amount of time and effort to find a replacement tenant.
- The 'security' might not be the entire value of the underlying asset; it would take into account the security factor of the leasehold interest. For example, if the lease of a building is for three years and the building has a useful life of 30 years, the security interest would reflect the value of the three-year leasehold interest rather than the fair value of the building as a whole.

'similar economic environment'

- The currency in which the lease is denominated might have an impact on the incremental borrowing rate. For example, for multinational groups the risk-free rate relevant to the currency in which the lease is denominated is likely to be the starting point before credit risk is factored in.
- Country-specific risk premiums might be applicable in assessing the security of the asset and the creditworthiness of the lessee.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

- The discount rate curve for the appropriate economic environment needs to be established at the correct date, based on the transition method (see example above).

Treasurers will likely be asked for input in developing the appropriate discount rates for the organisation's leases, and this might involve significant amounts of effort in order to establish the appropriate discount rate curve for a given lease. Since new leases are likely to continue to be entered into from time to time, discount rate curves will need to continue to be updated and available to those responsible for accounting for leases within the organisation. Organisations might establish a framework to standardise how discount rates are estimated, incorporating the factors listed above, and regularly update the framework over time. Whether simplifications can be applied to the process will depend on the complexity of the organisation, the underlying arrangements and the materiality of the leases.

2. Hedging lessee interest rate risk under IFRS 9

As discussed in the previous section, lease liabilities will generally be discounted by the lessee's implicit borrowing rate. This rate remains fixed throughout the lease term (unless there are modifications to the lease etc).

Hedging firm commitments to enter into leases ('fair value hedging')

Entities entering into leases with fixed payments will be exposed to changes in the risk-free rate until the lease commences. This can be viewed as analogous to committing to enter into a fixed-rate debt, with the entity receiving a right-of-use asset instead of cash. Entities might wish to hedge this risk in the same way as they might for a debt commitment.

Because the entity will be exposed to fixed-rate interest rate risk, the hedge would normally be designated as a fair value hedge. Only firm commitments will qualify as a fair value hedge. Therefore, to the extent that an entity firmly commits to a lease contract, but the lease will not commence until a future date, the lease contract might be a firm commitment eligible for a fair value hedge of risk-free interest rate risk. The hedged item could be designated as changes in the fair value of the firm commitment attributable to changes in the risk-free interest rate. In this type of hedge, a basis adjustment for the hedged risk would be recognised as the firm commitment, and this basis adjustment would ultimately adjust the lease liability when the lease commences; that is, the entity will record an asset or liability for the firm commitment on the balance sheet, based on the changes in the hedged risk, and this asset or liability will be incorporated as a premium or discount to the lease liability computed under IFRS 16 when the lease commences.

Note, the liability will be an amortising liability where each of the lease payments is treated partly as a payment of principal and partly as a payment of interest. Accordingly, the interest rate risk will have a diminishing impact on the entity over the term of the lease, and this should be taken into account in establishing the hedging relationship.

The entity will also be exposed to changes in its own credit risk, because the relevant credit spread will be part of determining the incremental borrowing rate.

Unfortunately, IFRS 9 does not allow credit risk to be an eligible risk component of a hedged item. However, it might be possible to designate a firm commitment managed using a credit derivative at fair value through profit and loss (see para 6.7.1 of IFRS 9).

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

Example of hedging risk-free rates for a committed lease

Assume an entity commits to a lease contract that commences in six months' time. The lease will be five years in duration, and the payments will be \$1m per year over five years. The entity wishes to lock in the risk-free interest rate in effect today as a component of the entity's incremental borrowing rate. The liability discounted at today's incremental borrowing rate is \$4.25m.

The entity is contemplating entering into a forward starting, receive floating, pay fixed interest rate swap in order to hedge changes in the cash flows of the lease liability attributable to changes in the risk-free interest rate.

In selecting an interest rate swap, the entity should consider the following:

- a) The principal amount of the liability will depend on the incremental borrowing rate. In this simple example, the principal will be the \$1m of payments each year, discounted for five years. The liability discounted at today's incremental borrowing rate is \$4.25m. Therefore, the entity might enter into a swap with a notional principal of \$4.25m.*
- b) The liability will amortise over time. Accordingly, in selecting a perfect swap to hedge the liability, the principal amount will need to amortise to reflect the lower exposure of the entity to interest rates over the term of the liability.*
- c) If the entity's strategy is only to lock in the interest rate that will be recognised on the lease liability, the swap would be terminated and net cash settled at the commencement date of the lease. The accounting exposure to market interest rates will no longer exist after the commencement date, because the discount rate is fixed at that date.*

Hedging forecast future leases ('cash flow hedging')

Some forecast future leases will not be firmly committed. The question arises, 'Could an uncommitted but highly probable forecast lease be designated in a hedge of interest rate risk in a cash flow hedge'?

It might be possible to designate such forecast leases if it can be demonstrated that the expected payments under a forecast lease will vary based on market interest rates (that is, the lessor prices the lease using risk-free rates as a component). In order to designate the risk-free rate as an eligible component of the lease payments, the effect of the risk-free rate must be separately identifiable and reliably measurable. This would involve analysing the relevant lease market and considering the pricing structure for leases in that market. Demonstrating that the lessor will change the cash flows based on movements in market interest rates might be complex, particularly where the lessee does not have complete insight into the pricing model used by lessors. If a forecast lease will become a firm commitment at some point in the future, and assuming the entity was able to demonstrate a separable interest rate risk component in the forecast transaction, the entity could choose to designate a hedge of the risk-free rate as a cash flow hedge until the date of the firm commitment, and to designate a fair value hedge thereafter.

Example of hedging risk-free rates for a forecast lease

Assume an entity forecasts that it will enter into a lease contract with fixed payments that will commence immediately on signing in six months' time. The lease will be five years in duration. The lease payments are unknown, but the entity has demonstrated that the forecast lease is highly probable and that, based

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

on market structure, the lease payments contain a separately identifiable and reliably measurable risk-free interest rate component.

Based on conditions today, it is expected that the lease would be priced at \$1m per year for five years, and that the lease payments would vary based on the risk-free interest rate in effect at the commencement date in six months' time. It is estimated that the present value of the lease liability at the commencement date would be \$4.25m.

A forward-starting receive-floating pay-fixed amortising swap, with an initial principal amount of \$4.25m, might be an effective hedging instrument to hedge changes in the cash flows of the forecast lease liability attributable to changes in the risk-free interest rate.

The lease liability will be a 'fixed rate' liability, because IFRS 16 requires the lease obligation to be discounted based on a fixed interest rate at commencement of the lease (typically the incremental borrowing rate). Accordingly, the swap would be net cash settled at the commencement date, and the amounts included in accumulated other comprehensive income for the hedge would be amortised to the income statement in relation to the interest recognised on the lease liability (taking into account the amortising nature of the liability).

3. Hedging foreign currency risk in leases under IFRS 9

Leases denominated in currencies other than an entity's functional currency will give rise to foreign exchange risk. It is important to note that the underlying foreign currency risk in existing lease arrangements is not new, but previously foreign currency risk was less apparent. Prior to IFRS 16, operating leases were treated off balance sheet, and so the foreign currency risk was only accounted for on the payments accrued during the period. However, under IFRS 16 the foreign currency risk of all future fixed lease payments is reported through retranslation of the associated lease liability. Accordingly, the volatility in earnings from foreign exchange risk is significantly amplified by the new standard.

Foreign currency lease liabilities as the hedged item

Given the additional volatility that foreign currency lease liabilities can cause, some entities might choose to hedge foreign currency risk associated with those liabilities using a cash flow hedge.

Similar to any recognised foreign currency liability, various derivative hedging instruments could be used including forward contracts, swaps or purchased options.

The payments made under a lease are generally equal each year. However, for accounting purposes such payments include both a principal and an interest element, since the lease liability is treated as an amortising loan.

It would be possible to use an amortising foreign currency swap whose principal amount amortises to match the reductions in the lease liability over time. However, ultimately, the entity is still exposed to the aggregate payments that must be made, whether these are through interest or principal payments. Hence, a flat swap could be used as a hedge partly against principal and partly against the future foreign currency interest to be recognised on the liability. In the case where a flat swap is used, the accounting entries will need to ensure that, where the hedge is fully effective, the amounts booked to profit or loss are matched against the retranslation of the principal and interest reported in the period, and that amounts relating to future interest payments are deferred.

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

Although using a non-amortising swap requires more complex accounting for the hedging relationship, this would need to be weighed against the benefits of higher liquidity in the non-amortising swap market.

Foreign currency lease liabilities as the hedging instrument

Foreign currency lease liabilities are essentially a foreign currency financing arrangement. These liabilities can be designated as hedging instruments against eligible foreign currency risks.

One common designation of such foreign currency liabilities is to hedge against the foreign currency risk of net investments in foreign operations.

Example of a net investment hedge using a foreign currency lease liability

Entity P has a CAD functional currency. Entity P's subsidiary, Entity S, has a USD functional currency. Entity P enters into a lease denominated in USD and records a lease liability of the equivalent of USD5m. The unhedged net investment in Entity S is more than USD100m.

Entity P chooses to designate the USD5m lease liability against a layer of its net investment in Entity S on a spot basis, and it puts in place appropriate hedging documentation. The impact is that the foreign currency gains/losses from translation of the lease liability are recorded in other comprehensive income and matched against the foreign currency translation of the net investment of Entity S. The foreign currency gains/losses from translation of the lease liability will be recycled from other comprehensive income to the income statement when the foreign operation is disposed of.

There are various ways that net investment hedges can be designated. IFRIC 16 provides more detail on designating net investment hedges within a group structure.

Hedging foreign currency risk in committed or forecast leases

An entity might wish to hedge foreign currency risk relating to either committed or highly probable forecast leases that will commence at a future date.

Similar to conventional borrowings, it is not possible to pre-hedge foreign currency risk of a forecast or committed issuance of a liability; this is because eligible foreign currency risk does not exist in such liabilities until they are drawn.

However, the initial recognition of the lease liability drives the initial measurement of the right-of-use asset relating to the lease. Therefore, the transaction can be analogised to a forecast or committed purchase of an item of equipment which is to be paid for in foreign currency.

Therefore, an entity might consider designating the foreign currency risk associated with the future 'purchase' of the right-of-use asset. In this case, the effective portion of the gains or losses from the eligible hedging instrument (including cost of hedging, if appropriate) will be adjusted against the cost of the right-of-use asset.

Example of hedging foreign currency risk in a committed future lease

Assume a CAD functional currency entity commits to a lease contract that commences in six months' time. The lease will be five years in duration and the payments will be USD1m per year over five years. The entity wishes to hedge against the risk of changes in the USD/CAD exchange rate.

The entity is contemplating entering into a forward starting USD/CAD swap to match the lease payments.

The hedging instrument might be effective in a cash flow hedging relationship of the risk associated with the hedge of the purchase of the right-of-use asset and

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2018 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.

subsequently as a hedge of the recognised lease liability. If appropriately designated, the cumulative gains or losses on the hedging instrument to the commencement of the lease will be adjusted against the right-of-use asset. Subsequent to commencement, the derivative could continue as a hedge against the principal and interest payments associated with the recognised lease liability.

Hedging foreign currency risk in inter-company leases

Under IFRS 16, leases between entities within a consolidated group will need to be considered. For example, the stand-alone accounts of a subsidiary might record a lease from its parent. On consolidation, the lease will need to be eliminated on the consolidated balance sheet.

However, foreign currency translation of inter-company balances that do not form part of the net investment in a foreign operation will not eliminate in the consolidated income statement (that is, such inter-company balances give rise to foreign currency risk that does not eliminate on consolidation).

Leases have defined repayment schedules, and so they will generally not qualify for treatment as a net investment in a foreign operation. Accordingly, if a party has a lease liability or a receivable denominated in a currency other than its functional currency, it will need to translate this balance through profit or loss on consolidation.

IFRS 9 does allow for foreign currency risks associated with inter-company balances to be eligible hedged items to the extent that they impact profit or loss. Accordingly, entities might wish to consider designating amounts relating to inter-company leases in qualifying hedging relationships.

Closing remarks

We hope that you found this publication useful in understanding how the treasury function might be impacted by the IASB's new leasing standard. Although this publication does not purport to cover all of the issues that might arise, we hope that it will be useful in sparking conversations amongst yourselves and your advisors.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

Authored by:

Scott Bandura
Partner
Email: scott.bandura@pwc.com

Jessica Taurae
Partner
Email: jessica.taurae@pwc.com

Sandra Thompson
Partner
Email: sandra.thompson@pwc.com

Richard Brown
Senior Manager
Email: richard.brown@pwc.com