Preparing your plan for IFRS 16 *Leases*

Questions to consider

Are you ready? What help do you need?

1. Do you know which of your contracts are, or contain, leases?

For some this technical assessment will be relatively straightforward, whilst for others, even some lessors, it may require considerable effort. The new definition of a lease is based on a customer having a right to control an identified asset. This requires an assessment of, amongst other items, whether a customer has rights to substantially all of the economic benefits from an identified asset for a period of time, whether they have the right to direct its use and whether supplier substitution rights are substantive. A transitional relief means that companies don't need to re-assess on transition whether their existing contracts contain a lease.

2. Are your systems and processes capturing all the required information?

Do you have all your lease data recorded in a database or master spreadsheet? Is this data up-to-date, reliable and in a format that can be manipulated and does it cover everything you will need to know under IFRS 16? Entities will need to make sure systems and processes are capable of capturing all leasing data necessary to apply IFRS 16, including disclosures. This could require significant effort from various departments, not just finance.

3. Are systems and processes capable of monitoring leases and keeping track of the required ongoing assessments?

Lessees are required to remeasure the liability for any changes to amounts expected to be paid under residual value guarantees, changes in contingent rentals based on indices or rates, changes to the lease term, rent reviews or changes to the assessment of a purchase option being exercised. Modifications to lease terms will also need to be monitored. Systems need to be able to track all of these items to make sure the correct accounting is applied. Internal control activities also need to be suitably robust.

4. Have you considered the potential use of IFRS 16's recognition exemptions and practical expedients?

Leases with a lease term of 12 months or less and no purchase options and leases for low-value assets (such as small IT equipment and office furniture) can be kept off-balance sheet and an expense recognised, typically straight-line. As a practical expedient lessees can decide not to unbundle leases from services in a contract and treat such contracts entirely as leases, although this would increase the asset and liability recorded. Another practical expedient allows IFRS 16 to be applied to portfolios of similar contracts if this is not expected to materially differ from contract-by-contract application.

5. Do you know what transitional reliefs are available, and whether you will apply any of them?

Subject to EU endorsement, IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Lessees can apply a full retrospective approach, or a modified approach. Under the latter, the cumulative effect of applying IFRS 16 is reflected in opening retained earnings and comparatives left unchanged. The modified approach requires the liability to be measured using the incremental borrowing rate on transition and includes a choice on how to measure the asset. An impact assessment of these different options, both in terms of effort required to implement and the financial effect, may reveal that some approaches are more desirable than others.

6. Do you know what discount rates you'll be using for your different leases?

Lessees are required to discount their liabilities to a present value, using the rate implicit in the lease if this is readily determinable. However, this requires knowledge of an underlying asset's fair value and residual value, which may not be known – for properties which tend to increase in value the pure mathematical approach may also produce unreasonable answers. Where the implicit rate is not readily determinable the incremental borrowing rate is used, as if the lessee had borrowed the funds to purchase the right-of-use asset and is repaying them over the lease term - this can also require considerable judgment to determine and have a significant financial effect.

7. Have you considered the impact of the changes on financial results and position?

Following the calculation and recognition of a right-of use asset, attracting depreciation, and a lease liability, attracting interest, lessees will become more asset-rich as well as more heavily indebted. For individual leases that were previously operating leases the expense profile will typically shift from being straight-line to front-loaded and boost performance metrics such as EBITDA. This could have a knock-on impact on debt covenants, remuneration schemes, earnout clauses, regulatory capital and various KPIs.

8. How will you communicate this impact to affected stakeholders?

Analysts' and investors' expectations need to be managed and potential impacts communicated well in advance. Loan agreements, remuneration plans, earnouts and similar may all need to be re-negotiated if entities are affected by the changes – such considerations are equally important when entering into similar, new agreements.

9. Have you planned when you will consider the tax impacts?

The UK tax treatment for leases is currently based on the IAS 17 model of operating and finance leases, but IFRS 16 could prompt changes in the tax legislation. Tax is often a key consideration when an entity is making decisions as to whether assets should be bought or leased. Management should keep abreast of developments in this area and consider revising their leasing strategy if necessary.

10. Have you considered whether your leasing strategy requires revision?

Given the significant accounting impact of the new Standard, entities should consider revising their leasing strategy if they want to avoid potentially undesirable accounting. Entities may wish to reconsider lease-buy decisions or renegotiate terms of existing leases, for example considering shorter term leases to avoid or reduce the impact of IFRS 16. Sale and leaseback structures may produce less desirable accounting given restrictions on the gains that can be recognised by sellers.

Other considerations?

For information on how Deloitte can help, including assisting with a more comprehensive readiness assessment, visit **www.deloitte.co.uk/ifrs16**

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