



Thinking allowed

The new lease accounting
Judgements a lessee should think about

Most businesses have leases. From 2019 the requirements for accounting for leases will change.

Although the basic change is that leases that IAS 17 *Leases* classifies as operating leases will now be accounted for in the same way as finance leases, the new requirements give us a lot more to think about.

This Deloitte publication is designed to help you think about matters such as:

- how to assess the general, base-line, effect of the new leases requirements on the financial statements;
- which factors will create the greater implementation challenges;
- what factors are important in deciding whether or not to take advantage of the practical expedients available;
- whether your contracts provide a clear analysis of lease, service and shared components; and
- whether leasing, under the current terms and period, is still the most efficient way to secure the particular asset.

We think that it is important that you start thinking about leases well in advance of the application date. There could be significant benefits in changing how you contract for assets, and such changes can take time to implement.

This publication is relevant to controllers, audit committees and chief accountants.

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Introduction

IFRS 16 *Leases* was issued by the IASB in January 2016. It will replace IAS 17 *Leases* for reporting periods beginning on or after 1 January 2019. You can apply it in earlier periods, provided that you also apply IFRS 15 *Revenue from Contracts with Customers*.

Although you have three years to prepare for the new requirements, you will need to make some important decisions about how you are going to apply the Standard – there are several exemptions and practical expedients available. We also think that the way some “lease” contracts are written is likely to change, to clarify what rights the contract is conveying. And because the financial reporting implications could be significant, early planning and thinking are likely to pay off.

Background

Leases was one of the first projects started by the IASB when it was formed. The IASB and FASB worked on the project together, publishing a joint discussion paper and two joint exposure drafts. Although IFRS 16 and the new FASB requirements, which were issued in February 2016, have much in common they are not a common standard – they treat some leases differently and have different exemptions and practical expedients. The FASB’s requirements are also effective from 1 January 2019.

The general idea that a lease creates an asset and a liability for the customer has remained central throughout the project. Unsurprisingly, because the likely effect on the financial statements will be significant for many entities the proposals attracted strongly expressed views, many of which were not supportive of the changes. In response to concerns about the cost of applying the original proposals, IFRS 16 has several practical expedients and policy choices.¹

Judgement

We think that IFRS 16 will require preparers to use more judgement than was required for IAS 17, in two ways.

There are some decisions for which you will need to use the guidance in the Standard to help you determine the appropriate treatment for the particular facts and circumstances – such as differentiating between a service and a lease and between an acquisition and a lease; deciding whether a lease qualifies for the low-value asset exemption; and assessing the effect of options to extend or terminate a lease, modifications to the lease and contingent rentals. IFRS 16 provides guidance for many of these decisions, filling some of the gaps in IAS 17. Even though IFRS 16 retains some of the wording used in IAS 17, no doubt some people will read them with fresh eyes in their new context. In this publication we identify the main areas where this judgement will be required.

The second area is in deciding how to use the discretion the Standard provides to get the best financial reporting outcome. IFRS 16 includes exemptions and practical expedients that, if used judiciously, can help you reflect the underlying economics of the contracts that contain leases, in a cost effective way.

Overview and conceptual changes

The project to replace IAS 17 *Leases* was launched as a joint effort by the IASB and US FASB in 2006. IFRS 16 *Leases* and the equivalent update to the FASB's accounting standards codification were issued at the beginning of 2016.

The most significant changes will affect lessees. IFRS 16 requires contracts that IAS 17 classifies as operating leases to be brought onto the balance sheet, using the finance lease approach already familiar to us in IAS 17. For a lessor the finance lease and operating lease distinction remains, with the new requirements pretty much carrying forward the old requirements from IAS 17.

The cynical will say that it took 10 years of joint work for the IASB to simply remove the concept of an operating lease, for lessees. Such a characterisation overlooks some important differences in the thinking behind IFRS 16 from that in IAS 17 – a move from a risks and rewards model to one based on control and a move from a whole-of-asset approach to one that focuses on recognising rights. Those changes are likely to affect how we think about a lease and how some contracts are written.

The FASB solution is similar, in that operating leases are also recognised on-balance sheet. But rather than applying the finance lease methodology for subsequent measurement, the expense recognition profile mimics how operating leases are accounted for today. The IASB and FASB models lead to different timing and classification of the expense for these leases.

Basic implications

The IASB estimates that listed companies using IFRS or US GAAP disclose almost US\$3 trillion of off-balance sheet lease commitments. The effect on individual companies will vary. The IASB examined a sample of companies from a range of sectors. They estimated that liabilities related to non-cancellable operating lease commitments were an average of 5.4% of total assets, but that this varied by sector – from 2.9% for healthcare to 22.7% for airlines. The effect of individual companies within each sector also varied significantly. The timing of the related expense recognition is also affected, as well as how it is categorised in the income statement.

Contracting incentives and consequences

A change from risks and rewards to control has two major consequences. Control carries with it more asset specificity. The lessee has control of a particular asset for the period of the lease. That control, and specificity, distinguishes it from a service. A rights, rather than whole of asset, approach means the elements of a contract are more important than whether they combine to transfer the risks and rewards of the whole asset to the lessee.

Both of these factors will affect how we interpret the new requirements and how new contracts for assets are likely to be written.

What is a lease?

The new Standard defines a lease as “a contract, or part of a contract, that conveys to the customer the right to use an asset (the underlying asset) for a period of time in exchange for consideration.”

The two essential factors of a lease relate to the asset. The lease must be in relation to an **identified asset** and you must get **control** of that asset.

You have the right to control the use of an asset if you have the right to direct its use and have substantially all of its economic benefits during the period of the lease. The Standard uses the terms “right to use” and “right-of-use asset” in relation to a lease, because it is developed on the premise that a lease gives you the right to use a specific asset.²

This idea of a right-of-use reflects an important assumption underlying the Standard – that a physical asset can be separated into different rights. An entity leasing a car for three years will have the right to use that car for that period – deciding when and where to drive it. The lessor, meanwhile, retains the remaining rights to the asset once the lease period ends.

You do not need to control the car for the whole of its life, nor obtain (substantially) all of the benefits of the car. The control and benefits criteria relate to the period of the lease. And nor does control need to be unfettered. A lessor might place some restrictions on the use of the asset, such as limiting the distance a car is allowed to be driven over the term of the lease, to protect their interest in the residual value of the car. Protective rights do not prevent you having control of the leased asset during the lease term.

What is important is whether you have the right to substantially all of the economic benefits from using the identified asset over the lease period, not substantially all of the economic benefits of the whole of the asset.

Scope exclusions

For a lessee, IFRS 16 excludes from its scope rights to explore for or use minerals, oil, natural gas and similar non-regenerative resources and leases of biological assets.

It also excludes rights held under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. For other intangible assets entities have an accounting policy choice of applying IFRS 16 and recognising the leased asset and liability or simply expensing the costs as they are incurred – i.e. recognising a “rent” expense.

If you do apply IFRS 16 to the leasing of intangible assets, the Standard should be applied in full. It is not just a matter of analogising to the recognition and measurement principles.

Basic requirements

The accounting and financial reporting requirements in IFRS 16 will not be new to those applying IFRS. The new requirement is, in essence, that all leases will need to be accounted for using the finance lease approach in IAS 17.

As a lessee you will need to recognise the leased asset and the related lease liability at inception of the lease. The leased asset is expensed over the lease period and the lease payments reduce the liability, after first having the interest and principal components of each payment separated.

However, despite the similarities, IAS 17 and IFRS 16 were developed using different assumptions which means that there are different things to think about.

Recognition

In IAS 17 the accounting for a finance lease is designed to give the same accounting outcome as borrowing funds to acquire the asset. IAS 17 states that finance leases “transfer substantially all the risks and rewards incidental to ownership.”³ In contrast, IFRS 16 moves away from a “whole of asset” approach and is developed on the basis that a lease transfers, at least some of, the rights of an asset to the lessee. It is those rights that are recognised as an asset, along with the liability to pay for them over time.

This means that a lease need not transfer the whole of the asset to the lessee. The lessee’s asset is the right to use the leased asset during the lease period. The lessor has rights to the residual asset after it is returned. They are different assets.

Leases are not limited to contracts for long periods of time, or high value items. Renting equipment for a day, or even hiring a tray of glasses for an evening function, will meet the definition of a lease. IFRS 16 provides exemptions and practical expedients to simplify the accounting requirements for some leases.

Recognition exemptions and practical expedients

IFRS 16 provides two exemptions that you can elect to use that relieve you from having to recognise the lease asset and liability. The exemptions relate to short-term leases and leases of low-value assets. You can elect to account for the payments as an expense – essentially the same as operating lease accounting in IAS 17. There is also no requirement for you to demonstrate that there is not a material difference between capitalisation and depreciation and the simpler approach. These leases will qualify for the simpler accounting even if the amounts involved, singularly or in aggregate, are material. In both cases the contracts will still be viewed as leases, but the accounting requirements are simplified.

IFRS 16 also has a practical expedient that lets entities choose not to separate contracts into lease and non-lease components.

Short-term leases

Any lease that, at commencement date, has a lease term of 12 months or less is a short-term lease, but not if it contains a purchase option. You can elect to use the simplified accounting.

If you elect to apply the short-term lease exemption, you must apply it to all short-term leases for that class of underlying asset – such as all short-term leases of audio-visual equipment.

IFRS 16 has guidance on how to assess the lease term when a contract has one or more extension or termination options. You cannot simply access the short-term exemption by creating a series of one-year leases with “options” to renew, or an option to cancel. You are required to determine the substance of that option by assessing the economic incentives you have to extend or cancel the lease.

Leases of low-value assets

Many organisations lease equipment. Sometimes the assets are low-value items such as printers, telephones and desktop computers. IFRS 16 allows entities to use the simplified accounting for such items, relieving them from tracking potentially many small lease contracts.

You need to look at the value of the whole of the asset being leased, and not the rights that the lease gives to you. You also need to assess the value of that asset as a new asset. Hence, a short-term lease of a new car would not be a low-value lease (although it might qualify for the short-term exemption). And nor would the lease of old machinery qualify if that machinery would not be of low value in a new state.

Assessing whether an asset qualifies as low value will require judgement, both initially and over time. Some equipment that today would not be considered low value could easily evolve into a low value item as technology changes. It would not have been feasible for the IASB to specify a value that would work across jurisdictions (currencies) and over time. Instead, IFRS 16 includes examples that the IASB considers today to be low-value assets – desktop and laptop computers, office furniture, telephones and “other low-value equipment.” The Basis for Conclusions notes that the IASB had USD5,000 per item “in mind” when it developed the exemption.

Assets will qualify even if they are material to the entity in aggregate. For example, a training organisation may have thousands of desktop computers for students. They will qualify for the simpler accounting even if they are their major assets.

The election for leases of low-value assets can be made on a lease-by-lease basis. Two assets leased by an entity could therefore be accounted for differently.

Separation of non-lease components

IFRS 16 requires non-lease components to be separated from the lease. This means that if a contract contains a lease of an asset and a contract to provide an associated service, the contract has two distinct components – a lease and a service agreement.

As a practical expedient, you are allowed to treat the whole contract as a lease. In other words, you do not have to identify and separate non-lease components. The result will be that the leased asset and the lease liability will both be higher than they would be if the service component was separated from the contract. But this is clearly a simpler approach.

As with the exemptions, you do not have to justify this on the basis that it would not make a material difference. The expedient is freely available.

In later sections of this paper we assess the factors to think about when deciding whether to use the expedient – see page 13.

There is a difference between a presumption that a lease *includes* a financing component and a presumption that *all* of the excess over the cash price is a finance charge.

Measurement

Basic measurement principle

The initial measurement focuses primarily on the liability. The leased asset is then deemed to be equal to the lease liability, plus acquisition related costs incurred by the lessee and any initial payments that have been made but are not included in the lease liability.

Initial measurement of the liability

The first step is to identify the payments related to the right to use the asset during the lease term that have not yet been paid. These comprise the payments over the lease period plus payments due at the end of the lease period.

Payments over the lease period will comprise fixed payments, less incentives receivable from the lessor, and variable payments, but only if they depend on an index such as the Consumer Price Index or a rate such as a benchmark interest rate. Contingent rents, such as those based on sales value, are not included in the measurement of the lease liability.

Payments due at the end of the lease period will be amounts you expect to pay under residual value guarantees or the exercise price of a purchase option if you assess that you are reasonably certain to exercise that option. Or, if you have assessed that you are reasonably certain to exercise an option to terminate the lease, any related penalty payments.

At the commencement date, the lease liability is measured at the present value of the lease payments discounted using the *rate implicit in the lease*. That rate causes the present value of the lease payments and the residual value to equal the fair value of the underlying asset (plus any initial direct costs of the lessor).⁴ If that rate cannot be readily determined, you use your entity's *incremental borrowing rate*.

The discount rate

The calculation of the lease obligation will be familiar, because it is required by IAS 17. However, IAS 17 was developed with the goal of aligning the accounting for acquisitions and finance leases – all of the assets capitalised were considered to be equivalent to a purchase. When a lease transfers all of the economic benefits of the asset to the customer the incremental rate and the rate implicit in the lease should be the same.

The original proposal from the IASB and FASB would have required the use of the incremental borrowing rate because this is closer to the economically correct rate. The change to using the rate implicit in the lease as the default was made because the boards decided that determining the incremental borrowing rate could be costly and difficult for some entities. However, when you move to a model of recognising only some of the rights in an asset the opposite is often true. It becomes more difficult to calculate the rate implicit in the lease, because the depreciable amount – i.e. the amount expected to be consumed over the lease period – is more difficult to assess.

We think many entities will find that it becomes necessary to use the incremental borrowing rate for some types of leases, particularly those involving premises – see our examples on page 16.

Also, when the period of the lease covers a smaller portion of the economic life of the asset it will become increasingly likely that the lease payments include a service component – see our discussion on shorter-term leases on page 19.

Term of the lease

The term of the lease is also an important factor, because the initial measurement of the liability reflects all of the cash flows made over the lease term. In most cases the term will be clear. However, when a lease contains an option to extend the term or to terminate the lease early you will need to assess whether you are reasonably certain to exercise the option. If you are reasonably certain to extend the lease then all of the payments you would be contractually obliged to make over that longer period will be part of the initial liability.

Similarly, if you are reasonably certain to terminate the lease at an earlier date then any termination payment will be part of the liability. IFRS 16 provides more guidance around options to extend or cancel a lease than IAS 17, including a discussion of some of the economic incentives that could affect the likelihood of exercising the option. The factors include the importance of the asset to the business or investing in significant leasehold improvements to a leased asset. These could create an economic incentive to exercise an option to extend the lease of that asset. You are also required to consider your past practice.

Some people could see entering into a series of short term leases, with an option, as a way of getting access to the short term exemption. However, IFRS 16 observes that the shorter the period the more likely it is an option to extend will be exercised because of the costs of getting a replacement asset.

The financial reporting implications of an option in a lease contract, for property in particular, become more significant. With the expanded discussion of economic incentives, and the short-term exemption, we are likely to see different types of options being developed. It is likely to be an area for which more judgement will be required.

Subsequent measurement

After initial recognition, the lease payments are separated into principal and interest components. Any variable lease payments (e.g. contingent rentals) that were not included in the lease liability are recognised as an operating expense in the period in which the obligation for those payments is incurred.

For the right-of-use asset, the basic approach is to use a cost model. IFRS 16 achieves this by applying IAS 16 *Property, plant and equipment* to right-of-use assets (i.e. depreciating the asset). The leased asset will also need to be assessed for impairment, in accordance with IAS 36 *Impairment of Assets*.

The exceptions to the cost model relate to revaluation. If you are already using the fair value model in IAS 40 *Investment Property* to account for investment properties you must also use that model for any right-of-use asset that is an investment property. And if you are already using the revaluation model in IAS 16 for a class of property, plant and equipment you can elect to also revalue the right-of-use assets in the same class.

Measurement practical expedient

IFRS 16 sees a single contract to lease 100 printers as a contract with 100 leases, assuming that each printer can be used independently of the others. The requirements of IFRS 16 would be applied to each individual lease. The Standard provides relief through a practical expedient.

Portfolio application

As a practical expedient, an entity can aggregate leases with similar characteristics into a portfolio and apply the requirements to that portfolio, rather than on a lease-by-lease basis. However, you must have a reasonable expectation that the effects on the financial statements of using a portfolio approach would not differ materially from applying the requirements to the individual leases within that portfolio.

This practical expedient might be helpful if your entity has leased a fleet of similar cars on similar terms. Even if, say, a third of the cars are replaced each year it could still be possible to make estimates and assumptions that reflect the size and composition of the assets and contracts in the portfolio.

Financial statement impact

Presentation

IFRS 16 requires that leased assets be shown separately from other assets and that lease liabilities be shown separately from other liabilities. However, that separation can be either on the face of the primary financial statements or in the notes. If you do not present these items separately on the statement of financial position, the leased assets must be included within the same line that corresponding owned assets are, or would, be included. The line items in the statement of financial position that include leased assets and lease liabilities must also be disclosed.

In the statement of profit or loss and other comprehensive income, interest on the lease liability is a component of finance costs.

Statement of financial position

Leverage

The new requirements will almost certainly see an increase in recognised assets and liabilities. How a particular entity will be affected depends on many factors, including which exemptions and practical expedients it elects to use. It also depends on the composition of its portfolio of, mainly, operating leases and specifically the financing rate and the length of the non-cancellable period.

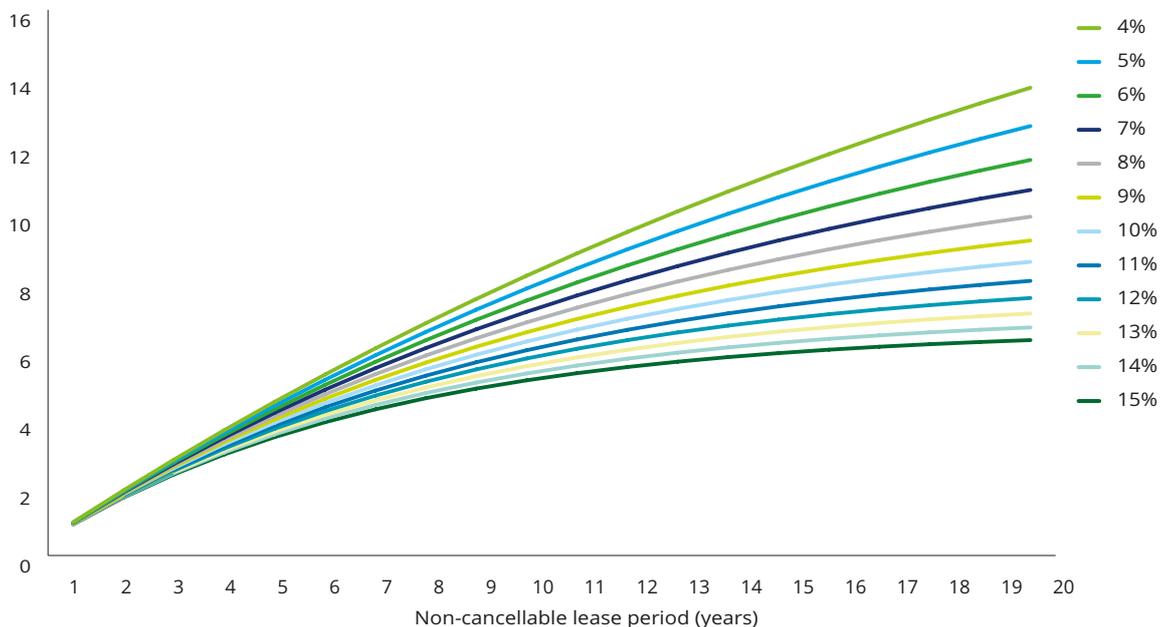
Example

For an entity with IAS 17 operating leases that have an average non-cancellable period of 4 years and a financing rate of 8 per cent, the leased assets and lease liability recognised are likely to be about 3.4 times the annual operating lease expense. For a 15 year lease with quarterly payments and a finance rate of 8 per cent the multiple would be about 8.7. So, for example, the initial lease asset and lease liability for an annual property rental of £750,000 would be £6,648,020.

The longer the lease period and the lower the interest rate the higher the multiple. The following graph provides an indication of the multiple to convert an annual operating lease expense into the initial lease asset and lease obligation for leases ranging from 1 to 20 years with interest rates from 4 to 15 per cent. These estimates assume that all of the payments relate to a lease. The multiples will be lower if part of the annual payment relates to services.

Capitalisation multiple

Multiple of annual operating lease expense



Classification

IAS 17 treats finance leases as being like an asset purchase. The leased asset is depreciated along with other property, plant and equipment, with IAS 17 requiring the application of IAS 16 to the leased asset. Even though IFRS 16 has moved away from a whole of asset approach, it still retains the link to IAS 16.

Right-of-use assets will be classified in the same category as the underlying asset that is the subject of the lease agreement. Hence, leases of motor vehicles are part of motor vehicles within property, plant and equipment, although you must disclose the leased assets separately from owned assets either on the face of the primary financial statements or in the accompanying notes.

In a similar manner, if the right-of-use asset meets the definition of an Investment property it must be presented as an investment property and leases of intangible assets would also be intangible assets.

Lease liabilities must be reported separately from other liabilities.

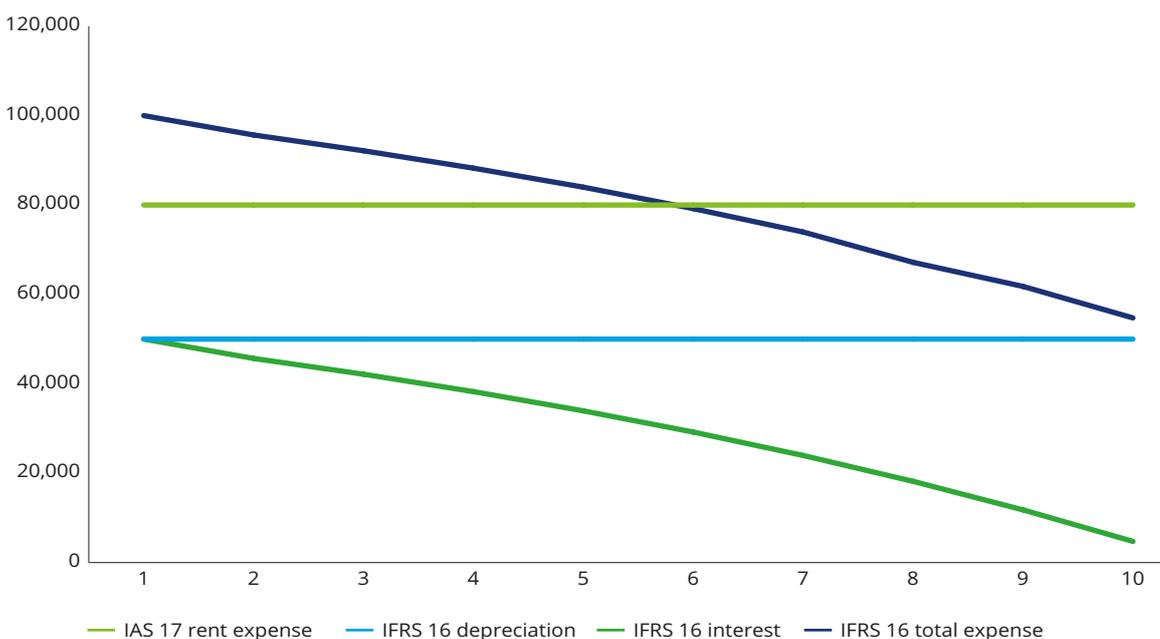
Statement of comprehensive income

Expense profile

The total expenses related to a lease from applying IFRS 16 will be the same as from applying IAS 17, but the timing will generally be different.

Operating leases generally give an even recognition of expenses over the lease period. With the new requirements there will be more expense recognised in the early period of the lease, and less in the later periods. This is because the finance costs are front-end loaded. For a 10-year lease with a 10 per cent finance rate the switchover point at which the annual expense drops below a straight-line expense is typically year six, as shown on the graph that follows. We have additional examples on page 17.

Expense recognition



Costs associated with setting up the lease will be included in the cost of the leased asset. Accordingly, for new leases that would be operating leases if IAS 17 was applied some costs will now be spread over the lease term rather than being recognised when they are incurred.

Classification

Expense classification will change for many leases. Today, the operating lease expense in IAS 17 is an operating expense. With IFRS 16 the expense will all be classified as a financing cost or in depreciation expense, moving down below metrics such as “operating profit”, EBITDA or EBIT, which should all increase.

There are some exceptions. Any contingent rental payments not included in the initial measurement of the liability are classified as operating expenses, as are the expenses associated with short-term and low-value asset leases for which you elect to use the exemption available.

Cash flows

IAS 7 *Statement of Cash Flows* allows an entity to present interest payments in either operating or financing activity, because “there is no consensus on the classification of these cash flows”. That free policy choice will remain in place when IFRS 16 takes effect.

If an entity has a policy of presenting cash flows related to interest in leases as financing flows, then there will be a shift of the payments previously associated with operating leases to the financing category unless they make a policy change. Cash from operations and financing activity outflows will both increase for these entities.

The accounting decision points

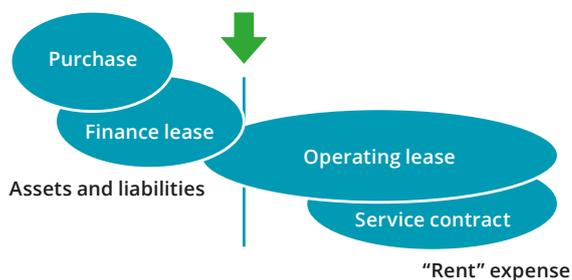
IAS 17 – financing versus operating lease

Today, the main accounting decision relates to whether a contract contains a finance lease or an operating lease. The financial reporting outcomes are significant – finance leases lead to the recognition of a leased asset and a lease liability whereas operating leases do not, they are “off-balance sheet”.

We have not had to be too concerned about the difference between a purchase and a finance lease, because a finance lease is treated as being equivalent to a purchase.

Similarly, the distinction between a service contract and an operating lease is not as significant in terms of financial reporting requirements, because both are off-balance sheet.

Hence, the main decision point has been the finance versus operating lease distinction:



IFRS 16 – acquisition versus lease versus service

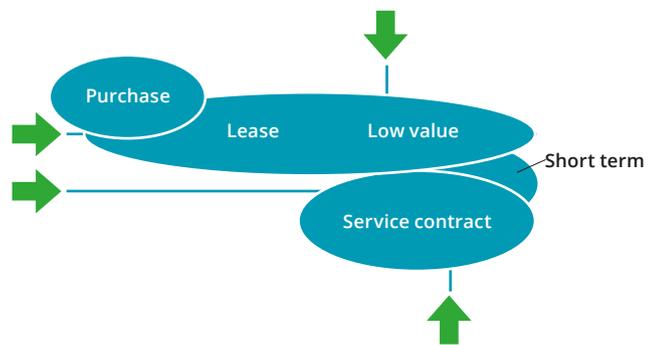
For lessees the distinction between a finance lease and an operating lease disappears and, on the face of it, IFRS 16 brings all operating leases onto the balance sheet.

That change means that it is important to distinguish between the lease of an asset and a contract for services, which are executory contracts. Executory contracts are not capitalised. Therefore, the extent to which payments relate to services affects the initial measurement of the leased asset and lease liability, the portion of the payments recognised as interest and the expense recognition profile.

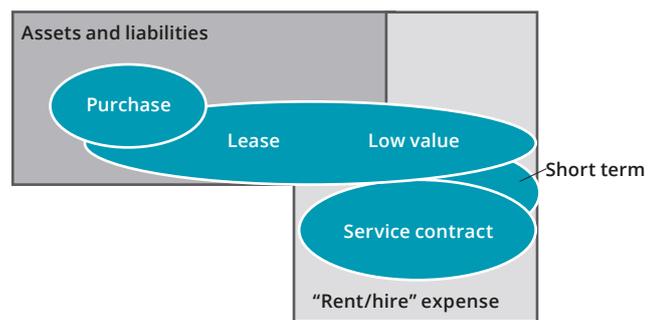
The distinction between leasing and buying an asset also becomes important because there are measurement differences between buying and leasing an asset.

The exemptions create two additional decision points. Leases that are short-term or are for low-value assets have simplified “off-balance sheet” accounting available to them. Both decisions will require some judgement – see page 5.

The result is four decision points:



In terms of financial reporting outcomes:



Lease versus acquisition

The importance of distinguishing between a lease and a service received a lot of attention from the IASB when it developed IFRS 16. Less attention was given to the distinction between the acquisition of an asset and a lease. Getting that distinction right is important because there are differences in the accounting and disclosure requirements.

	Purchase	Lease
Contingent consideration	There are no specific requirements, but a common analogy is to a business combination, which requires that contingent consideration be estimated at the acquisition date and treats differences between this additional consideration and the estimate as post-acquisition expense or income. The IFRS Interpretations Committee has not been able to resolve this issue.	There are specific requirements for determining what type of additional payments are part of the lease. Some contingent consideration leads to adjustments to the lease asset and liability, which leads to a smoothing of income.
Disclosure	IAS 16 or IAS 40 disclosure requirements.	IFRS 16 disclosure requirements, which are more extensive than those in IAS 16 or IAS 40.

Economically, there is no difference between the acquisition of an asset that is financed by a loan secured by the asset and a lease in which title of the asset transfers to the customer at the end of the lease period.

The lessor accounting requirements are largely unchanged, and some sections of IAS 17 have been brought into IFRS 16. For example, IFRS 16.63(a) states that a lease would be a “finance lease” if the lease transfers ownership of the asset to the lessee by the end of the lease term.⁵ Paragraph 16.32 also states that a leased asset must be depreciated to the end of the useful life of the underlying asset if the lease transfers ownership of the underlying asset to the lessee by the end of the lease.

The similarity of the language could suggest that the distinction between a lease and an acquisition is largely unchanged from IAS 17. On the other hand, IFRS 16 moves us from a whole of asset approach to a right-of-use and there are consequences associated with distinguishing between a purchase and a lease that IAS 17 did not have. These factors suggest that this decision will attract more attention.

Leases versus services

The Standard distinguishes between a lease and a contract for services. A lease transfers control over, some aspects of, an asset to the customer. In a service contract the supplier uses the asset to deliver the service, and retains control of that asset.

An example of a contract where the distinction is clear would be a cleaning service where the provider uses their own cleaning equipment. Similarly, a construction company that hires another company to excavate a building site using the provider's equipment will be receiving a service. In contrast, the construction company could hire the equipment and use their own personnel to operate it. This would be a lease.

Service-only contracts

The definition of a lease provides the two main factors in assessing the contract. A lease involves a specific asset and the customer gets control of the right to use that asset.

A contract to rent a container to ship goods every month over a five year period would be a lease if the contract related to a specified container and you had the right to use that container as you see fit.⁶ If the contract allows the provider to choose a container that suited each shipment it is more likely to be a contract for services.

It is common in the transportation sector to use “wet leases” – arrangements where the provider provides an aircraft (or ship), complete crew, maintenance and insurance. Many such arrangements will not be leases as defined by IFRS 16, because the customer will not be controlling the asset. In other cases the customer will be leasing an asset and also entering into a service agreement.

It is an area where we expect to see contracts evolve to make it clear whether the contract involves a specific asset and who controls its right-of-use during the period of the contract.

Service components

It will not always be that easy to distinguish between a service agreement and a lease. The construction company might hire the equipment and an equipment operator from the same company, as part of the same contract. Depending on the terms, the contract could contain a lease and a service or just a service. Hence, you are not necessarily deciding whether a contract is a lease, but you are considering whether it includes a lease.

IFRS 16 offers a practical expedient that allows a lessee to elect, by class of underlying asset, not to separate non-lease components from lease components and instead combine them with the lease components.

Although this may sound attractive, in terms of simplicity, there are circumstances for which it would be better to separate the services. We discuss this in relation to premises rental in the next section.

Equipment leases

Many equipment leases for which the contract states that they are for the economic life of the asset include a service component. For example, it is not unusual for lessors to be responsible for collecting the assets at the end of the lease and disposing of them. This will be priced into the contract and is one of the reasons that the rate implicit in a lease could be higher than the incremental borrowing rate.

An entity could separate that service component, but the benefits of doing so in terms of improved financial reporting are unlikely to outweigh the administrative costs.

We expect to see more contracts to occupy premises separating the occupancy costs from the associated services.

Premises

Thinking about contracts for the right to occupy premises will be important for two reasons.

The first is that it is this type of lease for which we are likely to observe the largest impact on the financial statements – IAS 17 has always treated these as operating leases whereas with IFRS 16 they are simply another lease that will result in the recognition of leased assets and lease liabilities.

The second reason is that there is much more to think about when you recognise and measure leases of premises than simply applying mechanical calculations. There are important decisions about how best to account for a contract for premises and the financial reporting consequences of those decisions could be significant.

Measuring the leased asset

While many equipment leases specify the cash price and provide a contractual interest rate, this information is not typically specified in contracts for premises (or in short-term equipment rentals, as we explain on page 19). IFRS 16 requires the lease liability to be measured initially using the *rate implicit in the lease*. If that rate cannot be readily determined the lessee uses its *incremental borrowing rate*. Leases of land or premises are likely to be just such cases.

In general, land values rise. In a simple lease of land, if the value of the land at the end of the lease is higher than it was at the start of the lease it means the depreciable amount is negative. Mechanically, the calculations using the rate implicit in the lease result in all of the payments being classified as interest expense. Entities would not rationally borrow funds to rent land at the rate implied by these calculations.

Leases of premises are more complicated because some of the payments for access to the premises will compensate the owner for the use of the land. And the building itself could hold its value over the lease period.

We expect to see many entities calculating the liabilities for leases of premises using the incremental borrowing rate rather than the rate implicit in the lease. The March 2015 project update produced by the staff of the IASB included examples involving premises, using an assumed discount rate of 5 per cent. Although the examples did not indicate why this rate was used, realistically it can only have reflected an incremental borrowing rate.

Non-lease components

If you owned a building and contracted a third party to look after maintenance and security you would not capitalise the contract or recognise the liability. It would be an executory contract. On a similar basis, IFRS 16 requires that if a component of the contract for premises relates to services then those services should be separated from the contract and accounted for separately.

Some costs, such as property taxes, would not be included in the cost of a property if you owned it. If a contract to lease premises specifies that the payments include amounts to compensate the owner for annual property taxes, you will need to consider whether these are part of the lease or a separate payment for services.

In some cases part of the payment will relate to shared or common space. For example, renting two floors in a multi-storey building will require the sharing of the lobby, lifts and other common areas. You cannot control shared space. The implication is that payments that are clearly related to shared space or facilities could be non-lease components of the contract.

IFRS 16 provides a practical expedient that allows an entity to treat the services and other non-lease components as part of the lease. Whether you want to take advantage of that practical expedient will be an important decision.

Your ability to identify and measure service components of a contract for premises will depend on how clearly they are identified in the contract. We have seen contracts with separate pricing of these components, but in other cases it will require judgement to separate the components.

We expect to see more contracts to occupy premises separating the payments related to controlling specified space from the associated services and non-lease components.

Separating non-lease components reduces the amounts recognised as the leased asset and lease liability. It will also give a smoother expense profile, but the expense related to the non-lease components is classified as operating.

Example

To illustrate the potential differences in financial reporting outcomes, suppose a business has a non-cancellable contract that gives it the right to occupy two floors of a building for 10 years for an annual rent of £750,000. This would be an operating lease in IAS 17 with the rent included in operating expenses.

The contract identifies services such as security and cleaning that are included in the annual rental charge. The costs for these services are specified as being £225,000 of the £750,000 annual charge.

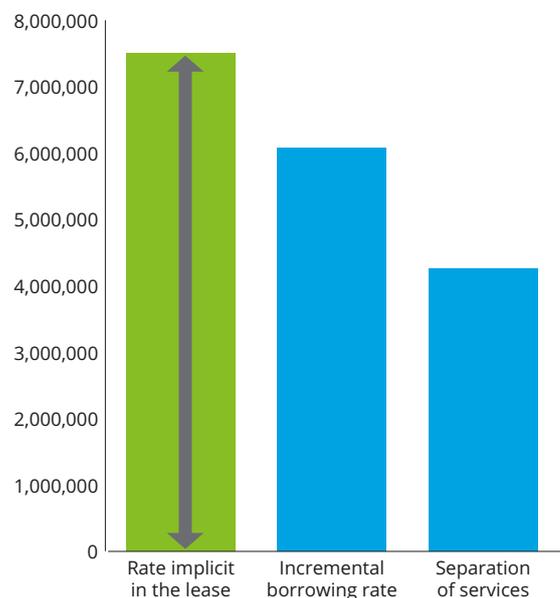
Initial recognition and measurement

To recognise the leased asset using the rate implicit in the lease you need to determine how much of the value of the asset is consumed over the 10 year period. For this example we have assumed that this is £3.5m, which is half of the total lease payments. For an asset that holds its value this is likely to overstate the actual level of consumption. Even at this “conservative” depreciable amount the implied interest rate is just about 17%.

The incremental borrowing rate of the entity is 4%.

Using this data, the amounts recognised at inception would be as shown in the following graph. The bar labelled “Incremental borrowing rate” assumes that the entity has decided not to separate the service component. The bar labelled “Separation of services” shows the implied net cost of the asset using the incremental borrowing rate after the service component has been separated from the payments. The bar for the rate implicit in the lease shows the potential range of the amounts that could be recognised as an asset initially, depending on the assumptions made. The calculations for the rest of the illustration assume an initial amount of £3.5m. As we have emphasised, use of the rate implicit in the lease is not likely to be practical for many property leases. It is included here for completeness.

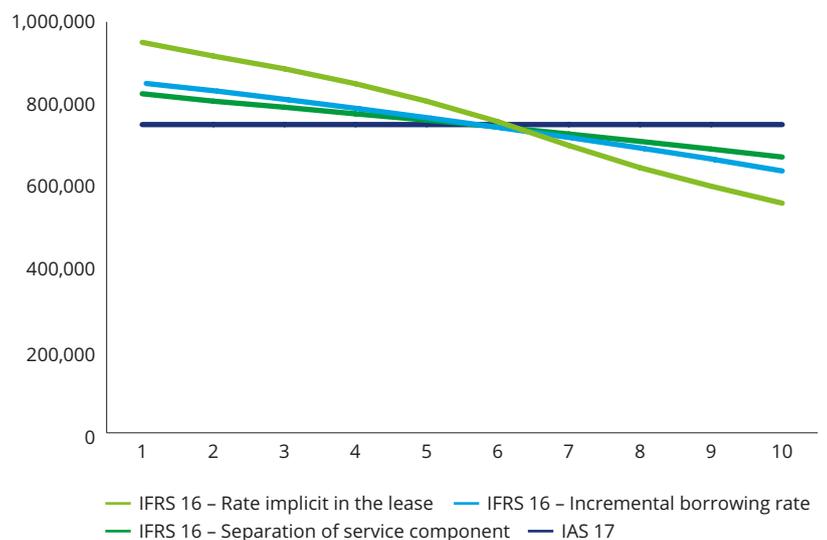
Initial asset and liability



Subsequent measurement

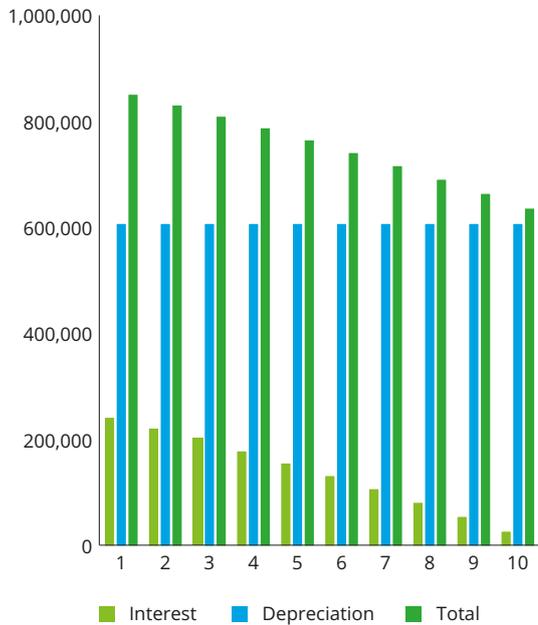
The expense patterns for the three approaches are shown in the following graph. Because the rate implicit in the lease has a higher implied interest rate the expense is accelerated. Using the incremental borrowing rate allocates more of the cost to the straight-line depreciation. Separating the service component gives a flatter expense profile because the interest is calculated on a lower lease liability.

Expense pattern

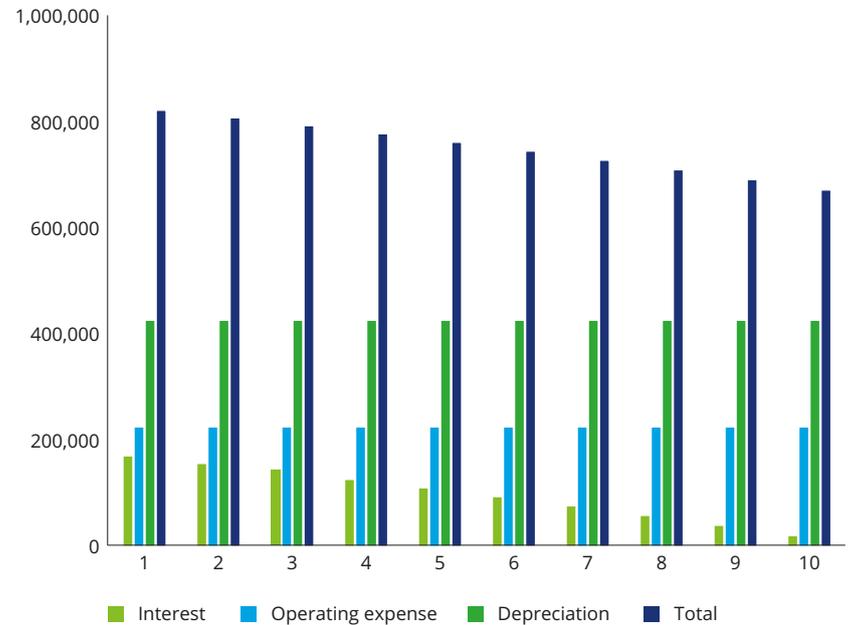


The split between operating expenses and interest expense is highlighted next, for the two extreme cases.

No separation of services



Separation of services



Summary

We think for premises leases the implicit rate is unlikely to be readily determinable. And if it is clear that if the asset has held its value the implied interest rate will be unrealistic.

The main decision you will have to make is whether to separate the non-lease components. In the example we have assumed that those components are clear.

Although more work would be required in making the assessments and maintaining the accounting records, separating the service component will align the accounting for those services with service contracts on owned buildings.

Shorter-term leases

It is clear in IFRS 16 that even very short-term rental contracts for equipment will generally contain a lease. Renting a car for a week, or even a day, will usually give the customer the ability to use a specific car for the period of the lease. Yet it is also clear, economically, that the amount payable will not simply be a fee for the value of the asset consumed plus a cost to borrow that amount for the lease period.

The daily rate for hiring gardening equipment can be about 25 per cent of the cost of buying the asset. This “reduces” to about 40 per cent for a week-long rental. Some AV equipment we examined, that had a two year warranty which we used as a conservative proxy for its useful life, had a daily hire rate equal to about 7 per cent of the cash price to own the asset.

A large portion of the payment will be for the services, and convenience, the customer obtains from hiring rather than buying the asset. The equipment is normally “serviced” after each hire, insurance is normally included in the hire charge and the customer does not have the responsibilities of ownership over the life of the asset. Also, it is likely that the asset being hired is not core to the business of the customer and is required only for a specific, short-term, purpose. Presumably it would be idle for long periods of time and the customer might not be able to extract the benefits from the asset. In all, paying for this convenience is rational.

It is clear from observations of hire rates that the shorter the term of the lease relative to the life of the asset the smaller the portion of the total rental payable will likely relate to the lease and the larger will be the portion for non-lease components. It certainly cannot be attributed to a finance charge.

Applying the short-term exemption

Strictly speaking, IFRS 16 requires the customer to separate the service component from the lease of the asset. While that is feasible, it would be costly to implement and rely on some strong assumptions. The resulting accounting would likely be a low leased asset value and a very low interest expense. The larger portion of the cost would be the service component and the financial reporting would look much like a simple rental does today.

IFRS 16 recognises this by allowing lessees to elect to account for leases of 12 months or less by simply expensing the rental. As we noted on page 5, the exemption is available without any need to assess materiality.

When it is clear that an entity has made a decision to hire assets on such a short-term basis because they have decided that it is worth paying for the convenience of having access to the asset without the responsibilities of ownership, applying the short-term exemption will lead to accounting that reflects that decision.

Applying the short-term exemption moves (or keeps) these leases off-balance sheet and has a smoother expense profile, but the expense is classified as operating.

Other issues

Sale and lease-back

A common method for getting off-balance sheet treatment has been to sell an asset and then lease it back under an operating lease agreement. That opportunity all but disappears with the new standard.

IFRS 16 interacts with IFRS 15 *Revenue from Contracts with Customers*. For a sale to be recognised the lessor (i.e. the buyer) must control the asset as set out in IFRS 15. As the seller you would recognise any gain or loss on the sale, but only to the extent that it relates to the rights the buyer retains at the end of the lease period.

You also recognise the asset associated with the leaseback, being the right to use the asset. It is measured as the proportion of the previous carrying amount of the asset that you are retaining.

Lease modifications

If you modify a lease you will need to determine whether you have a new, separate, lease or whether you are changing an existing lease.

You will have a new, separate, lease if you increase the scope of a contract by adding the right to use one or more underlying assets, and increase the consideration payable by a commensurate amount. An example would be adding a new floor to an existing contract to occupy premises. You simply have a new leases liability and a new leased asset for that additional floor.

If the modification is a change to the existing terms of a lease you will need to remeasure the lease liability by discounting the revised lease payments using a revised discount rate over the remaining lease period. If the modification is a partial, or full, termination of the lease (i.e. it reduces its scope) you recognise a gain or loss. If the modification increases the scope (e.g. the length of the lease period) or the amounts payable you adjust the right-of-use asset.

Transition

As a lessee you are required to recognise a liability and an asset for each of your leases, whether they have previously been classified by IAS 17 as a finance or operating lease. In doing so, you can elect to apply full retrospective accounting, which means you would go back and reassess all contracts as if IFRS 16 had always been in place.

However, the standard does offer concessions on transition which you can elect to apply, as long as you apply them to all leases. If you do take advantage of the transition concessions you do not restate comparative information. Instead, any cumulative effect of recognising the lease liability and asset on transition is adjusted against the opening balance of retained earnings.

Transition relief

Definition of a lease

You do not have to reassess whether contracts contain leases if they were entered into or modified before the date of initial application. Instead you can rely on your application of IAS 17 to those contracts. Any finance or operating leases are then transitioned into the new standard using the special transitional relief described next.

Leases previously classified as finance leases

For leases that you have classified as finance leases in accordance with IAS 17 you can elect to simply use the carrying amounts of the lease asset and lease liability at the date of initial application as the transition amounts. You then apply the subsequent accounting requirements in IFRS 16 to those amounts.

Leases previously classified as operating leases

You are required to recognise a lease liability and a lease asset for each of your operating leases. The transition relief relates to how the amounts are calculated.

The liability can be measured at the present value of the remaining lease payments discounted using your incremental borrowing rate at the date of initial application.

There are two simplifications for assets. You can choose to measure the asset at its carrying amount as if the new requirements had been applied since the commencement date, but using a discount rate based on your incremental borrowing rate at the date of initial application. Or you can choose to recognise the asset at an amount equal to the lease liability, adjusted for recognised prepaid or accrued lease payments relating to that lease.

When discounting to measure either the liability or asset you can choose to apply a single discount rate to a portfolio of leases with reasonably similar characteristics.

If you have leases that end within 12 months of the date of initial application you can elect to account for these leases in the same way as short-term leases – this covers leases with a lease period of less than 12 months as well as longer-term leases with less than 12 months to run.

You can choose to rely on previously recognised onerous lease provisions rather than undertaking a separate impairment review. You can also choose to exclude initial direct costs from the measurement of the leased asset and use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

Amounts previously recognised in respect of business combinations

If you have previously recognised an asset or a liability in accordance with IFRS 3 *Business Combinations* relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, you will need to derecognise that asset or liability, adjusting the carrying amount of the right-of-use asset.

Disclosure

Whether or not you use the transition concessions you will need to comply with the general requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, such as disclosing the nature of the change and which transitional provisions you used.

However, you are not required to disclose the effect of the change on each financial statement line item affected, for the current and prior period. Instead you must give the weighted average incremental borrowing rate you used to measure lease assets and liabilities on transition and an explanation for any difference between the operating lease commitments you reported at the end of the annual reporting period preceding the date of initial application discounted using the transition date incremental borrowing rate and the liability you recognised on transition for those leases.

Lessor accounting – implications

When the IASB, and FASB, were developing the new Standard they proposed changes to the requirements for both lessee and lessor accounting. The feedback the IASB received “indicated that it was not essential to have symmetrical lessee and lessor accounting models.” Both boards decided not to make changes to lessor accounting, for cost-benefit reasons.

Accordingly, the IASB has retained the finance lease – operating lease distinction for lessors, and carried into IFRS 16 the related requirements set out in IAS 17. The IASB did, however, add lessor disclosure requirements about exposure to residual value risk.

Retaining the requirements and language used in IAS 17 for lessor accounting creates some tensions with the new requirements in IFRS 16. As well as the more obvious retention of the financing and operating lease categories, the lessor requirements use the risks and rewards and whole-of-asset language in IAS 17. The different requirements are uncomfortable companions.

Land and buildings

Of particular interest is the effect of the language about land and buildings retained from IAS 17. Those words make it clear that a contract related to occupying a building and the land on which the building sits will have, at least two, components. The payment related to the land will provide a return on the land whereas the payment for the building will provide a return as well as compensation for the value of the building consumed, if there is any such consumption.

In IAS 17 distinguishing between asset consumption and the return to the lessor had limited practical implications. Such contracts were, invariably, classified as operating leases with the lessee recognising a rental expense and the lessor recognising rental income. In contrast, IFRS 16 will lead to the lessor accounting for rental income on the land whereas the mechanics of the lessee requirements force a lessee to separate the return to the lessor into depreciation, based on whatever amount has been calculated as the leased land, and interest expense.

Implications for lessees

Although the land and building analysis is included in the sections of IFRS 16 that discuss lessor accounting, it is also helpful in identifying components of a contract in IFRS 16 more generally. The analysis has implications for how a lessee might think about property contracts. If a lessee is able to demonstrate clearly that a contract has components that relate to a separate asset, shared assets and services, only the part of the contract relating to the separate asset would meet the definition of a lease. You do not control an asset that you share with others.

In a multi-tenanted building you might lease a floor, to which you have exclusive access. If some of the contractual payments you are making relate to common space in the building that is shared with others, those payments could be outside the scope of IFRS 16.

If you lease a whole building you are likely to control access to the land on which it sits by virtue of your access to the building. However, if you are a tenant in a multi-tenanted building, none of the tenants are likely to control the land.

There is no reliability test for separating components of a contract. You are only required to maximise the use of observable information. You may choose to bundle them and treat them under a lease using the practical expedient, but there could be incentives to account for the components separately.

Double counting

The retention of lessor accounting also means that there will be some double-counting of assets across entities. If a lessor has concluded that it has leased an asset out under an operating lease, the lessor retains the whole of the asset on its books. At the same time the lessee will also recognise its right to use the asset. To that extent, there will be some assets recognised on two sets of books.

The double counting will be most noticeable for shorter term leases, such as executive leases of vehicles, leases of long-lived assets such as aircraft, ships and construction and exploration equipment, and property leases.

US GAAP

As we mentioned in the introduction, although the IASB and FASB worked together with the objective of developing the same requirements they did not achieve this for all leases. The main differences relate to leases that today in US GAAP are operating leases.

Whereas IFRS 16 does not differentiate between an operating lease and a finance lease for a lessee, that distinction will remain in US GAAP. The accounting for finance leases is similar to the approach IFRS 16 uses for all leases – with a finance charge and depreciation of the leased asset, although the US GAAP requirements refer to this as amortisation.

Operating leases will also be brought onto the balance sheet, initially measured in the same way as IFRS 16. However, a single operating lease expense will be recognised on a straight-line basis over the lease term. The straight-line measurement is achieved by having the implicit amortisation of the leased asset accelerate over the term of the lease so that when it is combined with the implicit interest on the lease liability the total is the same in each reporting period. That single expense is an operating expense, rather than interest and depreciation (amortisation). The related cash flows will be included in operating activities.

The FASB has also changed how an entity classifies leases into finance and operating by adopting an approach based on the lease classification criteria in IAS 17. This means that some leases that would be classified as operating leases under the US GAAP requirements being replaced could be classified as finance leases when the requirements come into effect.

The different requirements mainly affect the timing of lease related expenses and where in the income statement that they are presented. The lease expense calculated using the FASB requirements will not be front-end loaded like the IFRS 16 approach. But the expense will be part of operating activities rather than depreciation and interest. The balance sheet is also affected, with the right of use asset likely to be higher under the FASB requirements, reflecting the slower related expense recognition. The IASB's effects analysis suggests that trillions of dollars of assets fall into this category.

The FASB model does not include a low-value asset exemption, so more assets and liabilities will be recognised on the balance sheet.

In most other matters the standards are aligned. The boards worked together to limit the differences in definitions and other requirements.

Even though there are differences between the requirements for what are today operating leases, the differences are deliberate rather than through disagreement on drafting. We hope the boards monitor this and review their standards together, with a view to seeing if they can remove the differences. The closer the requirements can be the more comparable the financial statements will be.

Explaining the implications

How the new lease requirements affect your business will obviously depend on the mix of lease agreements in place. But they will also depend on how you apply the Standard – which exemptions or practical expedients you elect to apply.

What will be important is that the greater are the likely changes to your financial statements the more important it is that you start to signal those changes to those who rely most on your financial statements – particularly investors and lenders.

Speak to your investors

When the IASB was developing its proposals some critics claimed that the changes were not necessary, because investors were already adjusting leverage using a “rule-of-thumb” multiple of the operating lease expense. However, the IASB found, by analysing individual company data, that although a rule-of-thumb adjustment works “on average” it overstates leverage in some cases and understates it in others.

As we have demonstrated, the actual effect will reflect the length and cost of the leases as well as how you apply the exceptions and practical expedients. Because the financial reporting implications will be specific to each entity, it is important that you start to explain to investors how the new Standard is likely to affect your financial statements.

You will need to explain the changes in the periods leading up to 2019 in your financial statements, as part of meeting the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in relation to forthcoming changes to IFRS.

Speak to your lenders

Lenders, and ratings agencies, generally factor non-cancellable operating leases into their assessments of entities. However, how existing operating leases, and new leases, convert into lease liabilities and leased assets will not always align with the expectations of your lender. Additionally, some contracts with lenders might refer to specific accounting numbers that could change when you apply IFRS 16.

The obvious example is that recognised liabilities are likely to increase. But there are other changes that could be important, such as a shift of expenses from operating (i.e. rent) to financing. This could affect interest coverage ratios.

It will be important that you assess how IFRS derived numbers used in contracts with lenders will be affected by IFRS 16, and discuss those changes with your lenders.

Summary

The new leases requirements will change how we think about leases. As we have indicated in this publication, the change in thinking that underpins lease accounting has important implications for interpreting the new requirements and for how you elect to apply them.

IFRS 16 contains several practical expedients that offer simplified accounting. But some of these expedients will accelerate expense recognition and increase reported debt. Others will give a smoother income profile and lower reported debt, but they shift the lease related expenses from interest and depreciation to core operating costs (reducing EBITDA).

This is not about manipulating the accounting to achieve a particular financial reporting outcome. These are free choices available to entities, with no burden to assess whether it creates a material difference to the financial reporting.

As the table below illustrates, there are trade-offs between the income statement and balance sheet effects of applying these expedients.

	EBITDA	EBIT	NPBT	Expense pattern	Assets	Liabilities
Change from IAS 17 - Lessee						
Operating leases	↑	↑	↔	Front loaded	↑	↑
Finance leases	↔	↔	↔	Front loaded	↔	↔
Discretionary choices - change from core IFRS 16 requirements						
Short-term leases	↓	↓		Smoother	↓	↓
Low-value leases	↓	↓		Smoother	↓	↓
Service separation exemption	↑	↑		Front loaded	↑	↑

Key and explanation

EBITDA = earnings before interest, tax, depreciation and amortisation

EBIT = earnings before interest and tax

NPBT = net profit before tax

↑ means, for example, that EBITDA will generally be higher when IFRS 16 is applied than it is from applying IAS 17

The economics of lease contracts

It is unlikely that we will see shorter term leases disappear. They will remain the most efficient means of contracting for some types of assets for particular entities. However, we may see some of the leases that would have been just on the operating lease side of the IAS 17 criteria being replaced by purchase agreements or longer term leases. Similarly, some entities may be attracted to shortening some lease terms to gain access to the short-term expedient or to avoid capital expenditure approval thresholds.

One of the factors that is often taken into account when contracts are written are the financial reporting requirements. IFRS 16 makes some factors more important than they were in IAS 17, particularly asset specificity, identification of non-lease components and any renewal or termination options.

10 questions you should ask yourself

- 1 Do you have any contracts that rely on the IFRS financial statements? If you do, have you made plans with those parties to discuss how your financial statements will change when the new leases requirements take effect?
- 2 When do you plan to discuss the implications of IFRS 16 with investors – in the financial statements and in analyst briefings?
- 3 Are your systems able to track individual leases?
- 4 Are you likely to take advantage of the short-term exemption as a general policy, or are there some classes of asset for which you think it would be better not to use the exemption?
- 5 Do you think you are likely to take advantage of the low-value exemption? How will you assess the upper boundary for which assets will qualify?
- 6 Do you have property contracts that include amounts for services? How clearly specified are those components? Is there scope to ensure that future contracts are more clearly specified?
- 7 How do you plan to assess the financing component on property leases, given the inherent difficulty of identifying the rate implicit in the lease?
- 8 Do your leases have renewal clauses? Have you assessed how these might be applied when IFRS 16 becomes effective?
- 9 Do you have contracts that provide access to assets that might be difficult to classify – i.e. are they a lease or a service?
- 10 Have you made an initial assessment of the extent to which non-cancellable operating leases are likely to be recognised on transition to the new leases standard?

Endnotes

1. This publication focuses in the accounting by a lessee. The accounting for lessors in IFRS 16 remains largely unchanged from those in IAS 17.
2. The term “right-to-use” does not capture all of the rights that can be conveyed in a lease. Some leases give other rights, such as the right to use the leased asset as security (the right to pledge) or to sell the rights to other parties.
3. IAS 17, paragraph 8.
4. Another way of expressing this is that the rate implicit in the lease is the rate you apply to discount the lease payments to equal the depreciable amount of the asset being leased – i.e. the cash price less the estimated amount the asset will be worth at the end of the lease expressed as a value today.
5. That section of IFRS 16 includes other examples where the customer effectively has ownership of the asset.
6. Because shipping containers have unique registration numbers it is possible to lease a specific container.

Contacts

If you would like to discuss any of the above matters with one of our experts, or simply for further information, please contact your local Deloitte partner or one of the following:

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