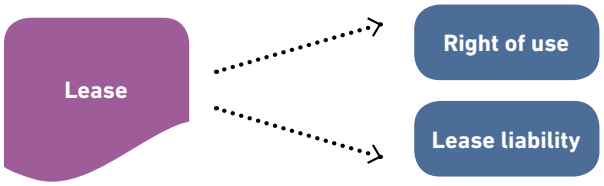
MAZARS' FINANCIAL REPORTING FORUM – DEBRIEF

NOVEMBER 2017

Mazars' Financial Reporting Forum is a series of practical, hands-on, technical workshops designed for organisations involved with IFRS reporting. In these workshops we discuss the most pressing issues related to implementation of new standards (including IFRS 16), with discussions based on active member participation and sharing of information.

IFRS 16: Leases

The new IFRS 16 leases standard will place the financial obligations of all qualifying leases onto a lessee's balance sheet. A lessee also will be required to recognise the corresponding right created by the lease as a right of use asset.



The latest session focused on IFRS 16 and covered:

- Factors concerning lease payments and measurement of lease liability
- Advantages and disadvantages of the transition approach options

Our series on IFRS 16 commenced with:

- **Topic 1:** Key drivers of determining whether your contract is in or out of the new leases standard
- **Topic 2:** Taking advantage of the benefits of built-in exemptions

Topic 3: Factors concerning lease payments and measurement of lease liability

The initial amount of the lease liability is the present value of the future lease payments that are not paid as at the lease commencement date.

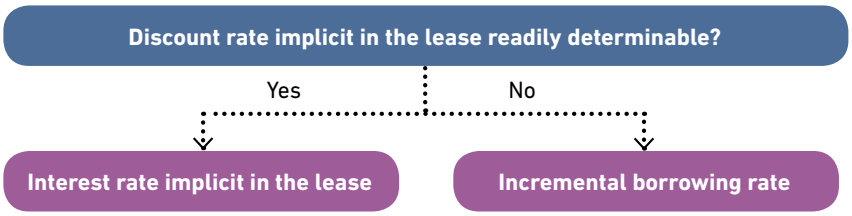
Initial measurement

The initial amount of the lease liability is a key input to the initial measurement of the right of use asset.

The initial cost of the right of use asset is the sum of the initial amount of the lease liability, payments already made, initial direct costs of the lessee and any dismantling and/or restoration costs. The initial cost is reduced by the amount of any lease incentives received by the lessee.

Significant judgement may be required for the determination of any or all of the following inputs to the initial measurement of the lease liability: discount rate, lease payments and lease term.

A. Discount rate

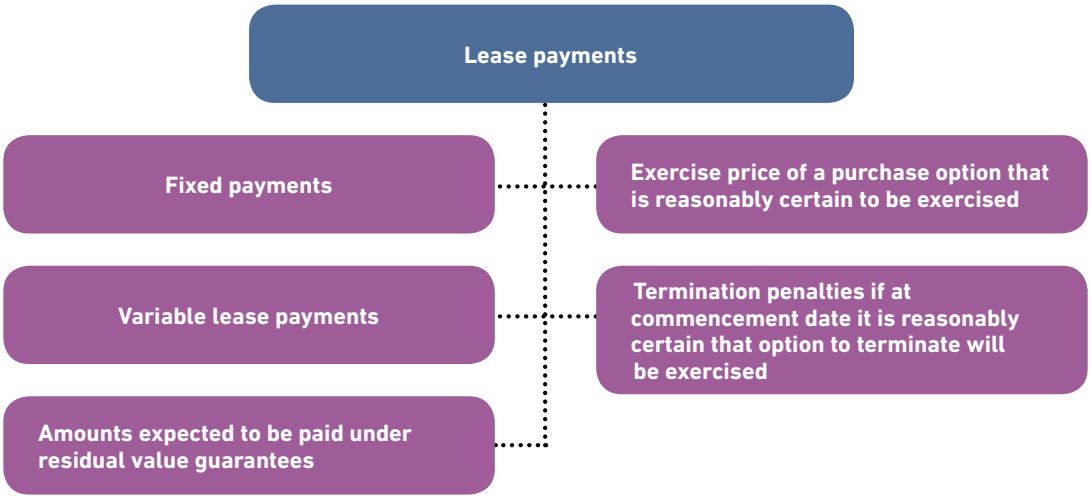


To calculate the initial amount of the lease liability, a lessee is required to use the discount rate implicit in the lease when it is readily determinable. Establishing the discount rate implicit in the lease may not always be possible because it relies, in part, on the lessee having knowledge of the asset's fair value and the lessor's initial direct costs. When the discount rate implicit in the lease is not readily determinable, the lessee uses its incremental borrowing rate.

Key implication:

Key estimates may be required to determine an appropriate incremental borrowing rate. The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow funds to obtain a similar asset, over a similar term with similar security in a similar economic environment. To support the estimate, lessees may need to setup new processes to collect the necessary data for determining incremental borrowing rates.

B. Lease payments



Identifying lease payments to be included in the initial measurement of the lease liability can be quite straightforward. However, some complexities arise when lease payments are variable or there are options contained within the lease e.g. an option to buy the asset.

Key implication:
All variable lease payments are excluded from the lease liability calculation, except those that depend on an index or rate and those that are, in substance, fixed (i.e. the variable clause does not have real economic substance). Variable lease payments linked to performance or usage will usually be excluded from lease liability measurement and are expensed over the lease term, instead.

C. Lease term

The lease term begins when the lessor makes an underlying asset available for use by the lessee. It comprises the non-cancellable period and any optional periods to extend the lease when it is reasonably certain that the option will be exercised. It also includes any periods covered by the lease to terminate the option when it is reasonably certain that the lessee will not exercise the termination option.

Examples of circumstances that may create an economic incentive to include optional periods:

- Extension options at below market rates.
- Improvements made by lessee are expected to have significant economic benefits when the option to extend the lease becomes exercisable.
- Costs relating to termination of lease which may include negotiation costs, relocation costs, costs of identifying a new underlying asset, or costs of returning the asset to a specified condition.
- Importance of the asset to the lessee's operations such as a specialised asset or a particular location, and whether other suitable alternatives are available.

Reasonably certain

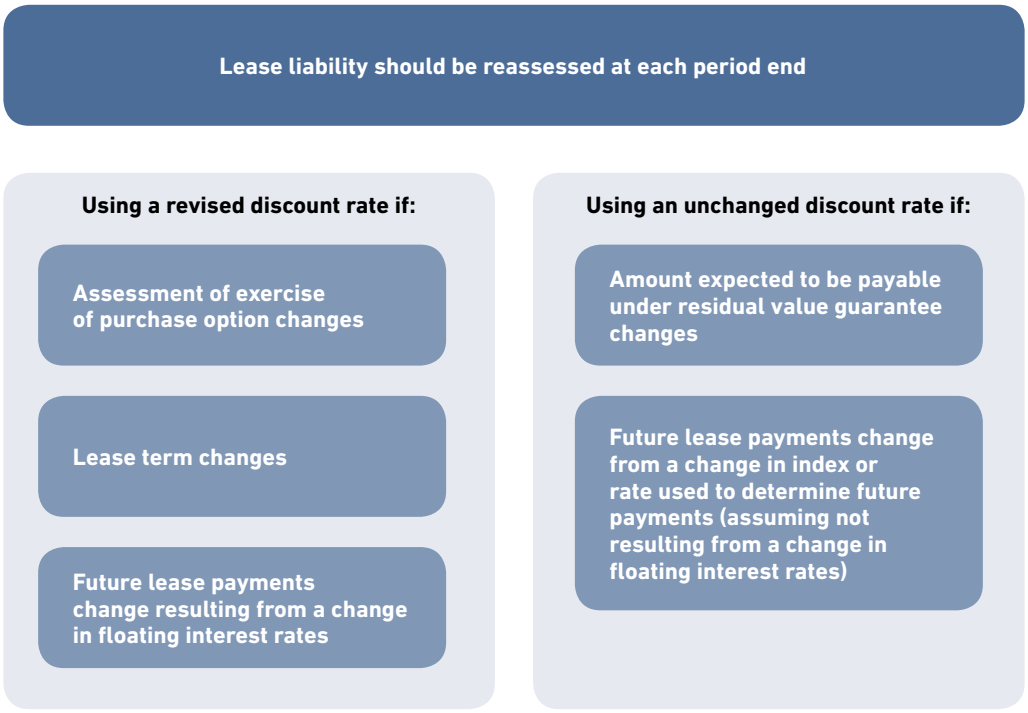
The assessment of whether it is reasonably certain that a lessee will exercise an option to extend or terminate a lease is a key estimate in determining the lease term. The assessment is performed from the lessee's point of view considering all relevant facts and circumstances that create an economic incentive.

The reasonably certain assessment is only revisited if a significant event or change in circumstances occurs due to an action or decision that is within the control of lessee that could influence the assessment.

The lease term is revised when there is a change in the non-cancellable period of the lease. For example, if the lessee exercises an option during the lease term that it had not initially planned to exercise, or an event occurs that places the lessee under a contractual obligation to exercise an option when it had not planned to exercise this option at the commencement date.

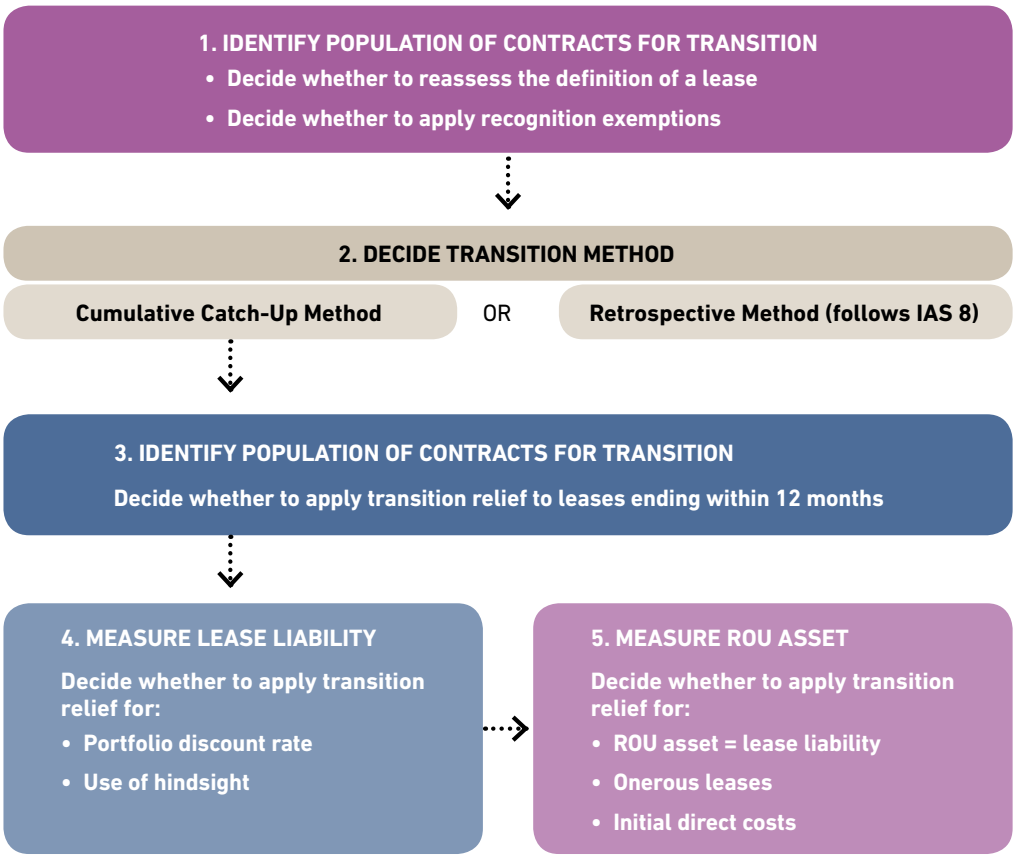
Key implication:
It matters who holds the option to terminate a lease. When the lessee holds the option, the option is taken into account. However, when the lessor holds the option to terminate, the option is not taken into account i.e. the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

After initial recognition, the lease liability is unwound at the relevant discount rate and reduced by any lease payments made. At each reporting date, the lease liability may need to be reassessed if, for example, the lease term is reassessed, or there is a change in residual value guarantee, or a change to an index related to variable lease payments. The rate used to reassess the lease liability value will depend on the nature of the event, as depicted in the diagram below.



Topic 4: Advantages and disadvantages of the transition approach options

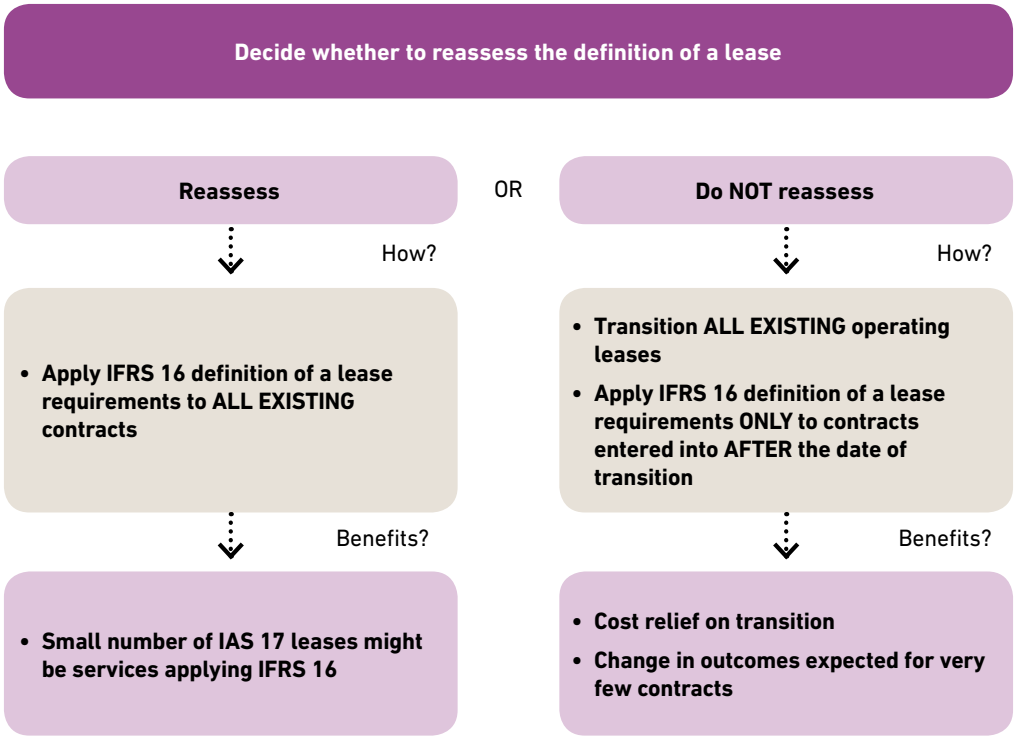
There are several transitional relief options available to lessees. Some of the main decisions are summarised in the decision tree below.



Key aspects of each of the decision steps 1 to 5 are summarised in the diagrams below.

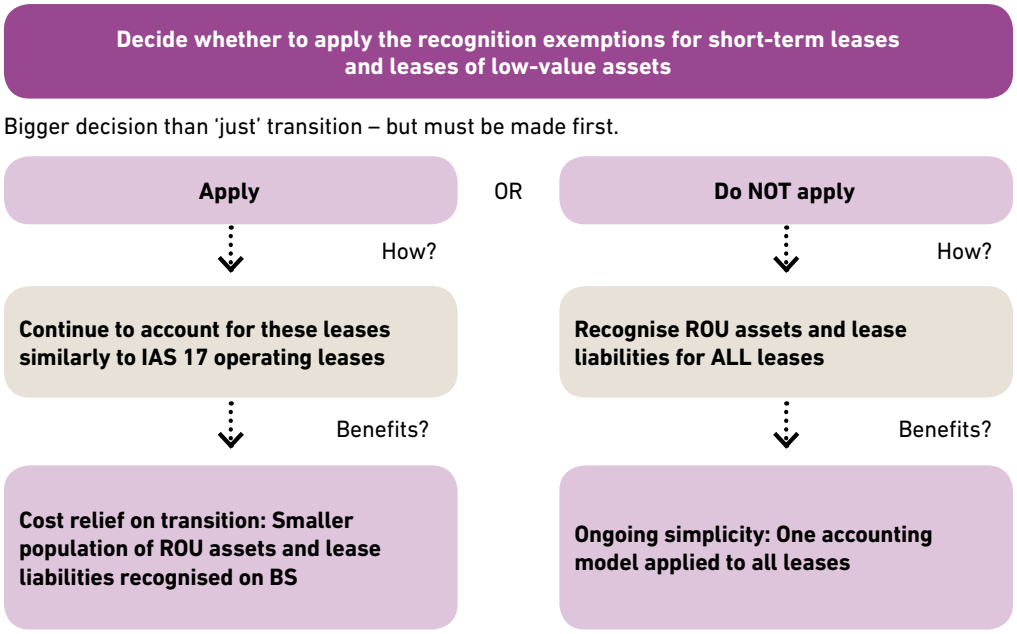
Step 1: Identify the population of contracts for transition.

The first aspect of Step 1 is available to both lessees and lessors and allows reassessment of the lease definition.



The option to reassess the lease definition is an accounting policy choice i.e. applies to all leases.

The second aspect of Step 1 is only available to lessees and relates to application of the low-value and short-term lease recognition exemptions as set out below.



Step 2: Decide on the transition method.

There are two transition methods available for lessees: Retrospective method and cumulative catch-up method.

Retrospective method

The retrospective method requires the lessee to restate its comparatives and to present the financial statements as if the new standard had always been applied. Although it provides better quality of reported information, it requires disclosure of the effect of initial application on each line item in the current and prior years. The method also requires availability of past information, which may not always be available e.g. lessee's assessment of incremental borrowing rate at commence of the lease.

Cumulative catch-up method

The cumulative catch up method recognises the impact of transition in the opening balance of retained earnings in the year of initial application. The transition method does not require restatement of comparatives and also does not require a line by line impact disclosure. Although the transition method is expected to provide significant cost relief, it provides poorer quality of reported information.

Choosing the retrospective method or cumulative catch-up method is an accounting policy choice i.e. the decision applies to all leases. While the retrospective method relies on the measurement of the lease liability and right of use asset by determining their values from commencement date of a lease, the cumulative catch-up method requires the lease liability (formerly an operating lease) to be determined at the date of initial application of the standard using the lessee's incremental borrowing rate and remaining lease payments at that date.

For lease liabilities of lessees that were formerly finance leases under IAS 17, the cumulative catch-up method requires the entity to use the carrying amounts of the lease asset and lease liability measured by applying IAS 17 as at the date of initial application and to apply IFRS 16 thereafter.

KEY IMPLICATION:

Retrospective method

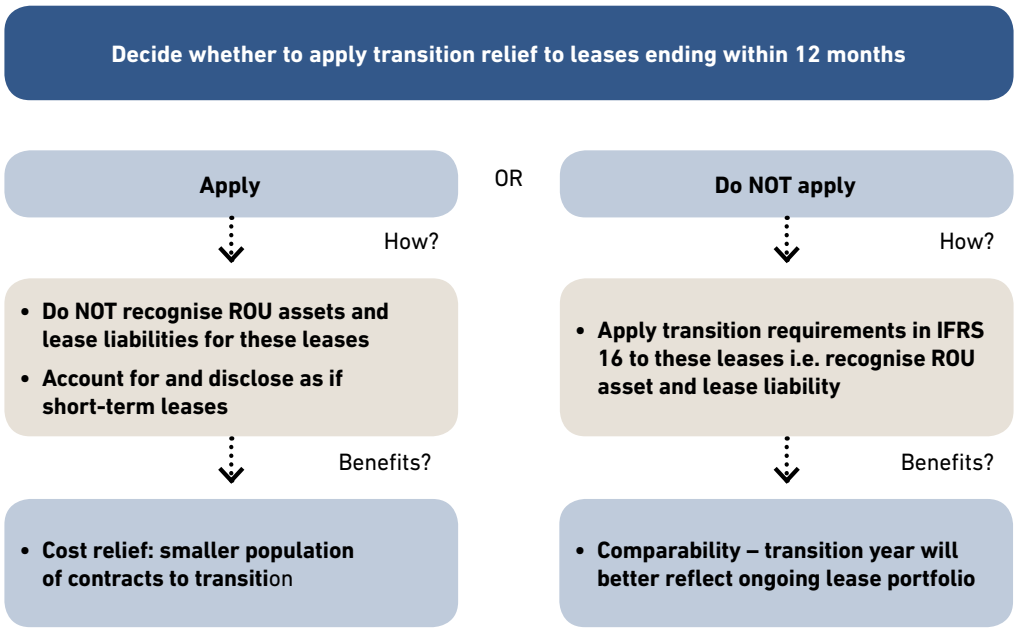
Due to the disclosure requirements of IAS 8, electing the Retrospective Method will require the lessee to run two sets of accounts in the year of initial application and the comparative year: One set based on the current IAS 17 requirements and the other set based on the new IFRS 16 requirements.

Cumulative catch-up method

The transition relief contained in steps 3 to 5 (discussed on the next pages) of the IFRS 16 decision tree are only available to a lessee if the lessee elects the cumulative catch-up method.

Step 3: Identify population of contracts for transition.

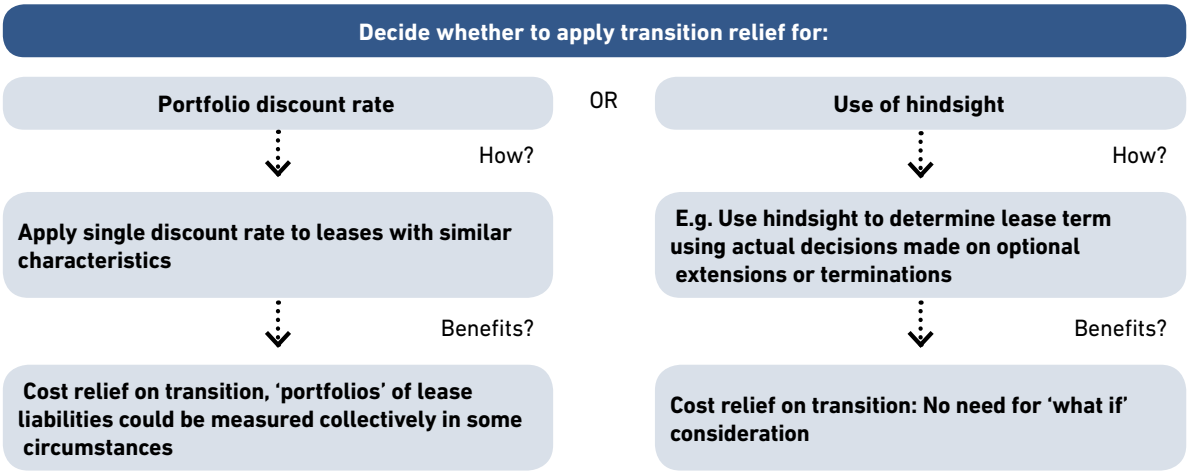
For lessees who have elected the cumulative catch-up method in Step 2, there is optional relief for operating lease contracts ending within 12 months of initial application of the new standard, as set out in the diagram below:



Step 4: Measure lease liability.

For lessees electing the cumulative catch-up method in Step 2, the lease liability (of formerly operating leases) is measured at the present value of the remaining lease payments at the date of initial application. No backward looking information is required.

As part of the determination of the lease liability, there are two relief options available: portfolio discount rate and use of hindsight:



Relief availability

The relief for portfolio discount rates, use of hindsight and leases ending within 12 months are available independently of each other on a lease-by-lease basis.

KEY IMPLICATION:

Portfolio discount rate

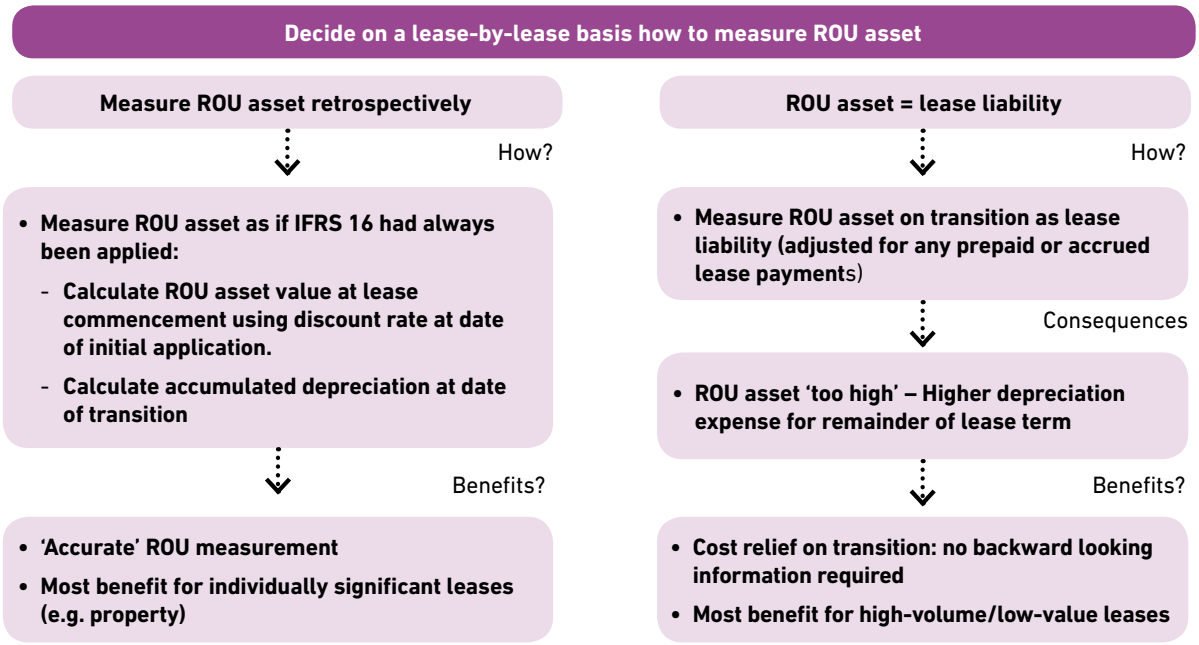
The portfolio discount rate relief may prove useful for lessees that have high volumes of leases for similar classes of assets, with similar remaining terms, and in a similar economic environment e.g. large fleets of vehicles leased by a branch ending on a similar date.

Use of hindsight

An entity is generally precluded from using hindsight when applying IFRS. However, when an entity applies the cumulative catch-up method, it may elect to use hindsight. Lessees that have unexercised options to extend or terminate a lease at the date of initial application may find the relief beneficial.

Step 5: Measure the right of use asset.

A lessee who has elected to apply the cumulative catch-up method may elect to measure the right of use asset using one of two methods: 'retrospectively' or using the lease liability amount. The election is available for leases formerly treated as operating leases on a lease-by-lease basis and is explained below:



The 'retrospective' method determines the carrying amount of the right of use asset as if the standard had always been applied, except that the discounting is done using the lessee's incremental borrowing rate at the date of initial application. The lease liability amount method determines the carrying amount of the right of use asset as being equal to the lease liability amount at the date of initial application.

Method comparison

The 'retrospective' method is the more accurate means of determining the carrying value of the right of use asset. Although the lease liability amount method is not as accurate, it is simpler and less costly to implement.

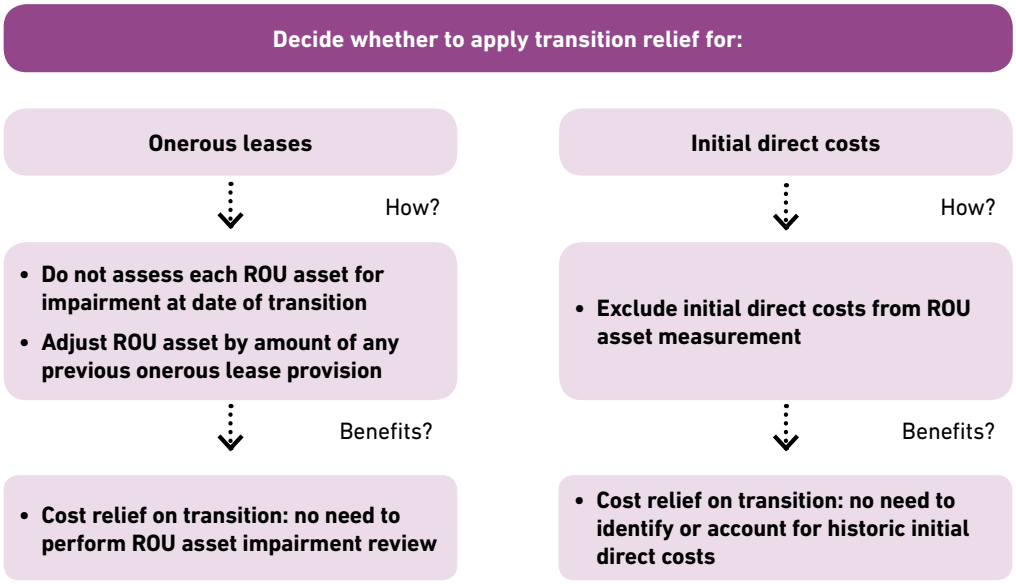
Key implication:

The right of use measurement choice warrants careful consideration and comparison as it could impact future profits significantly. It is generally expected that electing to use the lease liability amount method generates a higher right of use asset which will result in higher depreciation expense in future years.

In light of the costs and benefits associated with each method, many companies are expected to apply the relief for right of use assets in one of the following two choice combinations:

- 'Retrospective' approach for significant assets and the liability amount approach for other assets
- Liability amount approach for all leased assets

The second part of Step 5 involves two further relief options for the same set of qualifying leases: onerous contract relief option and an option not to capitalise initial direct costs. These options are available independently on a lease-by-lease basis and are expected to be attractive for resource constrained entities.



The cumulative catch-up method requires the right of use asset to be assessed for impairment at the date of initial application. The onerous contracts relief option allows the lessee, instead, to adjust the right-of-use asset at the date of initial application by the amount of any provision for onerous leases at the date immediately before initial application. The initial direct costs relief allows the lessee not to capitalise the initial direct costs associated with the lease.

Reminder

Onerous contracts are those contracts in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Initial direct costs are incremental costs of lessee of obtaining a lease that would not have been incurred if the lease had not been obtained and are normally capitalised to the right of use asset.

Our next session

At our next session on 20 March 2018, we will discuss inter-alia:

- Lease databases and accounting software
- Meeting the disclosure burden
- Avoiding the pitfalls in subleases and sale and leasebacks

How we can help

Transition support

IFRS 16 gives a company a number of choices on transition. We can help you interpret and implement the new transition requirements, including advising on the optimal transitional approach. We have a number of IFRS 16 checklists to help with the transition process.

Disclosure burden

With all companies impacted by the demanding new disclosure requirements of the new Standard, we can draft or review your disclosures, ensuring you are aware of compliance and best practice matters.

Impact assessments

With the effective date of the new Standard fast approaching, we can help you understand its impact on your financial position and performance, as well as future contracts you are negotiating, giving you the opportunity to avoid or mitigate unwanted implications.

Bespoke training

We can provide bespoke training courses designed to meet your needs and adapted for your industry and chosen audience, giving you, your finance team and/or your board of directors a thorough and practical knowledge of the new requirements.

Please get in touch...

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