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GAAP: Drawing it together

Financial Services – implications of the new leasing standard

Point of view

In a nutshell

- IFRS 16 *Leases* was published in January 2016 and is effective for periods beginning on or after 1 January 2019, (subject to EU endorsement).
- Changes to the definition of a lease mean arrangements previously outside the scope of lease accounting may now be captured and vice versa.
- The distinction between operating and finance leases will no longer apply for lessees, and a right-of-use asset will be recognised on the balance sheet together with a lease liability for most lease arrangements.
- The right of use asset recognised may have regulatory capital consequences on adoption of IFRS 16.
- Straight line operating lease expenses will be replaced with depreciation and front-loaded interest.
- For lessees' sale and leaseback transactions only the gain on the portion of the asset not leased back is recognised immediately.
- For lessors, the requirements remain largely unchanged, however the changes for lessees may lead to a change in the length and terms of arrangements they are willing to enter into as well as requests for more pricing information.

What's happened?

With a year having passed since IFRS 16 *Leases* was issued many companies are getting to grips with what it will mean for them. For lessees, the new Standard brings most leases on-balance sheet under a single accounting model similar to the existing finance lease model. However, lessor accounting, with the distinction between operating and finance leases, remains largely unchanged. The new Standard supersedes the previous Standard and interpretations and brings in a new definition of a lease that will be used by lessors and lessees to identify whether a contract is, or contains, a lease.

Although IFRS 16 is a result of a joint project with the US standard setter (FASB), and both bring 'operating leases' on balance sheet, there are some key differences with the revised US standard. In particular the US standard still has an operating/finance lease distinction for lessees, with the former producing a straight line expense over the lease term.

Subject to EU endorsement, IFRS 16 is effective for periods beginning on or after 1 January 2019, with earlier adoption permitted if IFRS 15 *Revenue from Contracts with Customers* is also applied. The UK Financial Reporting Council has recently proposed updating FRS 102 for consistency with IFRS 16 with effect from 1 January 2022.

Another outstanding question is what will happen to the UK tax rules. In Autumn 2016 HMRC issued a discussion document addressing the taxation of plant and equipment leases, but not property leases. In the document they set out four possible approaches, either retaining the current tax rules or following the accounting, potentially with further adjustments for lessees. A consultation document is expected from HMRC early in 2017, setting out a formal proposal.

What does it mean for financial services companies?

The new Standard is likely to have an impact on financial services entities in their capacities as lessees, lessors or as lenders to lessees, as set out below. Companies should carry out an early assessment of the commercial, accounting and systems' implications, including the effects of various elections and transitional provisions that are permitted and develop a plan for explaining this to their stakeholders.

Capturing all the necessary data required to implement the new Standard and ensuring that it is a sufficiently robust basis for making material accounting entries is likely to be a considerable challenge for many. In some cases careful consideration will be required to assess whether a contract is, or contains, a lease under IFRS 16's new definition, which applies to both lessees and lessors.

A contract will be a lease if it enables a customer to control the use of an identified asset, by directing its use and obtaining substantially all the economic benefits for the duration of the arrangement. A degree of judgement will be required to identify whether an asset is identified. An asset may appear to be implicitly or explicitly specified, but it will also be necessary to establish whether the supplier has the ability to substitute an alternative asset during the period of the contract. If the supplier can practically substitute another asset (excluding any obligation to replace a defective asset), and there is an economic benefit for the supplier to do so, the asset will not be considered "identified" and therefore the contract would not be considered a lease.

A transitional relief permits contracts existing at transition to retain their historical classification as leases or services, although this does not mean that leases can stay off balance sheet. Other transitional reliefs mean that the Standard does not necessarily need to be adopted with full retrospective application and comparatives can potentially be left unchanged, with any necessary adjustments made to opening retained earnings on transition.

Some of the key impacts on financial services entities in their capacity as lessees, lessors or acting as lenders to lessees are outlined below:

Capacity as	Impact under IFRS 16	Financial services implications
Lessee	Leases previously treated as operating leases will generally now be on balance sheet. The recognition of a right-of-use asset and lease liability will lead to depreciation, generally on a straight line basis, and interest expense, which will be front-loaded, rather than the straight line operating expense at present. The new Standard will therefore have an impact on reported profit and performance measures, the extent of which will depend on the size and maturity of a lessee's lease portfolio and the elections and transitional reliefs selected.	• For those entities that are regulated subject to the Capital Requirements Directive and Regulation (CRD and CRR) the asset that comes on balance sheet will most likely be classified as a non-credit obligation and will receive a risk weight of 100% under Article 156 of CRR. • For those entities subject to the UK Bank Levy, the liability that comes on balance sheet will most likely be considered a chargeable liability and therefore be subject to the bank levy. • The difference between the straight-line depreciation under IAS 17 and the front loaded interest under IFRS 16 could give rise to a net stable funding ratio ('NSFR') impact.
Lessor	Lessor accounting remains largely unchanged, although it is possible that the new definition of a lease will capture different contracts from those historically treated as leases. IFRS 16 requires lessees' lease liabilities to be measured using the implicit rate of interest in the leases, or if that cannot be readily determined, their incremental borrowing rate. Determining the rate implicit in the lease requires knowledge of the underlying asset's residual value and its fair value; information that may not be readily available to lessees without consultation of the lessor.	• Lessors may be subject to an increase in requests for commercially sensitive information (e.g. the residual value of the asset and the finance value of the lease payment), and will need to consider carefully how they respond to such requests.
Lender	Entities providing financing to lessees will also need to consider the impact of IFRS 16 on their customers' accounting. The impact on the profit and loss account, along with balance sheets becoming more asset rich, but also more heavily indebted, could impact compliance with debt covenants based on financial ratios. Lenders will have to consider whether covenants will need to be revised and whether existing arrangements apply "frozen-GAAP".	• Increases in both assets (right of use) and liabilities (present value of lease payment stream) will mean capital ratios change. This may require the recalibration of credit and risk models. • The changes to the payment profile of lease payments, with higher expenses in the earlier years of lease contracts, may change the profitability of borrowers who are significant users of lease financing; this could require re-assessment of the way that risk models treat leases.

Determining discount rate

The discount rate to be used in measuring a lessee's lease liability is the rate implicit in the lease or, if that cannot be readily determined, the incremental borrowing rate for a similar secured borrowing over a similar term and in a similar economic environment. Determining the rate implicit in the lease may be challenging in certain cases, for example property leases, as it requires knowledge of the underlying asset's residual value, and its fair value; information which may not be readily available to lessees. Whilst IFRS 16 provides an alternative in the incremental borrowing rate, determining this hypothetical rate may still present practical challenges and may require a considerable use of judgement.

Are there recognition exemptions?

There are two optional exemptions from the recognition requirements, enabling lessees to keep certain leases off balance sheet. Lessees may elect, by class of underlying asset, to account for leases with a term of 12 months or less as service contracts. Treatment as a service contract is also available, on a lease-by-lease basis, for leases of underlying assets which have a low value when new. An indicative threshold of US$5,000 is included in the basis for conclusions for the purpose of identifying assets of low value.

Are there reliefs at the date of adoption?

As noted above, a key area of judgement will be whether a contract contains a lease. On adoption, an entity is not required to reassess whether existing contracts contain a lease, but can choose to carry forward the assessments under IFRIC 4 and IAS 17, and apply the definition of a lease only to new contracts entered into after the date of initial application.

Having decided whether to apply the lease definition to past contracts or not there are several other options available on transition.

One decision to be made will be whether to apply the standard fully retrospectively, restating the prior years as if IFRS 16 accounting had always been applied, or to recognise a liability and right-of-use asset from the date of application. If the latter approach is chosen, the liability is determined using the entity's incremental borrowing rate at the date of application. Choice also exists as to how the right-of-use asset is measured in this case – either as if the standard had been applied since commencement date, but discounted using this incremental borrowing rate or to measure it at the same amount as the liability on initial recognition.

Where can I go for more information?

This publication highlights just some of the issues that will be of interest to entities in the financial services sector.

More detailed information on the new Standard can be found in Deloitte's Need to Know publication, available at **www.ukaccountingplus.co.uk**.

If you would like to discuss any aspects raised in this summary in more detail please contact:

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