More transparent lease accounting

“IFRS 16 will bring most leases on-balance sheet from 2019. All companies that lease assets for use in their business will see an increase in reported assets and liabilities. This will affect a wide variety of sectors, from airlines that lease aircraft to retailers that lease stores. The larger the lease portfolio, the greater the impact on key reporting metrics.”

Kimber Bascom,
KPMG’s global IFRS leasing standards leader
What’s the issue?

Currently analysts adjust financial statements for off-balance sheet leases

Under IFRS 16, companies will bring these leases on balance sheet, using a common methodology
Major impacts for lessees
Lessees face major changes

All major leases on balance sheet

**Balance sheet**

- **Asset**
  - ‘Right-of-use’ of underlying asset
- **Liability**
  - Obligation to make lease payments

**P&L**

- **Lease expense**
  - Depreciation
  - + Interest
  - = Front-loaded total lease expense
Impact on balance sheet

Companies with operating leases will appear to be more asset-rich, but also more heavily indebted.
Total lease expense will be **front-loaded** even when cash rentals are constant.
## Impact on financial ratios

<table>
<thead>
<tr>
<th>Profit/loss</th>
<th>Balance sheet</th>
<th>Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA</td>
<td>Total assets</td>
<td>Gearing</td>
</tr>
<tr>
<td><strong>EPS</strong></td>
<td>Net assets</td>
<td>Interest cover</td>
</tr>
<tr>
<td><em>(in early years)</em></td>
<td></td>
<td><strong>Asset turnover</strong></td>
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</tbody>
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New definition, new accounting
Lease definition

The new on/off-balance sheet test for lessees – a key judgement area

New standard  
Old standard
Lease definition - Control

The new definition increases focus on who controls the asset and may change which contracts are leases.

Lease ✔  Not a lease?
Lease definition - Exemptions

Two major optional exemptions make the standard easier to apply

- **Short term leases**
  - ≤ 12 months

- **Leases of low value items**
  - ≤ USD 5,000 for example
Measuring the lease liability

Lease liability = Present value of lease rentals + Present value of expected payments at end of lease
Variable lease payments

Which variable lease payments are included in the lease liability?

Payments based on an index or rate

Payments based on turnover or usage
Lessor accounting

Lessor accounting remains similar to current practice…

but lacks consistency with new lessee accounting model

- Lease classification test: ✔️
- Finance leases and operating leases: ✔️
- Consistent accounting model for lessors and lessees: ❌
Sale-and-leaseback

IFRS 16 essentially **kills** sale-and-leaseback as an off-balance sheet financing structure.

- **Yes**: On-balance sheet lease at cost
- **No**: On-balance sheet financing, potentially at fair value
Multiple transition options
Applying the new lease definition

Apply the new definition to all contracts

OR

Grandfather existing contracts and apply the new definition only to new contracts
Applying the new standard

A lessee can choose to apply the standard...

Retrospectively to all accounting periods

OR

As a ‘big bang’ at the date of initial application
IFRS ≠ US GAAP
IFRS vs US GAAP

We expect the FASB to publish its new standard soon

IFRS and US GAAP standards converged?

- Lease definition
- Leases on balance sheet for lessees
- Lessor accounting

- Lessee accounting model
- Detailed measurement and transition requirements
- Exemption for low value items
Next steps
Things to think about now

Some questions to assess the impact on your company’s financial statements

- Which contracts are leases?
- Which transition options to choose?
- Database of all leases?
- Systems and processes in place?
- What about ratios and covenants?
Next steps

- Read the new standard
- Think about your implementation plan
- Watch out for our detailed analysis at kpmg.com/ifrs