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IFRS Today

KPMG's podcast series on IFRS and financial reporting

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IFRS 16 *Leases* – Where are companies underestimating the impacts?

Speakers

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Host

Hello and welcome to episode 2 of *IFRS Today*, KPMG's podcast series on IFRS and financial reporting. Our aim in this series is to help you understand and embed the many changes currently under way across the financial reporting landscape.

My name is James Bowe and I'm a member of KPMG's Global IFRS Institute. Today I'm delighted to have with me three KPMG partners, all well versed in the development and impact of the new leases standard – IFRS 16.

Brian O'Donovan is a key member of KPMG's International Standards Group, as well as deputy leader of two of KPMG's global IFRS topic teams – leasing and revenue recognition.

He's joined by Mag Stewart, a partner from the Department of Professional Practice in the Canadian firm. Mag is a member of the global team that develops KPMG's guidance on leasing transactions.

Finally, Jeff King, also a partner with KPMG in Canada working in the accounting advisory space, providing technical accounting advice and supporting Canadian companies in their IFRS 16 projects.

So Brian, Mag and Jeff – Thanks for joining us on *IFRS Today*…

Host

Let's make a start. Today we'll look at the view from the front line of lease accounting, a view that's dominated of course by the impending effective date of IFRS 16 – which requires companies to bring most leases on-balance sheet from 2019.

In line with the aim of this podcast series, we'll examine how effectively the upcoming changes are being embedded in systems and processes and their impacts communicated to stakeholders. How are companies coping with the demands presented by the new leases standard?

Now that companies are starting to really get under way with their IFRS 16 conversion projects, we're discovering some implications that are creating noise in areas we didn't necessarily expect.

First up Brian – What's your take on this?

Brian

Well, James, this standard comes with a big, banner headline – Leases are coming on balance sheets, the balance sheet is getting bigger, which means more assets and more liabilities. But if you look beyond the headline a lot more is happening as well. People are often surprised when they hear that this standard actually increases EBITDA. They are often surprised about the way that the different KPIs move on implementation. For example, somebody who is very focused on managing down reported lease liabilities, perhaps by introducing more break clauses into leases or maximising the use of the short-term and low-value asset exemptions, will find that those strategies actually dilute EBITDA. It's a real minefield about which KPIs you're trying to focus on.

On a practical level, the systems and data challenges are catching a lot of people out; they're really surprised at the resources it takes to implement.

And in other areas, people have the words in the standard, they can see words and phrases, sometimes whole paragraphs that are familiar from the previous leases standard, but does that mean the accounting is always exactly the same? I'd say there are three key areas where I hear again and again people under-estimate the impact: that's the lessor accounting; intercompany leases; and of course, those systems challenges.

Host

OK – Jeff – in terms of the systems challenges Brian's just mentioned, can you elaborate a bit on this?

Jeff

Sure James, many companies are still deciding which approach will work best for them in terms of setting up systems to deal with the changes. There are several considerations to make – What software system will you use? Will you implement a new system now or try and manage transition in spreadsheets? How will you collect data – are you going to have people physically read and abstract leases or use machine-reading software? Are you going to have a central process or a decentralised process and have each location enter their leases into the system?

Many organisations are also using smaller, bolt-on lease accounting solutions in the marketplace, some just as a short-term solution until their ERP provider releases their updated lease module. One thing to keep in mind is that these software packages have varying degrees of modelling capability of transition options and varying degrees of capability of producing transition entries and the necessary output for disclosure requirements.

Mag

Jeff, something you and I have chatted about a bit that's probably worth sharing, is not to get trapped into thinking that – once you've gone through this effort to pick the software – the bulk of the project is really done. So the software solution is part of a much bigger project. You still need to get the data into the system and that's going to require new processes, potentially involving more or different people than before, and then develop controls over those processes and then think about the outputs and how you're going to integrate all of this into your existing financial reporting process.

So this whole process is going to take time.

Jeff

Agreed, Mag – there also tends to be a focus on the effort of accumulating data from lease contracts to populate the system. But one caution I should also add is that it could take more work than you may anticipate on the back-end to ensure the system is compliant with the new requirements.

Host

OK, thank you, Jeff and Mag.

Brian – I know you frequently present to audiences across the globe about implementation challenges presented by the new leases standard. What were the issues that really grabbed people's attention in your view?

Brian

You know, James, it's often the simplest things that really cut through. Think about inter-company leases – if you push the new standard down to the level of the individual reporting entity, one immediate consequence is that inter-company leases will not eliminate on consolidation. Now, as soon as I say that it feels obvious [laughs] in the way that a really bad headache might feel obvious, but imagine you are in a big diverse group with tens or hundreds of thousands of inter-company leases, managing the consolidation suddenly got a whole lot harder. And it's not just the elimination entries, either – if some of those leases are not in the functional currency of the lessee, then there will be a new exchange difference to deal with in the consolidation. And, if you are a banking or insurance group, then the new leases standards can create new assets and liabilities arising purely from inter-company leases. But if those new assets and liabilities are in the regulated entities, that could have an immediate impact on regulatory capital requirements. Now this headache could have a real dollar sign attached to it.

Host

Interesting… headaches. Not good. Are there any actions that people need to take to address this side of things?

Brian

Well, James, I think there are three things to think about in the first instance.

The first of those is a decision – are you actually going to push the IFRS 16 accounting down to the reporting entity level? Because that will mean you have this elimination issue to deal with on consolidation. Now, the alternative is to leave the reporting entities on IAS 17 or just call everything an old-fashioned operating lease and do IFRS 16 for those inter-company leases purely for the purposes of the local statutory financial statements [laughs] – you could say you would be moving the headache around the group.

I think the second thing to think about is exactly what are the terms and conditions of those inter-company leases? Is it possible to manage down lease liabilities arising from inter-company leases by looking at break clauses and by looking at the proportion of variable lease payments in those inter-company leases? Now things that would have a major commercial impact if you were going to negotiate them with a third party lessor might be much more achievable in an inter-company scenario.

I think the third thing to look at is just how do you document those all-important inter-company leases? Do you have the paperwork? Do you have the approvals to help you assess just exactly what is the lease term in an end-company lease? That's going to be crucial to understanding the liability that needs to go in the individual financial statements – it's going to be essential to getting those individual financial statements signed off.

Host

OK – now, Mag, Brian mentioned earlier that some may be under-estimating the impact this new standard has on lessor accounting. Can you explain that a bit more?

Mag

Sure, James. I think for a lot of us, when we tend to think of lessor accounting we think about real estate companies first, and then maybe captive finance companies, something like the captive finance companies they have in the auto sector.

But really picking up on Brian's comments on inter-company leases, one of the areas of greatest change for some lessors relates to the interaction of lessee accounting and lessor accounting so these are companies with multiple sub-leases and we see this in our practice with franchisors. So these intermediate lessors may be surprised to learn that some of the sub-leases previously classified as operating leases may become finance leases – with interest income rather than rental income in the P&L. So the combination of new lessee accounting model and the fact they are likely to get a finance lease for the sub-lease is really reflected as a financing on the balance sheet and the income statement, so this is going to be quite a change for many companies.

I think it might also come as a bit of a surprise that lessor accounting is an area where we're getting quite a lot of questions and that's since the classification model in the lessor standard is really essentially a cut and paste from existing guidance. However, there are still questions – including around the definition of a lease – that are affecting lessors.

Another area where there have been some questions is around the interaction of other standards and the leasing guidance. So lessor accounting has always been somewhat intertwined with revenue, and everyone knows the revenue standard became effective at the beginning of this fiscal year. So one of the knock-on effects of the new revenue standard is that lessors are having to reconsider how to account for payments that the lessee makes to them that don't relate to the right-to-use leased asset. So, for example, payments related to maintenance of the asset or common area maintenance is an area where questions have come up, or even flow-through payments, like reimbursements of the lessor's insurance premiums.

Host

Thanks Mag – are there any other areas lessors might want to be thinking about now to prepare for adoption of IFRS 16?

Mag

I'd really encourage lessors to spend some time, if they haven't spent that time already, investing in understanding the implications of the lessee accounting model. The reason for that is they really want to make sure that contracts they're negotiating today anticipate customer requests. As Brian mentioned, lessees are experimenting with making changes to different aspects of their contracts, so things like break clauses and usage-based variable payments to potentially drive more favourable reporting and they may be looking to have more flexibility in some of these terms in the contracts you're negotiating with them.

Host

I see… Brian – do you have anything to add to this?

Brian

I guess for me I'd like to pull it back to lessees, the impact on lessees and the immediate task lessees are facing and that's to disclose the expected impacts of the new lease standard in their current-year interims. And not everybody's got a number yet; perhaps most people won't have a number until January 2019. So the number they're disclosing today is often driven off their IAS 17 operating lease commitment note. So that note… it's always been important… it's acquired a new importance because it's signalling the expected impact of the new standard. I talked to lots of people who because they are looking again at that note, are realising that maybe it's not quite as complete as it should be. They're finding additional embedded leases or perhaps the number should otherwise be a bit bigger than has been reported in the past and they ask me – what should we do? I always say, be open, be transparent. Tell the market the new information now.

Jeff

And to that point Brian, from what we're seeing, most companies are opting for the modified retrospective approach, so that explanation of differences between the operating lease commitment note and the lease liability will be a pretty common disclosure.

Brian, are you also seeing a preference for the modified retrospective approach?

Brian

Absolutely, lots of companies go through a journey, they think they want to do full retrospective but it's just so hard. I really do think the majority of people are going to be doing modified retrospective and are going to be pushed into providing precisely that disclosure.

Host

OK, so some really great discussion there. Stepping back, a lot of the practical issues people are facing when they implement the new leases standard may not be obvious when you just have the standard in front of you, but it really looks like there are a lot of interesting issues that are cropping up in practice.

Depending on the number of inter-company leases you have, or whether your company is a lessor or intermediate lessor, there may be fewer or more challenges on adoption of the standard. But either way, it's likely that some implementation and process changes will have to be addressed in the near term in order to ensure successful implementation.

Listeners, if you're looking for more detailed guidance on inter-company leases, we've put together a one-page guide which gives a snapshot of the points covered by Brian earlier. Take a look at the landing page for this podcast.

And for more information on the application of IFRS generally, visit KPMG's Global IFRS Institute at kpmg.com/ifrs or follow KPMG IFRS on LinkedIn.

Thank you all very much for taking the time to listen to our podcast and thank you to our panel. Look out for our next podcast, which will be released in the coming weeks.

Thank you again and have a great day!