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TALKINGPOINT

IFRS 16

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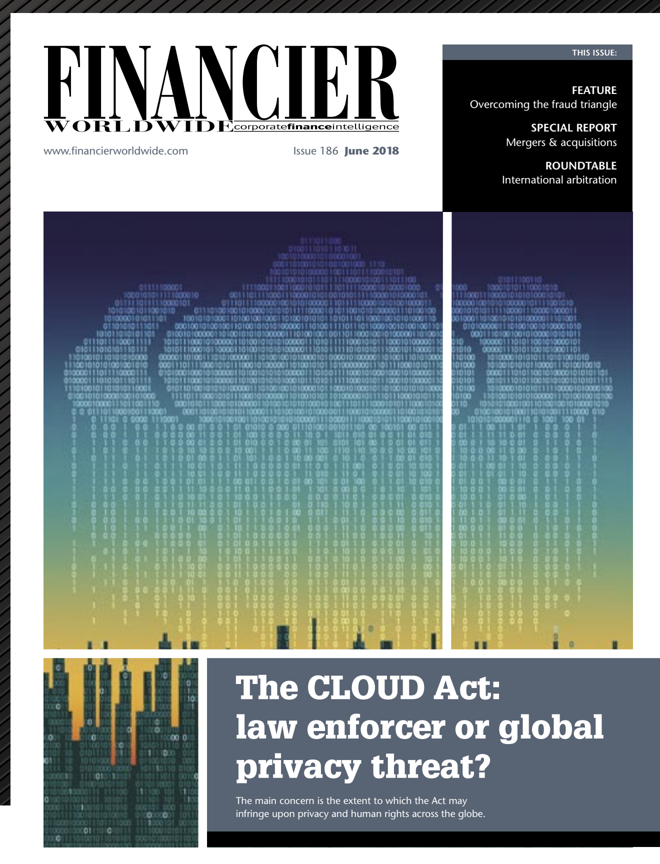

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FINANCE & ACCOUNTING

IFRS 16

FW moderates a discussion on IFRS 16 between Markus Kreher, Sai Venkateshwaran, Michelle Gibbs and Ruben Rog at KPMG.

THE PANELLISTS

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Markus Kreher is the global head of accounting advisory services and the head of finance advisory in Germany. He joined KPMG in 1993 and brings over 20 years of experience in advising family businesses and corporates, particularly in the areas of audit and consulting in various industry sectors. Mr Kreher has vast experience in the areas of IFRS and US-GAAP and assists clients in many areas, including the conversion to IFRS and US-GAAP.

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Sai Venkateshwaran is a partner at KPMG in India and leads the firm's accounting advisory services practice. Mr Venkateshwaran has in-depth expertise in financial reporting, corporate governance and capital market regulations and has been advising clients on complex issues, particularly in the context of transactions, including capital raising, acquisitions and divestitures. He has also worked extensively on cross-border capital market transactions as well as domestic and cross-border mergers and acquisitions.

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Michelle Gibbs is a director at KPMG, with 17 years' experience in providing technical accounting advice and related advisory services to clients across many sectors. Currently, she leads KPMG Australia's offering in response to the new lease accounting standard (AASB 16 Leases) and advises clients on how to successfully implement the standard. In addition, she advises the Australian Finance Industry Association (AFIA) which is the key leasing industry body for equipment and fleet leasing.

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Ruben Rog is a partner in KPMG's capital markets accounting advisory services group in the Netherlands, working with clients to analyse the accounting impact of regulatory change, transactions (buy and sell-side) and business development. He has led numerous GAAP conversions (both towards IFRS and US GAAP) and implementation of new IFRS standards, including IFRS 9, 15 and 16. He has also hosted IFRS 16 and IFRS 9 seminars.

FW: Could you provide an overview of the key principles of the new International Financial Reporting Standards (IFRS) 16 leases standard? What are the main reasons for the first major overhaul of lease accounting in 30-plus years?

Kreher: IFRS 16 Leases removes the concept of operating and finance leases for lessees which exists under IAS 17 Leases, replacing it with an accounting model under which lessees must recognise all leases on the balance sheet as a new 'right of use asset' and 'lease liability'. For periods beginning on or after 1 January 2019, all companies that lease major assets for use in their business will see an increase in both reported assets and liabilities, with the recognition of lease liabilities and right of use assets. Definition of a lease is based on the right to control the use of an "identified asset" for a period of time in exchange for consideration. Small value assets and short-term leases are excluded. The rules for lessors have not significantly changed. The change to bring the majority of leases on balance sheet was driven by the IASB to improve transparency and comparability for users of financial statements. It represents a change over the existing leases standard, which does not require lease assets and lease liabilities to be recognised by many lessees. It also now provides a clear and complete picture of companies' leasing activities by means of improved disclosures.

FW: What are the main accounting and financial implications of IFRS 16 for companies? To what extent will the new standard impact income statements, balance sheets and cash flows, for example?

Venkateshwaran: Although the economic benefits and risks of leasing do not change, the new lease accounting model will change key financial metrics and key performance indicators (KPIs). Companies will likely become more asset-rich but also heavily indebted, and this will have an impact on their gearing ratios. In the profit and loss,

> IN OUR EXPERIENCE, DATA EXTRACTION, ENRICHMENT AND REVIEW IS A TIME-CONSUMING PROCESS, WHILE THE LEASE-RELATED COMPUTATIONS CAN BE QUITE COMPLEX.
>
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a shift occurs as lease rent is no longer treated as an operating expense, but instead is recognised as part of depreciation and interest expense resulting in an increase in measures such as earnings before interest and taxes (EBIT) and earnings before interest taxes depreciation & amortisation (EBITDA). The timing of recognition of expenses will change from the straight-line model to a front-loaded profile for most leases, even when rental payments are constant year-to-year or back ended with escalations in subsequent years. While the cash flows are not impacted on the whole, there will be a change in classification – an increase in operating cash inflows with a corresponding increase in financing cash outflows. The impact will differ per company, but we note some sector trends where, for instance, the retail, telecom and airline industry will likely be significantly impacted.

FW: How would you characterise the extent of the challenge companies face upgrading their processes and systems in order to be IFRS 16 compliant? What steps should companies be taking to mitigate the disruption caused by IFRS 16?

Gibbs: The extent of the challenge depends on the volume of lease contracts that need to be assessed. The biggest challenge is to carry out an inventory of all lease contracts and update appropriately for all new required lease information. Historically, operating leases were recorded off the balance sheet as an operating expense item in the profit and loss when incurred, and required relatively less disclosure requirements. In comparison, with almost every lease now on the balance sheet, with different patterns of subsequent measurement, both in terms of nature and timing of expenses, a lot more data needs to be collected and tracked for accounting measurement purposes. Therefore, companies need to have a robust process in place to identify lease agreements, extract all relevant lease data and implement a lease accounting system in order to meet the requirements of the new standard. Companies that are geographically spread across the globe and operating in a decentralised manner are likely to find this more challenging than others, and may look to centralise the process to reduce cost and increase efficiencies. Companies should also look at transition choices and practical expedients provided by the standard to make the transition smoother.

> MOST COMPANIES HAVE BEEN EXPENDING SIGNIFICANT EFFORT ON THE TRANSITION TO THE NEW REVENUE STANDARD, IFRS 15, AND THE EFFORTS ON IFRS 16 WERE UNDERESTIMATED.
>
> MICHELLE GIBBS
> KPMG

FW: With IFRS 16 largely a principles-based standard, what advice would you give to companies in terms of managing the uptick in the volume of required data, remaining compliant and minimising duplications and errors? Are there any practical tools and implementation tips that companies could potentially benefit from?

Rog: We have seen that companies respond to these challenges with a preference for an integrated solution into their existing IT landscape. Considering fast-approaching timelines, companies are also considering compliance-oriented tools, including more agile SAAS solutions to ease the compliance burden. In addition to choosing the appropriate lease accounting software tool, in our experience, we believe there are five key elements for a successful implementation. First, identify a qualified project team and establish objectives and governance protocols. Second, identify the total population of leases. Third, define current system capabilities and data gaps.

> IN MANY SUCH SITUATIONS, WE ARE SEEING COMPANIES STARTING TO RE-THINK ABOUT 'LEASE VERSUS BUY' DECISIONS.
>
> SAI VENKATESHWARAN
> KPMG in India

Fourth, implement a pilot programme to meet global, country-level, and business unit reporting objectives. Finally, design a global solution and implement the new standard, including related internal controls. As part of this, companies should also lay down guidelines, within the broad principles of the standard, for use by group entities, to achieve consistency, with exceptions being managed by the central team. In our experience, data extraction, enrichment and review is a time-consuming process, while the lease-related computations can be quite complex.

FW: How difficult is the conversion process likely to be for companies used to analysing and reporting within their own data silos?

Kreher: The complexities in the conversion process depend on a company's size, structure, business practices and existing contract management systems. There are some companies that have over 100,000 lease contracts. Further, many large listed companies still use spreadsheets to administrate lease obligations and not all contracts are readily available from contract management systems. In addition, some required data points will not be included in the lease contract. As a result, collecting all the data can be quite a time-consuming process. Companies will also now need to have far greater coordination between various internal functions, such as finance, business units, information technology, real estate management and supply chain, as well as between corporate headquarters and business units including subsidiaries in various jurisdictions, in order to collect all the required lease information.

FW: In your opinion, how important is it for companies to evaluate their commercial contracts to take into account the effects of IFRS 16?

Venkateshwaran: Identifying commercial implications and whether it triggers any changes to contractual arrangements would depend largely on a company's size and the business model, and in general, an impact assessment would be necessary. We also believe that an accounting change should not be the driver of business and commercial decisions. Having said that, those business practices that have evolved with the objective of keeping assets and obligations off balance sheet will possibly be re-evaluated, as that objective will not be achieved anymore. In many such situations, we are seeing companies starting to re-think about 'lease versus buy' decisions. In certain cases, companies are also using this transition as a trigger to review the commercial construct of some of their arrangements, including evaluation of models where the lessor has greater skin in the game with a significantly higher element of contingent rent, and so on.

> THE COMPLEXITIES IN THE CONVERSION PROCESS DEPEND ON A COMPANY'S SIZE, STRUCTURE, BUSINESS PRACTICES AND EXISTING CONTRACT MANAGEMENT SYSTEMS.
>
> MARKUS KREHER
> KPMG

FW: Drawing on your experience, how would you describe current preparations for IFRS 16 in the run-up to its implementation? Are there likely to be any particular difficulties for companies as far as their transitioning efforts are concerned?

Gibbs: Most companies have been expending significant effort on the transition to the new revenue standard, IFRS 15, and the efforts on IFRS 16 were underestimated. For most companies, barring a few complex contracts, it is not a big 'technical accounting' issue, but the challenges come from a combination of the large number of leasing contracts in scope, the low levels of availability or accessibility of these contracts at a group level and the decentralised administration of these contracts. It is in this context that the tools, especially those supporting data extraction, become quite relevant. The analysis of these contracts can otherwise be a very time-consuming process, as most of these are not standardised and vary based on a number of factors, including nature of assets, country, region and local laws. As the deadline draws closer, there will be a continuing build-in demand on tool providers and implementation consultants, with all companies demanding support to meet the same implementation deadline.

FW: With the IFRS 16 introduction date approaching, what final advice would you give to companies in terms of developing and implementing an IFRS 16 solution to suit their business?

Rog: IFRS 16 should be embraced as an opportunity for change in a number of areas, such as digitalisation. Considering the pervasiveness of the impact of this standard across the length and breadth of an organisation, it is appropriate to bring in digitalisation and centralisation of processes, thereby bringing in greater efficiency and controls. The new digital processes and enablers should also serve as a more effective business intelligence tool, as well as support compliance and reporting needs. Companies with significant volumes should also consider using data abstraction tools for more effective and efficient data management. Another area for change is commercial and business decisions. It also serves as a trigger to consider lease versus buy decisions and also to change the commercial construct of arrangements, where possible. Further, while this is an accounting change, it is one which could change reported numbers significantly, and, therefore, there may be a consequential impact on other contractual arrangements, such as covenants in loan agreements or EBITDA-linked earnings multiples in acquisition agreements. Further, key KPIs and metrics such as opex vs capex limits, as well as budgeting and forecasting processes, are likely to require revision. Stakeholder engagement is another opportunity. Involve your key stakeholders, both internal and external, early in the process to deal with change management as well as educate investors on the key changes that can be anticipated. ■