#KPMGIgnite

Join the conversation
Agenda

Join the conversation

- Highlights of new standard
- Impact on financial results
- Lease definition
- Sale and leaseback transactions
- Transition rules
- How do we get started?
- Questions
Highlights of new standard

IFRS 16 and US GAAP Topic 842 largely converged

For Lessees:

- All major leases recognized on balance sheet
- New criteria for identifying a lease
- Sale leaseback accounting has changed

- Single model (IFRS)
- Dual model (US)
- “Right-of-use” asset, lease liability
- Practical expedients
- Complex area
- Differences may arise

Significant implications to financial results, processes
Highlights of new standard

For Lessors:

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
<table>
<thead>
<tr>
<th>Topic</th>
<th>IFRS</th>
<th>US GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessee accounting</td>
<td>- Single lease accounting model</td>
<td>- Dual lease accounting model (finance and operating leases)</td>
</tr>
<tr>
<td></td>
<td>- No lease classification test</td>
<td>- Lease classification test based on current Topic 840 classification criteria</td>
</tr>
<tr>
<td></td>
<td>- All leases on balance sheet:</td>
<td>- All leases on balance sheet:</td>
</tr>
<tr>
<td></td>
<td>- lessee would recognise a right-of-use (ROU) asset and lease liability</td>
<td>- lessee would recognise a ROU asset and lease liability</td>
</tr>
<tr>
<td></td>
<td>- treated as the purchase of an asset on a financed basis</td>
<td>- Finance leases treated as the purchase of an asset on a financed basis</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Operating leases would generally have straight-line recognition of total lease expense</td>
</tr>
<tr>
<td>Small-ticket leases</td>
<td>- Exemption for small-ticket leases, even if material in aggregate</td>
<td>- No exemption for small-ticket leases</td>
</tr>
<tr>
<td>Lessor accounting</td>
<td>- No restriction on recognizing selling profit on commencement for finance leases</td>
<td>- Selling profit not recognized on commencement of leases that qualify for finance lease classification solely due to the involvement of third parties other than the lessee</td>
</tr>
<tr>
<td>Subleases</td>
<td>- Assess classification based on right-of-use asset</td>
<td>- Assess classification based on underlying assets</td>
</tr>
</tbody>
</table>
Impact on financial results
All major leases on-balance sheet

**Balance sheet**

*Asset* = ‘Right-of-use’ of underlying asset

*Liability* = Obligation to make lease payments

**P&L (IFRS)**

**Lease expense**

Depreciation + Interest = Front-loaded total lease expense
Impact on financial results

Impact on Balance Sheet

Companies who currently have operating leases will appear to be more asset-rich, but also more heavily indebted.
Impact on financial results

Impact on Income Statement (IFRS)

Total lease expense will be front-loaded even when cash rentals are constant

Also note:
Operating costs down
EBITDA up
DDA up

© 2016 KPMG LLP, a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International.
Impact on financial results

Impact on Cash Flows (IFRS)

Cash flows from operating activities*

Funds from operations**

* Addback depreciation charge (ROU), interest (liability) to net income

** Cash flows from operating activities less interest, change in non-cash working capital

© 2016 KPMG LLP, a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International.
Impact on financial results

Impact on financial ratios (IFRS)

- Debt / Equity: Increase
- EPS (early years): Decrease
- Interest coverage: Decrease
## Impact on financial results - IFRS versus US GAAP

### How will metrics for competitors following US GAAP change?

<table>
<thead>
<tr>
<th>Key financial items as compared to previous lease accounting</th>
<th>IFRS 16</th>
<th>US GAAP (ASC 842)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance Sheet Assets</td>
<td>↑</td>
<td>↑</td>
</tr>
<tr>
<td>Liabilities</td>
<td>↑</td>
<td>↑</td>
</tr>
<tr>
<td>Income Statement Depreciation</td>
<td>↑</td>
<td>—</td>
</tr>
<tr>
<td>Interest expense</td>
<td>↑</td>
<td>—</td>
</tr>
<tr>
<td>Cash flow Statement Cash flow from operations</td>
<td>↑</td>
<td>—</td>
</tr>
<tr>
<td>Cash flow from financing</td>
<td>↓</td>
<td>—</td>
</tr>
<tr>
<td>Financial ratios EBITDA</td>
<td>↑</td>
<td>—</td>
</tr>
<tr>
<td>Interest coverage</td>
<td>↓</td>
<td>—</td>
</tr>
</tbody>
</table>
Impact on financial results:

Disclosure prior to transition

– IAS 8.30 disclosure — known/reasonably estimable possible impact of IFRSs issued but not yet effective.

– Consider timeline leading up to adoption for disclosure of impacts
Definition of a lease
Definition of a lease

- **Identified asset**
  - Explicitly or implicitly specified in the contract
  - Physically distinct or rights to substantially all of asset’s capacity
  - Supplier does not have a substantive substitution right

- **Control over the use of the identified asset**
  - Lessee obtains substantially all economic benefits
  - Lessee directs the use

= **Lease**

FASB and IASB definitions aligned

Source: KPMG
On/off balance sheet test

1. **Identified asset?**
   - Yes

2. **Customer obtains substantially all economic benefits?**
   - No

3. **Customer directs the use?**
   - Yes

4. **Contract is or contains a lease**

   **Contract does not contain a lease**
Sale and leaseback transactions
Sale and leaseback transactions

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

Is there a sale?

- **Yes**: On-balance sheet lease at cost
- **No**: On-balance sheet financing, potentially at fair value
Sale and leaseback transactions

Consider:

Objectives of sale-leaseback: Off B/S financing Upfront cash

Old IFRS guidance ✓ ✓
New IFRS 16 ✓ ✓

(ROU asset and lease liability likely less than previous carrying amount)
Relief from applying the new model
Exemptions and practical expedients

**Short-term leases**
- Leases with a term ≤ 12 months may apply current operating lease accounting
- If elected, the exemption is applied to all leases within that class of underlying asset
- Still subject to qualitative and quantitative disclosures

**Underlying assets of low value (IASB only)**
- Exemption for leases of underlying assets that are individually low in value (e.g., ≤ USD $5,000, when new) even if material in aggregate
- Leases would be accounted for off-balance sheet under IFRS

**Portfolio-level**
- Aspects of the new standard may be applied at a portfolio level (e.g., determination of discount rate and lease term)
- Must be a reasonable expectation that the portfolio approach is not materially different than application to individual leases
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
What can you be considering as you enter into new contracts today?

- Lease terms of < 12 months
  - Renewal terms or options to purchase?
  - Impact of short term lease on price?
- Lease definition
  - Substitution clauses
  - Predetermined rights
- Fixed vs. variable lease payments
  - In-substance fixed lease payments – on B/S
  - Payment based on usage or performance - expensed as incurred
- Transition options
  - Grandfather existing lease versus service contract decisions?
Transition rules
Applying the new standard (IFRS)

A lessee can choose to apply the standard…

Retrospectively to all accounting periods

OR

As a ‘big bang’ at the date of initial application
Effective date (IFRS)

- timeline is based on requirements applicable to a public entity with December 31 year-end;
- assumes company will transition on the effective date of the standard, January 1, 2019;
- a company may elect to early adopt (beginning in 2016) if IFRS 15 is adopted.

Effective date
January 1, 2019

Annual report
December 31, 2019

A lessee can choose to apply the standard if IFRS 15 is adopted.

Interim f/s
How do we get started?
How do we get started?

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?
Broader business impacts

IFRS 16
Accounting change

Treasury
Covenants
Credit rating
Regulatory capital (banks)

Systems
Leasing database
System solution
ERP integration

Finance
Transition options
Data collection
Tax KPIs

Strategy
Lease vs buy
Lease structuring
Sale-and-leaseback

Investor relations
Analyst queries
KPI’s (e.g., EPS)
Comparability

Employee benefits
Management remuneration KPI’s

© 2016 KPMG LLP, a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved. The KPMG name and logo are registered trademarks or trademarks of KPMG International.
Questions?
New leases standard - Introducing IFRS 16

Insight and analysis on the impact of IFRS 16 Leases.

The new leases standard – IFRS 16 – will require companies to bring most leases on-balance sheet from 2019.

Under the new standard, companies will recognize new assets and liabilities, bringing added transparency to the balance sheet. At present, many analysts adjust financial statements to reflect lease transactions that companies hold off-balance sheet.

Our First Impressions: IFRS 16 Leases [PDF 678 KB] can help you assess the potential impact of the new standard on your business. It explains the key requirements, highlights areas that may result in a change in practice, and features KPMG insights.
Sharlene Wilson
Partner, Accounting Advisory Services
T: 403 691-8024
E: sharlenewilson@kpmg.ca
Thank you

Download this presentation at:
kpmsg.ca/ignite