Seminar - Hot topics treasury
Leases IFRS 16 and the discount rate
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Welcome and introduction
1 Welcome and introduction

With you today

Karin Meijer
Director
Capital Markets and Accounting Advisory Services
T: +31 (0)88 792 2635
M: +31 (0)6 20303990
karin.meijer@pwc.com

Dino Tsafantakis
Senior Associate
Capital Markets and Accounting Advisory Services
T: +31 (o) 88 792 3693
M: +31 (o)6 1399 9045
dino.tsafantakis@pwc.com
IFRS 16 summary
IFRS 16 Summary

- **Lessee** has to recognise a *right-of-use asset* and a *lease liability* for almost all lease contracts.
- **Exemptions** for short-term leases and leases of low value assets.
- **Lessor** accounting stays almost the same as under current guidance.
- **IFRS 16** was published on 13 January 2016.
- **Effective date**: 1 January 2019.
- **Lease liability** represents the present value of the *lease payments* discounted at the interest rate implicit in the lease if readily determinable. If not readily determinable, incremental borrowing rate is used.
- **Enhanced disclosure requirements**.
- **Earlier application** permitted (together with IFRS 15).
- **Lessee** has to present interest expense (on lease liability) and *depreciation charge* (for right-of-use asset) separately.
Scope of IFRS 16

Lease = A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

All leases are in the scope of IFRS 16, except for:

<table>
<thead>
<tr>
<th>Items</th>
<th>Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease to explore for or use non-regenerative resources</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Biological assets within the scope of IAS 41</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Service concession arrangements within the scope of IFRIC 12</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Licences of intellectual property granted by lessor within the scope of IFRS 15</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Rights held by lessees under certain licensing agreements (motion picture films, patents, copyrights etc.)</td>
<td>Out of scope</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>Policy choice for lessees</td>
</tr>
</tbody>
</table>
**Exemptions**

**Short-term leases**
- Lease term of 12 months or less (may include periods covered by options)
- Accounting policy choice (by class of underlying assets)
- Reassessment in case of modification or change in lease term
- Only applicable for **Lessee**

**Low value assets**
- Assets with a value, when new, of USD 5,000 or less
- Accounting policy choice (lease-by-lease basis)
- Only applicable for **Lessee**
### Definition of a lease

1. **Is there an identified asset?**
   - **Yes**
   - **No**

2. **Does the customer have the right to obtain **substantially all of the economic benefits** from the use of the asset throughout the period of use?**
   - **Yes**
   - **No**

3. **Who has the right to **direct how and for what purpose** the asset is used throughout the period of use?**
   - **Customer**
     - **Yes**
       - Customer operates the asset or has designed the asset?
     - **No**
   - **Predetermined**
   - **Supplier**

**Contract contains a lease**

**Contract does not contain a lease**
Lessee accounting – Lease Liability

- **Fixed payments**
  - Only if they depend on index/rate
  - Measured using index/rate as at commencement date

- **Variable lease payments**

- **Residual value guarantees**
  - Expected payments lessee has to make under guarantee

- **Exercise price of a purchase option**
  - If the lessee is **reasonably certain** to exercise the option

- **Penalties for terminating**
  - If the **lease term** reflects the termination by the lessee
Lessee accounting – initial measurement

Right-of-use asset

- **Lease liability**
  - Lease payments made before or at commencement date
  - Restoration costs
  - Initial direct costs

Lease liability

- **Lease payments**
  - Discount rate
- **Provision**
Transition – Effective Date

**Effective date**

- Annual reporting periods beginning on or after 1 January 2019
- Date of initial application (DIA): Beginning of the period in which the entity first applies the standard
- Early adoption permitted in conjunction with IFRS 15

**Definition of a lease**

- No mandatory reassessment (i.e. contracts are “grandfathered”); practical expedient
- If entity chooses the practical expedient it shall be applied to all contracts
**Transition – Approach**

**Lessee**

- Retrospectively in accordance with IAS 8

  or

- **Simplified approach**

**Simplified approach**

- Retrospectively with cumulative effect as adjustment to opening balance of retained earnings (or other component of equity, if appropriate) on DIA

- No restatement of comparative information

Discount rate to be determined for each lease commencement date retrospectively, using interest rate implicit in the lease if readily determinable, otherwise utilising the incremental borrowing rate.
### Transition – Lessee

#### Simplified approach

<table>
<thead>
<tr>
<th>Previously operating lease</th>
<th>Previously finance lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Lease liability =</td>
<td>• Lease liability =</td>
</tr>
<tr>
<td>• remaining lease payments</td>
<td>• carrying amount of lease liability immediately before date of initial application</td>
</tr>
<tr>
<td>• discounted using incremental borrowing rate at date of initial application</td>
<td></td>
</tr>
<tr>
<td>• Right-of-use asset =</td>
<td>Right-of-use asset =</td>
</tr>
<tr>
<td>• retrospective based on incremental borrowing rate at date of initial application, or</td>
<td>carrying amount of lease asset immediately before date of initial application</td>
</tr>
<tr>
<td>• amount of lease liability</td>
<td></td>
</tr>
<tr>
<td>• Not required to apply if remaining lease term &lt; 12 months</td>
<td></td>
</tr>
</tbody>
</table>
Discount Rate
Interest Rate Implicit in the Lease

Interest Rate Implicit in the Lease

Rate at which

Present value of lease payments + Present value of unguaranteed residual value = Fair value of underlying asset + Lessor’s initial direct costs

Generally needs to be estimated by the lessee!

Must be readily determinable. The higher the level of estimation uncertainty, the less likely you can assert it is readily determinable
**Incremental Borrowing Rate**

The incremental borrowing rate is defined as the rate of interest that a lessee would have to pay to borrow, over a similar term and with a similar security, the funds necessary to obtain an asset of a similar value to the cost of the right-of-use asset in a similar economic environment.

- **Base rate**
  - Relevant economic environment (political environment, inflation, etc)
  - Reference to available risk free rates (e.g. government bonds)
  - Should represent currency and date of entering into lease

- **Credit worthiness**
  - Reflect credit worthiness of local lessee entity
  - Term of the lease (i.e. duration of the lease)
  - Consider group structure and financing arrangements

- **Contract**
  - Risk is reduced by asset serving as security
  - Nature and quality of underlying assets
  - Amounts of funds ‘borrowed’

**Practically:** A bucketing approach based on the operating lease grouping can be applied.
### Incremental Borrowing Rate – Practical Example

#### Simplified Approach

<table>
<thead>
<tr>
<th><strong>Base rate</strong></th>
<th><strong>Credit spread</strong></th>
<th><strong>Country risk premium</strong></th>
<th><strong>Inflation differential</strong></th>
<th><strong>Contract term group</strong></th>
<th><strong>Contract specific element</strong></th>
</tr>
</thead>
</table>
| • Bid zero coupon US Treasury Strips.  
• Bid zero coupon EUR German Government Strips. | • credit ratings: AA, A, BBB, BB, B. | • For example a separate country risk premium for Spain | | | • Four groups:  
(1) 0 - ≤ 5 years  
(2) 5 - ≤ 10 years  
(3) 10 - ≤ 15 years  
(4) > 15 years | • Contract specific element, could be a discount (high quality underlying collateral) |

Based on

- Circa 80% of the total lease exposure is denominated in USD.
- For example 5 credit ratings, resulting in 5 different credit spreads
- Spain is the only country in the population with a spread.
- Majority of the exposure is in USD (c. 80%), with no ID.  
• EUR is the 2nd largest exposure (c. 7%), with limited ID.  
• The AUD can be considered.
- For example assume 4 groups based on the terms in the operating lease portfolio
- For instance 5 variations

**As result, number of potential discount rates** = 600
**Incremental borrowing rate**

Important considerations

- Often lower than the historical IBR
- Does not contain all elements of the interest rate implicit in the lease
- Significant impact on transition and in future periods
- Comparability to peers
Questions?