IFRS 16 in the Travel, Tourism & Hospitality sector

VIVEK MEHAN

Recap... Current position

How do you determine if a lease is a finance lease or an operating lease under current IFRS (IAS 17)?

How do lessees account of finance leases?

How do lessees account for operating leases?

New proposals – executive summary

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Do we need to change?

Easyjet – Annual report – 30 Sept 2017

IFRS 16 'Leases' – effective for the year ending 30 September 2020

easyJet is currently planning to early adopt IFRS 16 on 1 October 2018, bringing the timing of adoption in line with that of IFRS 9 and IFRS 15. easyJet anticipates applying the cumulative catch-up ("modified") transition method.

The standard provides a single lessee accounting model, specifying how leases are recognised, measured, presented and disclosed. Under IFRS 16, easyJet will capitalise all aircraft and properties currently held under operating leases. Operating lease expenses will be replaced by a depreciation expense on Right of Use assets recognised and an interest expense as the interest rate implicit in easyJet's lease liabilities unwinds.

At 30 September 2017 (excluding the impact of the post balance sheet Air Berlin transaction (see note 28) which has not yet been evaluated) easyJet anticipates that on adoption of IFRS 16 on 1 October 2018, it will recognise approximately £0.3 billion of lease liabilities and approximately £0.3 billion of Right of Use Assets. Annual operating lease expenses of £0.1 billion, which would have been recognised under the existing leases standard, will be replaced by anticipated similar levels of depreciation and interest expense such that no material impact on profit before tax is expected in the year of transition.

Retained earnings are expected to decrease slightly on adoption of IFRS 16, reflecting the difference in carrying value between Right of Use assets and Lease Liabilities initially recognised.

Why a leases project

“ *These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company’s often-substantial lease obligations.*

The new Standard will provide much-needed transparency on companies’ lease assets and liabilities, meaning that off balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability between companies that lease and those that borrow to buy. ”

Hans Hoogervorst, IASB Chairman

Why things need to change

- The current approach can be confusing for investors and other users of financial statements
- Many assets used in a company's operations are off-balance sheet
- Limited information about operating leases
- Difficult to compare companies that lease assets with those that buy assets
- Analysts end up estimating the amount of off-balance sheet obligations

Listed companies using IFRS Standards or US GAAP estimated to have around

$3.3 trillion

lease commitments

Over

85%

do not appear on the balance sheet

IFRS 16

Replaces:

- IAS 17 Leases
- IFRIC 4 Determining whether an arrangement contains a lease
- SIC 15 Operating leases – Incentives
- SIC 27 Evaluating the substance of transactions involving the legal form of a lease

Recap... question

How would you account for the following **finance lease**

- Fair value of asset is £100,000
- 3 annual lease payments in arrears of £40,000
- Interest rate 9.7% (can use 10%)

Recap - solution (1 of 3)

Balance Sheet Extract	**Y1**	**Y2**	**Y3**
NBV	67,000	33,333	NIL*
Liability			

Profit and Loss Extract	**Y1**	**Y2**	**Y3**
Depreciation	33,333	33,333	33,333
Interest			

*Note 10% has been used for simplicity – but this does create small rounding errors

Recap solution (2 of 3)

Lease Liability	**b/f**	**Interest***	**Repayment**	**c/f**
Y1	100,000	10,000	(40,000)	70,000
Y2	70,000	7,000	(40,000)	37,000
Y3	37,000	3,700	(40,000)	NIL*

*Note 10% has been used for simplicity – but this does create small rounding errors

Recap - solution (3 of 3)

Balance Sheet Extract	**Y1**	**Y2**	**Y3**
NBV	67,000	33,333	NIL*
Liability	70,000	37,000	NIL*

Profit and Loss Extract	**Y1**	**Y2**	**Y3**
Depreciation	33,333	33,333	33,333
Interest	10,000	7,000	3,700

*Note 10% has been used for simplicity – but this does create small rounding errors

Why a leases project

RETAILER	OPERATING LEASE COMMITMENTS (UNDISCOUNTED)[1]	REPORTED DEBT [1]
Circuit City (US)	$4.53bn	$50m
Borders (US)	$2.79bn	$379m
Woolworths (UK)	£2.43bn	£147m
HMV (UK)	£1.01bn	£115m
Clinton Cards (UK)	£652m	£58m

- Extract from “By all Accounts” Financial Reporting Faculty magazine, January 2015

IFRS 16 – Leases

THE NEW STANDARD

What's the impact?

- Strands to consider:
- Stakeholder management
- Capturing the information
- Impact on decisions?

Lessee accounting

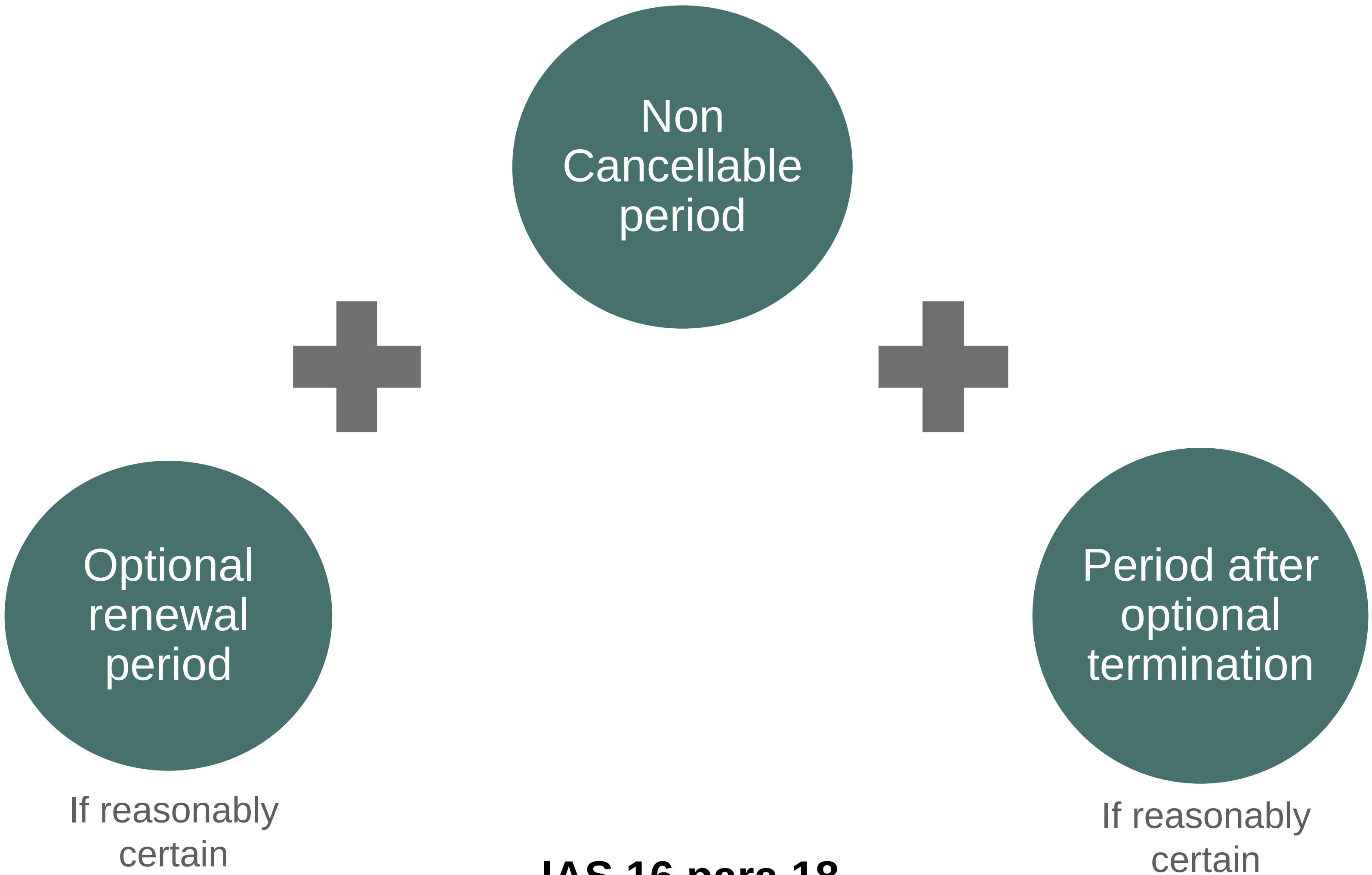
		Balance sheet	Income statement
Single model	Most leases on balance sheet	Right of use asset	Depreciation expense
		Lease liability	Front-loaded interest expense
	Exemptions for short-term and low value leases	Can elect to leave off balance sheet	Straight-line expense

Recognition exemptions

1. “**Underlying asset**” is of “**low**” value when new
   - Exemption taken on an asset by asset basis
2. “**Short term**” leases
   - Where the lease term is less than 12 months
   - Exemption taken on by class of asset

- For exempt leases
  - Don’t have to recognise these assets on the balance sheet
  - Do need to disclose that this exemption is being taken
  - Lease payments will be recognised on either a straight line basis or a systematic basis

Lease term



IAS 16 para 18

Measuring the lease liability

Discount rate

Interest rate implicit in the lease

If this cannot be readily determined then the lessee uses its incremental borrowing rate

Lease measurement at commencement

Right of Use Asset

- Measure at “cost”
- = liability + direct costs + estimate of dismantling – lease incentives

Lease Liability

- Present value of the lease payments
- Discount at rate implicit in the lease (if can’t ascertain then use incremental borrowing rate)

IFRS 16 – Leases

TRANSITION GUIDANCE

Transition

Effective date and transition

Effective for annual periods beginning on or after 1 January 2019

Early adoption generally permitted

Choice of transition methods – fully retrospective or simplified approach

Definition of a lease – apply to all contracts or grandfather existing contracts

Question

- What if I lease a car over a three year term for £5,000 per annum
- Included in the rental is a “service pack” where the car is maintained, serviced and any necessary repairs are carried out.
- It is thought that the value of the service pack is worth £1,000.
- How do I account for this under IFRS 16?

Lease and service components

- Identifying components
  - Can the lessee can benefit from using that underlying asset either on its own or together with other resources that are readily available?
  - Is the asset is highly dependent on, or interrelated with, the other assets in the contract?
- Accounting for components
  - Separate the consideration paid based on:
    - The relative standalone selling price of each lease component
    - The aggregate standalone selling price of the non-lease components
- Practical expedient
  - The lessee can elect to not to separate lease components on a class by class basis
  - The whole contract is then accounted for as a lease

Consider this scenario

- Bob obtains the use of “cloud storage space” from a company (This involves him getting up to 240TB of data on a specified hard drive (which has been tailored specifically for Bob) stored at Bob’s location.
- Bob will pay on a per TB basis, there is no minimum requirement and it is a 3 year agreement.

- Is this a lease...???

Definition of a lease

There is an identified asset

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Contract conveys the right to control the use of an identified asset

No identified asset if supplier has <u>substantive right to substitute</u> asset

Right to obtain <u>substantially all of the economic benefits</u> from use of the identified asset throughout the period of use

<u>Right to direct the use</u> of the identified asset throughout the the period of use