
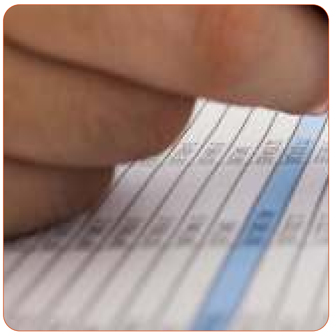

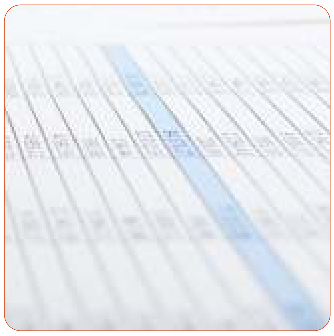

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Measuring leases under IFRS 16

IFRS 16 establishes a new accounting treatment for lease agreements

The way in which operating leases are accounted for will change in the coming years upon effectiveness of IFRS 16 - Leases. The prevailing accounting treatment distinguishes between operating and finance leases depending on whether or not the risks and rewards of ownership are transferred from lessor to lessee.

- When these risks are not transferred, the lease is classified as an operating lease and the lessee only recognises operating expense in profit and loss.
- If substantially all of the risks are transferred, the lease qualifies as a finance lease and the lessee recognises an asset and financial liability on its balance sheet.

IFRS 16, however, stipulates the same accounting treatment for both kinds of leases: regardless of whether the risks of ownership of the asset are transferred to the lessee, the latter must account for the lease arrangement using a traditional capitalisation formula. The new accounting standard therefore affects the accounting treatment of operating leases. The accounting treatment applicable to finance leases will not change.

Current accounting model
(IAS 17 and related interpretations)

Distinction between operating and finance leases

1) If substantially all the risks and rewards of ownership of the asset are transferred, the lease qualifies as a finance lease:
   - the lessee recognises an asset and a liability
2) If all that is transferred is a right of use, with the lessor retaining substantially all the risks and expenses, the lease qualifies as an operating lease:
   - the lessor recognises an annual operating expense in profit and loss

New accounting model
(IFRS 16)

Single lessee accounting model

- Regardless of whether the risks of ownership of the asset are transferred to the lessee, the latter must account for the lease arrangement using a traditional capitalisation formula.
- The new accounting standard therefore affects the accounting treatment of operating leases.

IFSR 16 is effective from 1 January 2019, although reporters applying IFRS 15 can choose to apply it earlier.

Impact on companies

Lessee financial statements stand to sustain very significant changes as a result of application of IFRS 16. These changes can be summed up as follows:

Assets

- Lessee reporters will see their assets increase by the amount of operating leases they are party to.
- Exemptions: lease terms of 12 months or less and underlying assets of low value.

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Liabilities

- Their liabilities will increase by the amount of their binding obligations under their lease agreements as if a financial liability.
- This change may well impact associated leverage ratios (e.g. the ratio of debt/EBITDA).

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Profit and loss

- Instead of lease expense, lessees will now recognise two items of expense in their statements of profit or loss:
  - Depreciation of the right-of-use asset.
  - Interest expense under lease liabilities (finance cost).

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The most significant impact is, unquestionably, the **increase in liabilities under the new accounting standard**, which could have a considerable impact on compliance with debt covenants. The traditional metrics used to measure a company's leverage and coverage, such as debt/EBITDA, will also be affected.

Afi's advisory proposal

AFI offers an advisory service consisting of the design of IFRS 16 implementation methodology and an analysis of the potential impact on reporter financial statements and credit ratios.

1. Definition of measurement methodologies

- Asset measurement methodology
- Liability measurement methodology
- Methodology for calculating the applicable discount rate

2. Measuring the portfolio of leased assets

- Individual measurement of each asset and liability
- Incorporation into the assessment of optional elements
- Overall measurement of the asset and liability portfolio

3. Impact analysis

- Impact on financial liabilities
- Impact on EBITDA and interest expense
- Impact on covenants: ND/EBITDA, EBITDA/interest
- Impact on credit ratings and borrowing terms and conditions

The main challenges implied by the new lease measurement requirements are:

1. **Determination of an appropriate interest rate for the purpose of discounting the cash flows** from the lease agreement in order to reflect reasonably the reporter's risk exposure.
2. **Determination of the lease term** for lease recognition purposes.
3. **Assessment of the impact of optional elements** on the duration of the lease agreements and the amounts that must be effectively taken into consideration for lease asset/liability measurement purposes.

AFI's advisory service is articulated around three key lines of initiative:

1. Designing the **methodology** for recognising operating lease assets and liabilities.
2. Simulating and analysing the **impact on lessee financial statements.**
3. Generating a back-up report for provision to the **auditor.**

Enquiries

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