KPMG

Accounting for leases is changing

What's the impact on consumer market and retail companies?

March 2018

The new leases standard – IFRS 16 – will require lessees to bring most leases on-balance sheet from 2019. Measuring lease liabilities for these companies will be a real challenge, but this is more than just an accounting change…

It could impact…

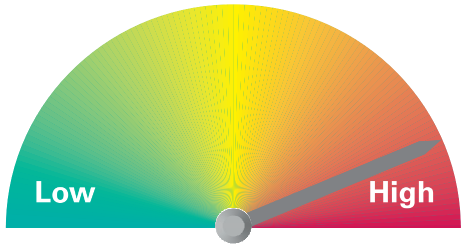
- debt, credit rating and covenants
- capital expenditure
- distributable reserves
- financial planning
- data availability and quality
- earnings
- IT systems, processes and controls
- lease contract negotiations
- employee performance plans
- tax

If you have…

- leases with termination and renewal options
- leases with variable payments – e.g. those based on sales, CPI or open market rent reviews
- service charges bundled with lease payments – e.g. property management or maintenance services
- leases with provisions to restore a property
- sub-lease agreements – e.g. with franchisees
- inter-company leases

Engage with your stakeholders to manage expectations of how your KPIs or business practices may change

Determining the impact



Leases with termination and renewal options

Potential impact

- The lease liability and right-of-use (ROU) asset will be misstated if your lease term is incorrect. Assessing the lease term is subjective because a lessee needs to determine whether it is reasonably certain that the lease term will be extended beyond a termination or renewal option. This can be particularly challenging when options to terminate or renew the lease extend beyond the company's typical forecasting period.
- Assessing the lease term is also critical as it is an input when estimating the discount rate used to calculate the present value of the future lease payments. For example, the incremental borrowing rate estimated for a 10-year lease of a particular asset is likely to differ from the rate for a 20-year lease of the same asset.

Actions to consider

- Identify those lease agreements with termination or renewal options.
- Operationalise how to apply the 'reasonably certain' test.
- As a lessee, identify short-term leases – i.e. leases for which the lease term (as determined under the new standard) is 12 months or less – and decide whether to utilise the optional exemption for the class of asset.
- Consider the lease term when estimating the discount rate – i.e. the incremental borrowing rate.

Leases with variable payments

Potential impact

- If a lease liability includes lease payments that vary based on an index or a rate – e.g. the consumer price index (CPI) or open market rent reviews – then it is remeasured periodically for changes arising from that index or rate.
- This remeasurement of the lease liability introduces volatility in gross assets and liabilities on the balance sheet. Current lease accounting systems may require upgrades to handle these periodic remeasurements of the lease liability.
- Conversely, variable payments that depend on sales or usage – e.g. turnover rents – continue to be expensed as incurred.

Actions to consider

- Evaluate whether your lease accounting system is equipped to handle complex and/or a high volume of reassessments of lease liabilities that include variable lease payments based on an index or a rate.
- Consider whether a commercial change in the basis of payments is desirable.
- Model the impact of changing from fixed to variable payments, or vice versa.

Service charges bundled with lease payments

Potential impact

- Lease contracts may contain non-lease components – e.g. property management, maintenance, security, distribution or power services. Each lease and non-lease component is accounted for separately.
- However, a lessee may elect, by class of underlying asset, not to separate lease and any associated non-lease components and instead account for them as a single lease component.
- The way in which lease components are separated will have a direct impact on KPIs and covenant metrics.

Actions to consider

- Identify which contracts contain both lease and non-lease components.
- Quantify and evaluate the effects of componentisation, including whether to elect, by class of underlying asset, not to separate lease and any associated non-lease components.

Leases with provisions to restore a property

Potential impact

- An obligation to restore an asset is included in measuring the ROU asset. However, expenses incurred to maintain a leased asset – i.e. wear and tear expenditure – are expensed as incurred.
- The ROU asset and corresponding depreciation will depend on when the lessee incurs the obligation to restore the leased asset and the period of depreciation. This will have a direct impact on the ROU asset and covenant metrics.

Actions to consider

- Identify contractual terms that may contain an obligation to dismantle and restore the leased asset.
- Outline the key judgements in determining when a provision to restore the leased asset is included in the ROU asset and when it is included in the cost of other assets – e.g. costs to remove the leasehold improvements.

Sub-lease agreements

Potential impact

- An intermediate lessor accounts for the head lease and the sub-lease as separate contracts. Therefore, different accounting models may apply.
- Classification of the sub-lease as a finance or an operating lease is based on the ROU asset arising from the head lease. More sub-leases may be classified as finance leases in the future when entering into back-to-back leases with franchisees.

Actions to consider

- Consider how the contractual terms of the sub-lease agreement may impact the lease term for the head lease – e.g. an option to extend the head lease is expected to be exercised when a sub-lease is for a period longer than the initial term of the head lease.
- Identify sub-lease contracts where the operating vs finance lease classification may change when applying IFRS 16.
- Ensure that the low-value lease exemption as a lessee is not applied to the head lease when the asset is sub-leased.

Inter-company leases

Potential impact

- Inter-company lease arrangements that were previously classified as operating leases by both the lessee and the lessor may no longer attract equal and opposite accounting in each group entity's accounts – that is, the lessor will continue operating lease accounting but the lessee will recognise an ROU asset and a lease liability.
- This could significantly increase the complexity of internal reporting and consolidation systems and processes.

Actions to consider

- Identify inter-company leases.
- Evaluate whether the consolidation system is equipped to handle complex or high volume eliminations.

Transition options[1]

Potential impact

- IFRS 16 may be adopted either retrospectively, by restating comparatives and adjusting retained earnings at the beginning of the earliest comparative period; or using a modified retrospective approach, by adjusting retained earnings with the cumulative effect of initially applying the standard at the beginning of the first reporting year.
- The selected transition approach will have a significant impact on net assets and trends in profit or loss in the post-transition years. It will also determine the amount of data required to implement the new standard.

Actions to consider

- Perform detailed modelling of the opening balance sheet and future income statements and balance sheets for each transition method, including application of the practical expedients when using the modified retrospective approach.
- Assess readiness to elect the retrospective or modified retrospective transition options.
- Engage with stakeholders to determine the impact on tax, treasury, IT systems, strategy, legal, employee benefits, distributable reserves, investor relations, regulatory compliance and financial planning.

- On transition, companies can also make an accounting policy choice to either:
  - apply the new lease definition to all contracts; or
  - apply a practical expedient to grandfather the previous assessment of which existing contracts are, or contain, leases.
- When making this choice, consider for each arrangement whether:
  - the conclusion of whether or not an arrangement is a lease may differ under the new standard; and
  - the quality of the existing analysis under IAS 17 *Leases* and IFRIC 4 *Determining Whether an Arrangement Contains a Lease* is sufficient.

- Evaluate the potential cost savings of grandfathering against the potential need to apply IFRS 16 to those arrangements that would not be a lease under the new definition.
- Review historical accounting assessments under IAS 17/ IFRIC 4 to determine whether those conclusions would continue to be appropriate at the date of transition.

1. You can find more detailed information about IFRS 16 in our publications Lease Definition, Lease Payments, Leases Discount Rates and Leases Transition Options.

How KPMG can help

Assess the impacts → Design a tailored approach → Help implement a future state

IFRS 16 is one of the biggest accounting changes in more than a decade and is imminent. A robust and timely assessment phase, that includes representatives from across the business, is critical for a successful implementation of the new standard.

Activities	What we can do	The benefits for you
Initial impact assessment – transition approach	Model the impact of the different transition options based on a sample of leases, including impact on the balance sheet, profit or loss and specific KPIs Assess the quality of the lease data and identify data gaps Assess readiness to elect the full retrospective or modified retrospective options	Understanding the impact of the different transition options on the balance sheet, income statement and KPIs – on transition and post implementation Allocating the appropriate time and resources by establishing the scale of your IFRS 16 project
Accounting diagnostic	Review existing lease accounting policies and disclosures and identify gaps in compliance with IFRS 16's requirements Review contracts identified as potentially containing embedded leases	Identifying the key judgements when applying the lease definition, determining the lease term, discount rates or the lease payments to be included in the measurement of the lease liability Determining the complete population of contracts to which IFRS 16 applies
Business impacts – e.g. tax, IT systems, data extraction, internal control and processes	'Stress-test' the existing IT system functionality and identify gaps in compliance with IFRS 16's requirements Support the data extraction plan Assess broader business impacts including investor relations, debt covenants, tax balances, remuneration schemes, M&A evaluations and ability to pay dividends	Gathering a consistent understanding and application across the organisation, including overseas subsidiaries Determining new processes and control requirements
Implementation plan	Work with you throughout the implementation project: including assisting with uploading the data and applying accounting policies to running the IT system and calculating the opening balances	Developing a robust plan and a successful IFRS 16 implementation

KPMG's Consumer & Retail practice

KPMG's Consumer & Retail practice is dedicated to supporting companies in this sector in understanding industry trends and business issues. Member firms offer customised, sector-specific services that can add value to your most pressing business requirements. At KPMG, our extensive network of professionals combines a global perspective with in-depth industry knowledge to help companies adjust to today's rapidly changing market.

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Publication name: *Accounting for leases is changing: What's the impact on consumer market and retail companies?*

Publication date: March 2018