

CHP Consulting Whitepaper

Lease Accounting Reform: The Systems Impact for Asset Finance Lessors



2016 FINAL

Revised to reflect IASB's IFRS16
and FASB's ASC842 final standards



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In January 2016, the International Accounting Standards Board (IASB) published its new lease accounting standard, IFRS16. This was followed in February 2016 by the US Financial Accounting Standards Board (FASB)'s standard, ASC842, finally bringing the lease accounting project to a close.

These standards are long-awaited; the first proposals, published as an Exposure Draft in August 2010, were heavily criticised. A second Exposure Draft in May 2013 was generally considered to be an improvement, but many respondents, while recognising the need to bring lessees' accounting for operating leases on to the balance sheet, felt that the proposed changes to the lessor accounting model were not cost-justified.

Many lessors will therefore breathe a sigh of relief that the final standard leaves lessor accounting broadly unchanged. There are, however, significant changes for lessee accounting, and lessors need also to be aware of other new standards that are more likely to require system changes.

In this final update of our whitepaper, CHP Consulting provides an overview of the current lease accounting standards, summarises the new standards for both lessors and lessees, and reviews the other new standards that may impact lessors' accounting and lease administration systems.

Introduction

The aim of the IASB's and FASB's lease accounting project was to provide new standards under International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP) to resolve perceived problems with existing accounting, especially with respect to lessees. The work was part of a larger programme of work to achieve a convergence of the two sets of standards.

Existing lease accounting is governed by IAS17 within IFRS, and by ASC840 (formerly FAS13) under US GAAP. These standards are fairly similar. Under both IFRS and US GAAP, existing accounting includes the classification of leases into two categories: operating leases and finance leases (known under US GAAP as capital leases). If a lease is classified as a finance lease, it is shown as an asset and a liability on the lessee's balance sheet¹, whereas for an operating lease the lessee simply accounts for the lease payments as expenses over the lease term. This means that investors and other users of financial statements must estimate the effect of operating leases on financial leverage² and earnings. The new standards will bring almost all leases on to the lessee's balance sheet.

While IFRS16 and ASC842 will bring little change for lessors, the new *Financial Instruments*³ standards (IFRS9 and US GAAP ASC825-15) will make changes to the accounting for credit losses, and these are more likely to require systems changes.

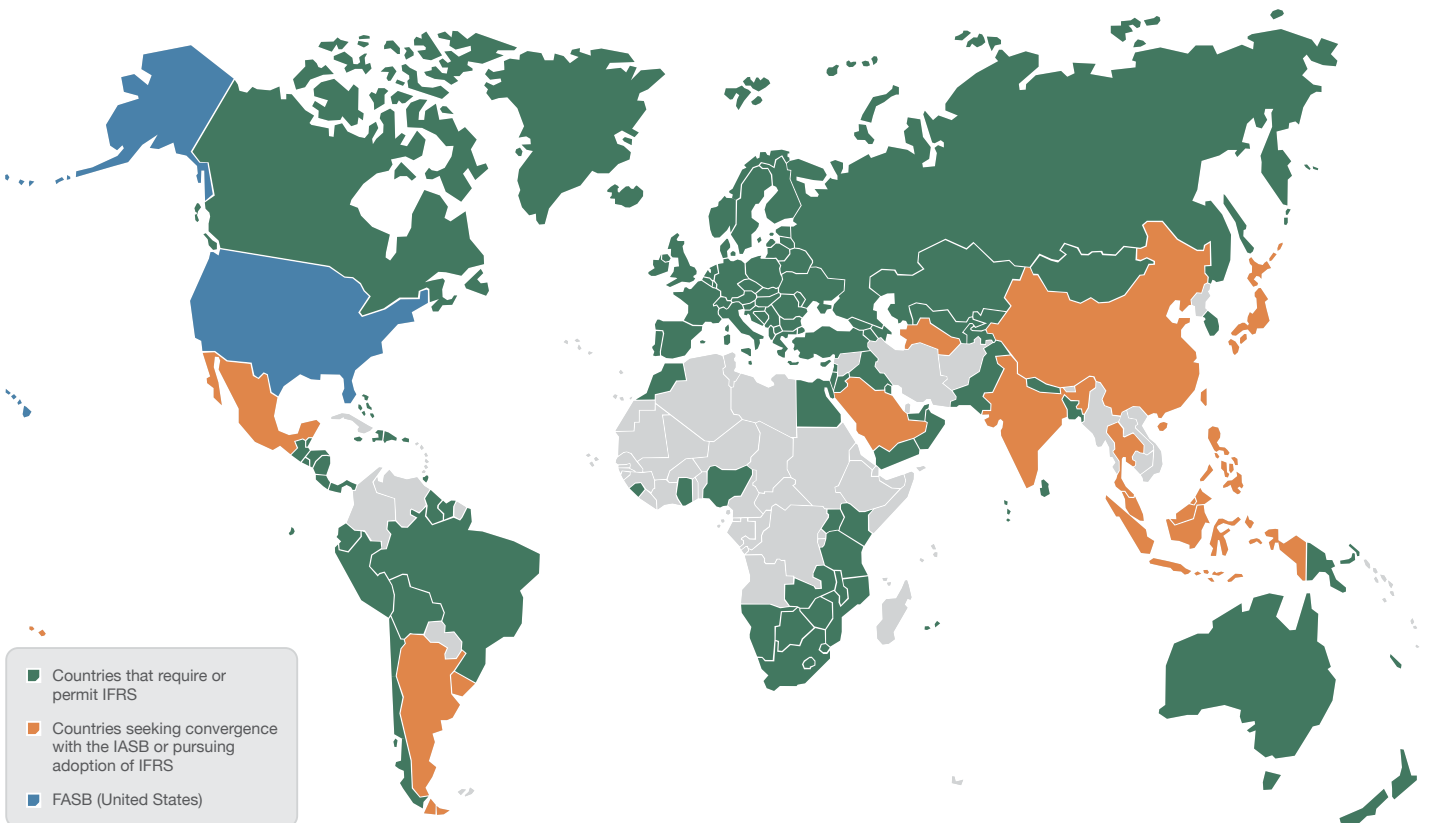
01 WHO WILL THE CHANGES AFFECT?

The new standards will be mandated for all lessors and lessees who prepare their accounts under IFRS or US GAAP. The scope includes leases of property (land and buildings), plant and equipment. This paper is concerned primarily with the leasing of plant and equipment.

¹ The **balance sheet** is a statement that summarises a company's assets, liabilities and shareholders' equity.

² **Financial leverage** refers to the use of debt to acquire assets.

³ **Financial instruments** include a wide range of financial products, including loans but explicitly excluding leases. However, lease receivables are still subject to the credit loss requirements.



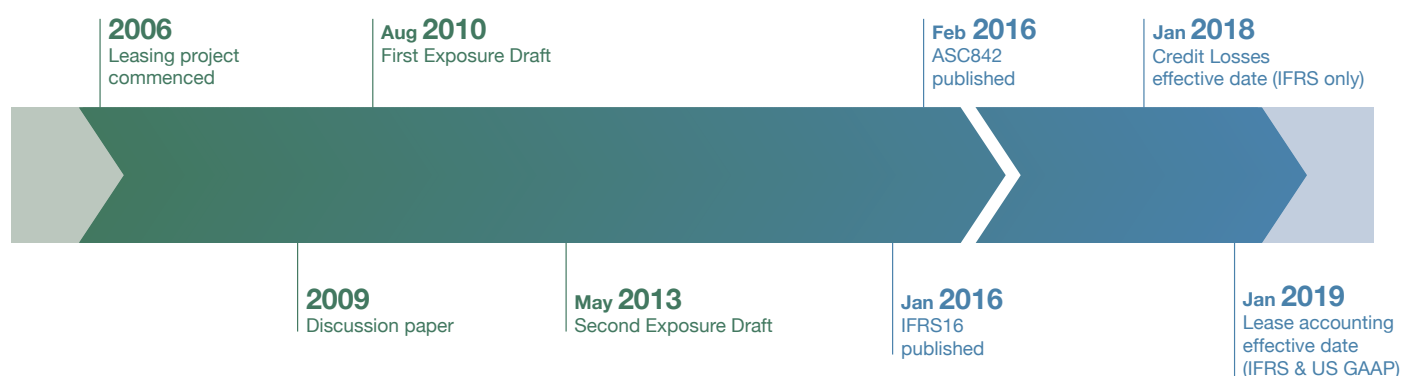
⁴ Small and Medium-sized Enterprises. The IASB defines SMEs as companies that do not have public accountability, and publish general-purpose financial statements for external users.

IFRS16 will be mandated for publicly listed companies and any unlisted companies that have opted to apply full IFRS. In most jurisdictions that have adopted IFRS, unlisted companies may use *IFRS for SMEs*⁴. *IFRS for SMEs* will not be updated in the near future (refer to *Adopting the New Standards*) so the existing IAS17-based standards will continue to apply.

In the United States, US GAAP is required for domestic publicly listed companies. There is no centralised control of financial reporting for privately owned companies, although in practice many such companies have contractual requirements to use US GAAP as part of credit agreements with financiers.

02 PROJECT TIMELINE

Proposed major changes to accounting standards are typically published as an *Exposure Draft* for public comment. The first lease accounting Exposure Draft was published in August 2010, and following substantial changes a second Exposure Draft was published in May 2013. Following the second set of feedback, the Boards conducted another round of redeliberation and targeted outreach before publishing the final Standards in 2016. The new Standards will be effective for the accounting period beginning in 2019, although early adoption is permitted - refer to *Adopting the New Standards*.



Current Standards

01 LEASE DEFINITION AND CLASSIFICATION

US GAAP and IFRS contain broadly similar definitions of a lease, as an agreement conveying the right to use an asset for an agreed period of time. Both standards include a lease classification applied by lessors and lessees:

FAS13

Lessees classify a lease as an operating lease or a capital lease according to four rules (“bright-line” tests). A lease is a capital lease if any of the following conditions are met:

- There is automatic transfer of title.
- There is a bargain purchase option⁵.
- The lease term is equal to or greater than 75% of the leased asset’s useful life.
- The present value⁶ of the minimum lease payments is equal to or greater than 90% of the asset’s fair market value.

Lessors classify a lease as an operating lease, sales-type lease⁷, direct financing lease or leveraged lease. A lease is a sales-type lease if any of the above conditions are met, and the lease gives rise to a manufacturer’s or dealer’s profit (or loss). A lease is a direct financing lease if any of the above conditions are met and it does not give rise to a manufacturer’s or dealer’s profit (or loss). A leveraged lease is a variation of a direct financing lease in which a long-term creditor provides substantial leverage to the lessor and is non-recourse to the lessor’s general credit, and the lessor’s net investment declines during early periods and rises during later periods. An operating lease does not meet any of the above four criteria.

IAS17

A lease is classified as a finance lease or operating lease based on whether it transfers substantially all the risks and rewards incidental to ownership of the asset. The following indicators that a lease is a finance lease are provided:

- There is automatic transfer of title.
- There is a bargain purchase option.
- The lease term is the major part of the leased asset’s useful life.
- The present value of the minimum lease payments is substantially all of the leased asset’s value.
- The asset is of a specialised nature.
- The lessee guarantees the lessor’s investment if the lessee can cancel the lease.
- The lessee receives the residual upside and bears the residual losses at lease end.
- There are bargain renewal options.

In practice, although more judgement is applied under IAS17, the FAS13 bright-line tests are often used to assist in interpreting the IAS17 indicators.

Classification by lessor and lessee could differ should they use different inputs. For example, from the lessee’s perspective, the discounted lease payments might be less than 90% of the fair market value and so it is classified as an operating lease. In contrast, the lessor might have a residual value guarantee from a third party, so the minimum lease payments (which include the residual value) exceed 90% of the fair market value and it is classified as a finance lease.

⁵ The lessee has an option to purchase at a price lower than the fair market value.

⁶ **Present value** means the value of a future cash flow movement expressed at today’s value. A payment of \$1,000 in a year’s time is worth less than \$1,000 received today. The present value is calculated at the rate implicit in the lease.

⁷ Usually, sales-type leases will arise when manufacturers or dealers use leasing as a means of marketing their products. The fair (marketable) value of the leased asset is usually greater than the carrying value of the asset in inventory. Other types of leases can give rise to a profit or loss at inception, but are not sales-type leases. For example, if a rail car lessor writes a new lease (not a renewal) for a used wagon, the asset may have a fair value greater or less than its carrying amount.

⁸ The rate the lessee would have incurred either under a similar lease (IAS17) or to borrow over a similar term the funds necessary to purchase the asset (FAS13).

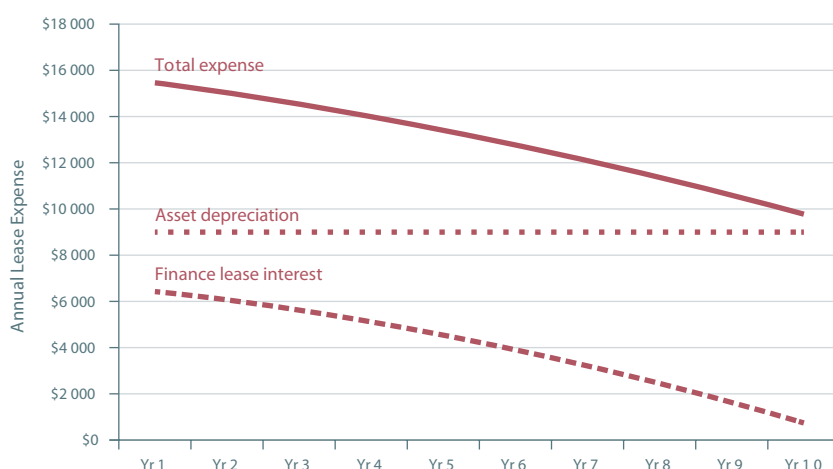
⁹ The rate that, when applied to the minimum lease payments and residual value, causes their aggregate present value at the start of the lease to be equal to the value of the leased equipment. The lessee uses the implicit rate if they know it (or the lower of the two under FAS13). The lessee will only know the lease's implicit rate if it is aware of the assumptions made by the lessor; for example, if the lessee guarantees the residual value or has a guaranteed purchase option price.

¹⁰ **Amortisation** is the same as depreciation, but in practice amortisation is used for intangible assets; while either term is used for tangible fixed assets. Intangible assets are non-monetary amounts that lack physical substance.

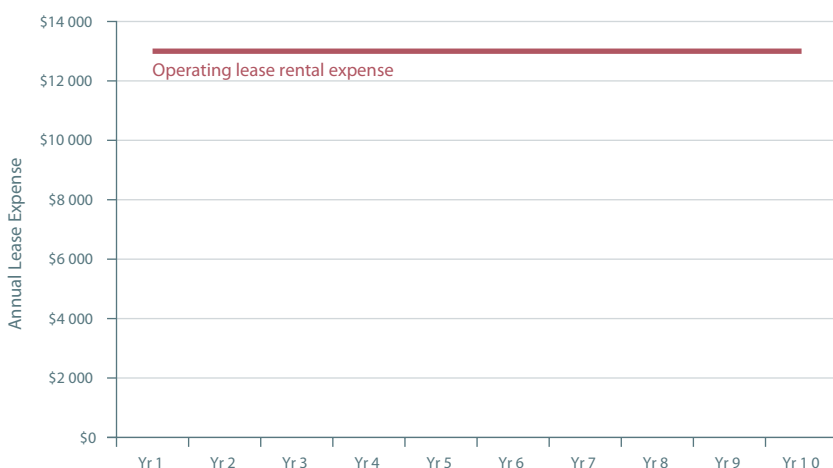
02 LESSEE ACCOUNTING

Under IFRS and US GAAP, finance leases are capitalised on the lessee's balance sheet. At lease commencement, the lessee shows a right-of-use asset and an equal and opposite liability to make the lease payments. These are calculated as the present value of the lease payments, discounted at the lessee's incremental borrowing rate⁸ or the rate implicit in the lease⁹.

The asset is amortised¹⁰ in accordance with the depreciation policy for owned assets, typically on a straight-line basis over the lease term. The finance charge is allocated at a constant rate according to the outstanding liability, so is generally greater at the start of the lease.



Operating leases are off balance sheet. The rentals are recognised as an operating expense, usually on a straight-line basis over the lease term.



It is this lessee accounting for operating leases that was one of the main driving forces for the lease accounting project. There was a desire to capitalise operating leases on to the balance sheet to provide the users of accounts (such as stock and credit analysts) with a better view of a business's assets and liabilities.

03 LESSOR ACCOUNTING

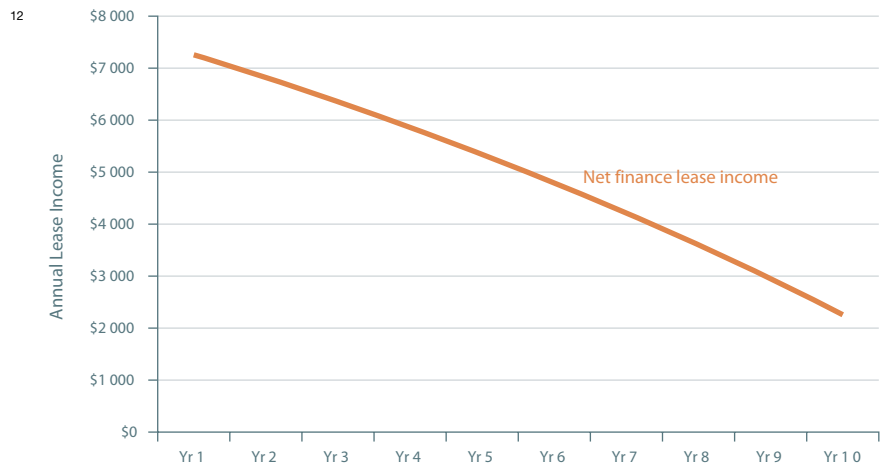
For operating leases under both IAS17 and FAS13, the lessor holds the underlying asset on its balance sheet and depreciates it (typically on a straight-line basis) to its assumed residual at the end of the lease. The lessor accounts for the rentals as income, usually on a straight-line basis over the lease term.

¹¹ In this example, the asset is \$100,000 and the residual value is \$20,000. The total depreciation is \$80,000. The asset is depreciated by \$8,000 every year for 10 years. The total rentals are \$129,200. \$12,920 is recognised as income every year, so the net income is \$4,920.



For finance leases, the lessor records on its balance sheet the net investment in the lease, comprising the lease receivables and the residual value discounted using the implicit rate in the lease. If the lessor had previously recognised the underlying asset, this is removed from the balance sheet. The lessor recognises the net interest income to Profit & Loss (P&L), as illustrated below.

¹² Using the same figures as above, the net interest income is \$49,200. This interest is recognised in proportion to the outstanding balance, and consequently greater income is recognised at the start of the lease than at the end.



Summary of the New Lease Accounting Standards

In this section, we summarise the key changes to lease accounting introduced by IFRS16 and ASC842. For a history of the lease accounting Exposure Drafts, refer to the previous versions of this whitepaper on www.chpconsulting.com.

01 LEASE DEFINITION AND CLASSIFICATION

Lease Definition

The new standards have changed the guidelines used to determine whether a contract is, or contains, a lease, most notably in that the customer has the right to control the use of an identified asset. There may be some transactions currently treated as leases which would no longer be leases under the new standard, and *vice versa*. This is important, since contracts not determined to be a lease will continue to be off balance sheet for the lessee, so there will inevitably be an increasing focus on lease definition.

The new standards also require both lessees and lessors to separate out the lease and non-lease components of a contract and account for the non-lease components in accordance with the new *Revenue from Contracts with Customers* standards (IFRS15 and ASC606). For example, for a fully maintained lease of a vehicle or office equipment, the maintenance component of the rentals must be identified and accounted for separately.

Lessees would do this by using observed or estimated stand-alone prices, so lessors should be able to avoid having to disclose to their customers proprietary information about how they price their contracts. The Boards also decided that lessors and lessees would need to reallocate the lease rental when a contract is modified or upon reassessment of the lease term.

Lease Classification

One of the aims of the lease accounting project was to remove the need for classification by lessees, which was seen by some as an opportunity for lease structuring. IFRS16 has indeed removed lessee lease classification, but the FASB has opted to retain in ASC842 a classification for the purposes of lessee expense recognition (see below).

Lease classification for lessors remains unchanged.

Exemptions

Both Boards have defined an exemption for short-term leases, which can continue to be accounted for by lessees using existing operating lease accounting. Short-term leases are defined as leases that have a term (as defined on page 10) of no longer than 12 months.

The IASB, but not the FASB, has allowed a similar exemption for leases of low-value assets¹³.

While the standards specify the accounting for an individual lease, both the IASB and FASB have permitted a portfolio-level application for leases with similar characteristics.

¹³ Assets that are individually small in value and not specialised in nature; for example, personal computers and other office equipment. It does not matter whether the leases are material to the lessee.

02 LESSEE ACCOUNTING

The most noteworthy change introduced by the new standards is the capitalisation of all leases (other than the exemptions outlined above) on to the lessee's balance sheet. While most respondents to the Exposure Drafts were supportive of this, the consequential front-loading of the lease expense (by applying finance lease accounting to former operating leases) was more problematic, especially for operating leases. This graph shows an agreement where the rentals increase year on year.

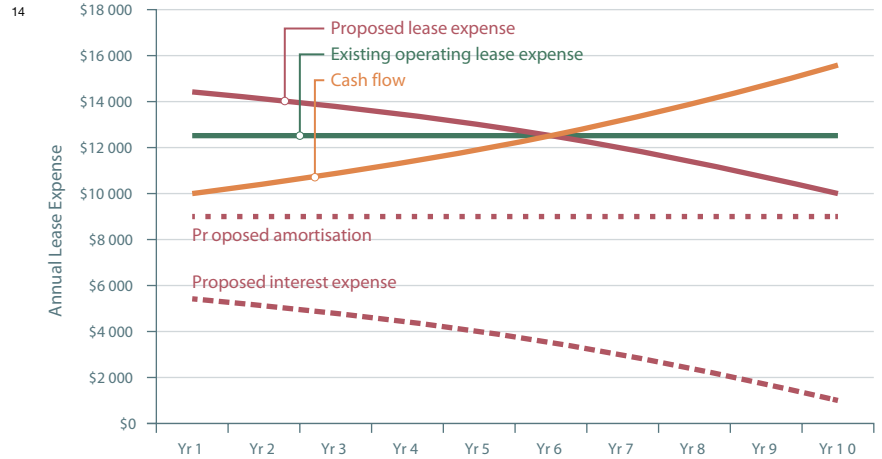
¹⁴ The actual cash flow expenditure increases each year. Under existing operating lease accounting, the total rentals are expensed on a straight-line basis (the same amount each year). Assuming existing finance lease accounting, the expense would be greater at the start of the lease and would decrease year-on-year.

¹⁵ **Initial direct costs** are costs incurred that are directly attributable to negotiating and arranging the lease, which would not have been incurred had the lease transaction not been made; for example, legal fees.

¹⁶ **Incentives** are payments made to or on behalf of the lessee, and losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party.

¹⁷ **Prepaid or accrued lease payments** are the difference between the lease payments actually made and the component of the lease expense that reflects payments made to the lessor.

¹⁸ An asset is impaired if its carrying value exceeds the sum of the undiscounted cash flows expected to result from the use of the asset and its subsequent disposal.



Ultimately, this caused the most significant divergence between the IASB's and FASB's new standards. Following much debate, the IASB decided to adopt a single recognition model for all capitalised leases, similar to existing finance lease accounting. This means that all leases will incur a front-loading of the lease expense. The IASB thought that this approach best supported the concept that all leases result in a lessee obtaining financing and the right to use an asset, meets the needs of users of the financial statements, and is simpler to implement, since leased assets would be depreciated in the same way as all other fixed assets.

The FASB, however, decided that while all leases will be capitalised as a right-of-use asset and a liability on the balance sheet, leases should continue to be classified as finance leases or operating leases for the purposes of expense recognition. Finance leases will continue to recognise an interest expense and amortise the right-of-use asset on a straight-line basis (so the total lease expense would be front-loaded), and for operating leases the total lease cost (including initial direct costs¹⁵ and lease incentives¹⁶) will continue to be expensed over the term of the lease on a straight-line basis. Under this method, the right-of-use asset is calculated as the lease liability, adjusted by any prepaid or accrued lease payments¹⁷, the remaining balance of any lease incentives received, any unamortised initial direct costs, and any impairment of the right-of-use asset¹⁸. This causes the value of the right-of-use asset to reduce more slowly at the start of the lease than at the end. This will require a new accounting methodology for lessees.

EXAMPLE OF LESSEE ACCOUNTING

- Annual lease rentals in arrears of 15,000, increasing by 5% each year
- Lessee's incremental borrowing rate: 4%
- Lessee's initial direct costs (IDC): 1,000

At lease commencement, the lessee recognises a right-of-use (RoU) asset and a lease liability:

- The lease liability is calculated as the sum of the present value (PV) of the lease payments, discounted at the lessee's incremental borrowing rate = **73,516**
- The RoU asset is calculated as the lease liability plus the IDC = **74,516**

Year	Rental	Interest component	Capital component	PV of Future Rentals
			0	73,516
	15,000	2,941	12,059	61,456
	15,750	2,458	13,292	48,164
	16,538	1,927	14,611	33,554
	17,364	1,342	16,022	17,531
	18,233	701	17,531	0
Total	82,884	9,369	73,516	

Interest calculation

- Year 1: $73,516 \times 4\% = 2,941$
- Year 2: $61,456 \times 4\% = 2,458$

All leases under IFRS16, and finance leases under ASC842

	Start	End Year 1	End Year 2	End Year 3	End Year 4	End Year 5	
Balance Sheet							
RoU asset (A)	74,516	59,612	44,709	29,806	14,903	0	
Lease liability (B)	73,516	61,456	48,164	33,554	17,531	0	
Net Assets	1,000	-1,844	-3,455	-3,747	-2,628	0	
Income Statement							
RoU amortisation (C)		14,903	14,903	14,903	14,903	14,903	74,516
Interest expense		2,941	2,458	1,927	1,342	701	9,369
Total expense		17,844	17,361	16,830	16,245	15,604	83,884

(A) Opening RoU asset less amortisation

Year 1: $74,516 - 14,903 = 59,612$

Year 2: $59,612 - 14,903 = 44,709$

(B) Opening liability less amount paid plus interest incurred

Year 1: $73,516 - 15,000 + 2,941 = 61,456$

Year 2: $61,456 - 15,750 + 2,458 = 48,164$

(C) Straight-line annual amortisation = $74,516 / 5 = 14,903$

(D) Lease liability plus accrued lease payments (rents paid less rents expensed) plus unamortised IDC

Operating leases under ASC842

		End Year 1	End Year 2	End Year 3	End Year 4	End Year 5	
Balance Sheet							
RoU asset (D)	74,516	60,679	46,361	31,510	16,076	0	
Lease liability (E)	73,516	61,456	48,164	33,554	17,531	0	
Net Assets	1,000	-777	-1,804	-2,043	-1,456	0	
Income Statement							
Lease expense (F)		16,777	16,777	16,777	16,777	16,777	83,884
Total expense		16,777	16,777	16,777	16,777	16,777	83,884

The annual lease expense is $82,884 / 5 = 16,577$

Year 1: $61,456 + (15,000 - 16,577) + 800 = 60,679$

Year 2: $48,164 + (30,750 - 33,154) + 600 = 46,361$

(E) Present value of the lease payments not yet paid, see (B)

(F) Straight-line recognition of total lease expense = $83,884 / 5 = 16,777$

03 LESSOR ACCOUNTING

In the feedback to the 2013 Exposure Draft, the majority of respondents did not support changing the existing model, arguing that it is well understood, does not require the users of accounts to adjust the lessor's financial statements regularly, and as such should not be changed just because lessee accounting is changing. These comments were accepted by the Boards, and the lessor accounting model is generally unaltered from the current standards.

¹⁹ **Grandfathering** means continuing to account for existing leases according to current accounting standards.

Under US GAAP, the most notable change to lessor accounting is the elimination of leveraged lease accounting for leases that commence after the effective date; leveraged leases that commence before the effective date are grandfathered¹⁹ under the current ASC840 standard.

The new standards have introduced a number of qualitative and quantitative changes to existing disclosure requirements to allow the users of lessors' and lessees' financial statements to better understand the cash flows arising from the leases. Lessors also need to provide information about how they manage residual value risk, although they do not need to disclose the fair value of their residual assets.

04 OTHER CONSIDERATIONS

Lease Term

Despite proposed changes to the definition of the lease term in the 2010 Exposure Draft, the definition remains unchanged from the current standards. There is, however, more guidance which could change the lease term in some cases, for both lessors and lessees. The lease term must take into account any extension or early termination option that the lessee is reasonably certain to exercise. The term needs to be re-evaluated only if it changes, i.e. when the lessee does not take up an extension or termination option that had been included previously in the determination of the term, or when they do take up an option that had not been included. Lessees also need to take into account significant changes in circumstances within their control that affect whether they will exercise an option.

²⁰ **Contingent rentals** are defined as lease payments that are not fixed amounts but are based on factors including usage, price indices and market rates of interest.

Contingent Rentals

Similarly, the 2010 Exposure Draft proposed substantial changes to broaden the definition of contingent rentals²⁰, but in the new standards they are limited to variable payments linked to an index or a rate such as a consumer price index or benchmark interest rate. Therefore the minimum lease payments comprise fixed payments, variable payments linked to an index or rate, residual value guarantees, purchase options (if the lessee is reasonably certain to exercise the option) and termination penalties (if the lease term reflects the lessee exercising the termination option).

²¹ A guarantee made to the lessor that the value (or part of the value) of the underlying asset at the end of the lease will be at least a minimum amount.

Residual Value Guarantees

Under the current standards, the lessee includes the amount of any residual value guarantee²¹ within the definition of the minimum lease payments. Under the new standards, only amounts expected to be paid are included.

Sale and Leasebacks

²² A sale and leaseback involves the sale of an asset and the leasing back of the same asset. The lease payment and the sale price are usually interdependent because they are negotiated as a package.

For sale and leaseback²² accounting, the new standards apply the conditions in IFRS15 or ASC606 (*Revenue from Contracts with Customers*) to determine whether the transaction first meets the conditions of a sale of the asset. This may mean that some transactions will no longer be considered as sale and leasebacks, and will instead be accounted for as financing arrangements. Furthermore, the change in lessee accounting may cause there to be fewer sale and leaseback transactions, since the leaseback will remain on balance sheet (albeit for less than the asset sale price).

Back-to-Back Leases

²³ In a back-to-back lease, an intermediary acts as a lessee to lease an asset from a head lessor, and as a lessor to lease the same underlying asset to a sub-lessee in a sub-lease agreement.

Back-to-back leases²³ (head lease, sub-lease arrangements) will be accounted for as separate transactions. The intermediate lessor will account for the head lease in accordance with the lessee accounting requirements, and therefore leases previously accounted for as operating leases will be brought on to the balance sheet.

For the intermediate lessor's classification of the sub-lease, there is divergence between IFRS and US GAAP. Under IFRS16 the sub-lease should be evaluated against the right-of-use asset arising from the head lease, whereas under ASC842 the sub-lease should be evaluated against the underlying asset. Some leases classified as operating leases under US GAAP will be finance leases under IFRS.

Accounting for Lease Changes

While the existing standards make no mention of accounting for changes to lease contracts, the new standards are prescriptive in this area.

If there is a change in lease term due to the reassessment of termination and extension options, or in lease payments caused by a change in linked interest rate, lessees must remeasure the lease liability using an *updated* discount rate. If there is a change in amounts expected to be payable under a residual value guarantee, or if the lease payments change due to a change in an index other than floating interest rate, they must remeasure the lease liability using the *original* discount rate. In each instance, the change in lease liability should be recognised as an adjustment to the right-of-use asset.

Lease modifications that add additional assets should be accounted for as separate leases. All other modifications should be accounted for by remeasuring the lease liability and adjusting the right-of-use asset as described immediately above. Under ASC842, lessees will also need to reclassify the lease as at the change date, i.e. based on the asset's current market value, its remaining economic life, and the remaining lease payments.

Lessors will also account for finance lease modifications that add new assets as separate leases. For all other modifications, the lease must be reclassified as if the modification had been in place at inception. For finance leases reclassified as operating leases, the modification is treated as a new lease for the remaining term, based on the carrying amount of the asset, as it is under the existing standards. A modification to an operating lease is accounted for as a termination of the old lease and creation of a new one for the remaining term - although, in reality, this means simply that the rental income recognition pattern, and possibly the depreciation profile, will change going forward.

Lessors Accounting for Credit Losses

Although the new lease standards will not change the accounting for many lessors, conversely IFRS9 and ASC825 *Financial Instruments* will impact almost all. IFRS9 is effective from 1 January 2018 (refer to *Adoption Timing* on page 14), while ASC825-15 is still to be finalised.

The changes to credit loss accounting were introduced into IFRS9 in July 2014 and are in response to criticism arising from the 2008 financial crisis. The existing standards delayed the recognition of credit losses until there was evidence of a trigger event. This was designed to stop companies from creating hidden reserves that could be used to improve earnings in poorer performing times. Although this did not require waiting for actual default to occur before recognising a credit impairment, in reality this was often the case. This allowed, or caused, credit losses to be deferred.

The new standards require expected credit losses to be recognised at all times; it is no longer necessary for there to be a trigger event.

01 OVERVIEW OF CREDIT IMPAIRMENT REQUIREMENTS

In IFRS9 the new impairment model is a three stage process:

- In *stage 1*, the lessor recognises *12-month credit losses* as soon as the lease (or loan) is originated. This establishes a loss allowance. The carrying value of the asset and interest revenue calculation is unaffected.
- In *stage 2*, if the credit risk worsens and the credit quality is no longer considered to be low credit risk, *full lifetime expected losses* are recognised. The carrying value of the asset and interest revenue calculation is still unaffected.
- In *stage 3*, if the credit risk continues to worsen such that the lease contract is considered to be credit impaired, full lifetime expected losses continue to be recognised, but the interest revenue calculation is now based upon the carrying value of the asset less the loss allowance.

However, there is a practical exemption to allow lessors to elect to account for credit losses on lease (and loan) receivables using a simplified approach of recognising full lifetime expected losses from origination.

FASB's proposed changes to ASC825 do not include the 12-month credit losses; therefore all contracts will incur a lifetime credit loss. Further, once the contract is credit impaired, ASC825 will continue to permit the suspension of the recognition of income, instead of requiring interest revenue to be calculated on the carrying value net of the loss allowance.

02 CALCULATING EXPECTED CREDIT LOSSES

Lifetime Expected Credit Losses

Lifetime expected credit losses are a present value measurement of the losses that would arise if the lessee defaults on their obligations throughout the remaining term of the agreement. Thus they are calculated as:

$$PV (\text{lease receivables}) \times \text{probability of default } \%$$

This means that a credit loss would occur even if the lessor expects to be paid in full but later than when contractually due.

12-Month Credit Losses

12-month credit losses are the effect of the entire lifetime credit loss on an asset, weighted by the probability of the loss occurring in the next 12 months; they are not the possible cash losses that will occur in the next 12 months. Thus they are calculated as:

$$PV (\text{lease receivables}) \times \text{probability of default in the next 12 months } \%$$

12-month credit losses are not the credit losses on assets that are forecast to actually default in the next 12 months, since these are assets on which credit risk has clearly worsened. Therefore, lifetime expected credit losses are recognised.

Probability of Default

The probability of default weighting should represent the likely outcome, not a best- or worst-case scenario, and should be based upon reasonable and supportable information that is available without undue cost or effort. This includes information about past events, current conditions and future forecasts so, for instance, may be based on historical loss rates adjusted for relevant current conditions and forecasts. The new standards do not prescribe particular measurement methods.

03 ASSESSING WORSENING CREDIT RISK

The initial pricing of a lease contract includes consideration of the possible credit losses. However, if the expected losses exceed these initial expectations then a financial loss is now more likely. Stages 2 and 3 of the new IFRS9 impairment model recognise this by increasing the credit loss allowance from the 12-month expected loss to lifetime expected loss.

There will be an increase in credit risk before the lease becomes credit impaired or an actual default occurs; therefore lifetime credit losses should be recognised before a contract is recognised as bad debt. On each financial reporting date, the risk of credit loss on each contract must be reassessed. For any absolute increase in risk, its significance will be greater on contracts that were priced assuming a very low risk of default, versus contracts priced assuming a higher risk of default.

Credit analysis may be performed on an individual lease or lessee, or on a group of leases. Sometimes it may not be possible to identify significant changes in credit risk of an individual lease, for instance in a portfolio of retail contracts, but to capture increased risk in a timely manner it may be necessary to group contracts by geographical or industry sector or pricing assumptions, for example. Events such as reschedule requests could also be an indicator. In any event, the latest that a full time credit loss should be recognised is when lease repayments fall more than 30 days overdue, unless the lessor can demonstrably prove why this should not be the case.

04 DISCLOSURES

Under IFRS, disclosure requirements are set out in IFRS7, to which IFRS9 makes a number of changes. As well as setting out the details of their credit policies, lessors must disclose:

- How contracts were grouped for credit analysis
- The inputs, assumptions and estimation techniques used to measure lifetime and 12-month expected credit losses, to determine whether credit risk has increased significantly, and to determine whether an asset has become credit impaired
- How forward-looking information has been incorporated into the determination of expected credit losses
- A reconciliation showing the change in each reporting period of lifetime and 12-month losses
- The carrying amount of asset by credit grade, which may be achieved by using a provision matrix

Adopting the New Standards

The new standards are retrospective, meaning they will apply to all contracts existing on the *date of initial application*.

01 LEASE ACCOUNTING ADOPTION TIMING

Effective Date

The effective date is the date from which companies need to apply the new standards. IFRS16 will be effective for the first accounting period beginning on or after 1 January 2019. Earlier application is permitted for companies also applying IFRS15 (*Revenue from Contracts with Customers*), which is effective for the first accounting period beginning on or after 1 January 2018.

For public companies, ASC842 will be effective for the first accounting period beginning after 15 December 2018, and 15 December 2019 for private companies.

Date of Initial Application

Ordinarily, for major changes in accounting policy, companies must provide comparative accounts using the new standard for reporting periods before the effective date, having originally filed their accounts for those periods under the existing rules. The date of initial application is the beginning of the first comparative period presented in the financial statements.

The periods for which this applies are dependent on the jurisdiction and type of company. US publicly listed companies must provide two years of comparative accounts; that is for the first accounting period after 15 December 2016. US private companies do not need to provide comparatives.

Companies subject to IFRS must provide one year's comparative accounts; that is for the first accounting period from January 2018. However, while full restatement of the comparative accounts is still permitted, IFRS16 allows a cumulative adjustment to be posted, in which case the date of initial application is the start of the first accounting period after the effective date.

SMEs

The majority of SMEs accounting under IFRS use *IFRS for SMEs*. *IFRS for SMEs* is updated no more frequently than every three years, but the IASB is aiming to make this every six years. *IFRS for SMEs* was last updated in May 2015 (effective from January 2017), at which time IFRS16 had not been finalised; consequently, the latest update is still based on the existing standards in IAS17. This means that IFRS16 will not be incorporated into *IFRS for SMEs* until at least 2020, but probably later. It is also not certain that IFRS16 will be incorporated, since the cost-benefit analysis may be different for SMEs.

02 TRANSITION APPROACH

Lessor Accounting

Since the new lessor accounting model remains substantially the same as current standards, there are now minimal transition requirements for lessors. Lessors may elect not to reassess whether existing contracts meet the definition of a lease. Similarly, there is no need to reassess sale and leaseback transactions to determine whether a sale occurred under IFRS15. The only transition requirement for lessors is that for sub-leases in a back-to-back lease, the intermediate lessor must reassess whether the sub-lease should be classified as an operating or finance lease. For existing operating leases reassessed as finance leases, the lessor must account for the sub-lease as a new lease at the date of initial application. Intermediate lessors will also need to apply the lessee transition to the head lease.

Lessee Accounting

For lessees, transition remains a significant concern. On the date of initial application, all current operating leases must be capitalised on to the balance sheet, with the exception of short-term leases and, under IFRS16 only, low-value leases.

Lessees may adopt a full retrospective approach, in which prior period comparative accounts are restated under the new standard, as if the standards had always been in place. This requires reassessment of each lease individually based on inputs evaluated as at its commencement date and any subsequent change to the lease payments. Alternatively, IFRS16 and ASC842 both offer a modified retrospective approach (which differs between the two standards), which provides a number of practical expedients to simplify the transition.

03 CREDIT LOSSES

The effective date for IFRS9 credit losses is 1 January 2018. Comparative accounts must be prepared for the prior period, so the date of initial application is the first accounting period starting on or after 1 January 2017.

At the date of initial application, lessors should apply the standards retrospectively to their existing contracts, using information that is available without undue cost and effort. To ascertain if there has been an increase in credit risks, lessors need to determine the credit risk at inception and compare it to the credit risk at the date of initial application. If determining the credit risk at inception is too great an effort, lessors may recognise lifetime credit losses.

The FASB project to update credit loss accounting in ASC825-15 is ongoing, with a final standard expected later this year.

Systems Implications for Lessors

In this section, we consider the likely software changes required to support the new standards, and highlight the differences that remains between IFRS and US GAAP.

01 SOFTWARE CHANGES FOR LESSOR ACCOUNTING

For lessors, the Boards' reversion to a model similar to existing lease accounting should mean required system changes are small. Nevertheless, there could be a few changes required, depending on the system's functionality and the lessor's portfolio.

Lease Definition and Classification

If systems include any rules to determine whether a contract contains a lease, or to classify the contract as a finance or operating lease, these may need to be updated. This might include the assessment of sale and leaseback contracts.

Segregation of Lease and Service Payments

Some lessors may price and record within their systems a single rental amount that covers the lease and service element of a full-maintenance contract, such that it is not possible to readily separate and account for the lease and non-lease income streams. The service elements will need to be recorded and accounted for separately in accordance with the new *Revenue from Contracts with Customers* standards.

Head Leases

For lessors with head leases, their lease administration and accounting systems need to be updated to support the new lessee accounting model for operating leases. This will be a greater effort for US GAAP.

Disclosures

More likely than not, any additional disclosures can be supported through reporting over existing systems data, but some systems may not record all of the data required in a systematic way.

Supporting Lessees

Many lessees have only operating leases (for example, for their property leases, office equipment and cars) and will not have any centralised systems in place for their administration and accounting. Consider a company that has a large fleet of car leases. These leases might be administered by an HR team on a spreadsheet, with the monthly expenditure accounted for via payroll.

Lessees accounting under IFRS16 or ASC842 will require more sophisticated systems and processes to manage their lease expenditure. Some lessors may assist and provide this information, both for transition and on an ongoing basis, as part of their service offering; others will neither want to share information with their lessees (for example, presenting the split of finance rental and maintenance), nor assume the risk of incorrect accounting.

Also, since under the new standards expenditure moves from operating to capital expenditure budgets, decision making will move towards the Chief Financial Officer. Lessor systems, especially sales systems, may need to provide more information to support lessee decision making.

Credit Analysis

Automated credit rules may need to be adjusted to reflect lessee's capitalisation of operating leases, since this will change a number of key financial indicators. Lessors will need different rules for listed companies compared to SMEs, since SMEs' operating leases will remain off balance sheet for the time being.

New Product Offerings

The burden of administering lease accounting may cause some lessees to consider alternative methods of finance. For those companies for which off balance sheet accounting is important, they might push for more service contracts or short-term leases, although it is important to note that the value that will be on the balance sheet for what were operating leases will still be significantly less than if the asset were purchased. Some lessor systems may be very restricted in the products they can administer, so system changes will be required to offer a wider product range.

02 SOFTWARE CHANGES FOR CREDIT LOSS ACCOUNTING

Required changes will be very dependent on both the lease portfolio and current systems architecture.

For a small-volume portfolio of structured leases, regular reassessment of each customer's credit risk is to be expected, so 12-month and lifetime credit losses will be assessed on a lease by lease basis. For a large retail portfolio there will be no ongoing credit assessment of each customer, so it is most likely that credit risk assessment will need to be performed using a provision matrix approach combined with analytical grouping of contracts by, for example, region, customer and asset characteristics.

Current credit risk management may be contained within the lease accounting system, be on a separate centralised system that combines credit information from a variety of different contract administration systems, or be based on reports and extracts. Regardless of the system in place, it will be necessary to capture the results of the analysis at each reporting period, in order to identify changes in credit risk. It is also necessary to systematically capture the information required for the disclosures.

Where credit risk management is managed in the lease accounting system, it is likely that system changes will be required to support the new requirements of IFRS9. For financial institutions that have sophisticated credit risk management systems, the changes required to these systems may be much smaller. In this instance however, leases assessed to be in the third stage of the impairment model will need to be fed back to the lease administration system, which will need to recognise ongoing income based upon the carrying value of the asset less the loss allowance.

03 DIFFERENCES BETWEEN IFRS AND US GAAP

Despite one of the overall programme's aims being the convergence of IFRS and US GAAP, there will remain a number of differences between IFRS16 and ASC842, and IFRS9 and ASC825. These are relevant for lessors that may have to account under both jurisdictions. Some of the key differences are outlined below.

Lessee Accounting Model

While both IFRS and US GAAP will capitalise all leases, IFRS16 will account for all leases similarly to existing finance leases, whereas ASC842 will retain a lease classification and recognise lease expense for operating leases on a straight-line basis, as detailed earlier.

Back-to-Back Leases

Under IFRS16 the intermediate lessor will classify the sub-lease as a finance or operating lease with reference to the right-of-use asset of the head lease, whereas ASC842 will classify the sub-lease with reference to the underlying asset. This means that more sub-leases will be classified as finance leases under IFRS.

Lessor Accounting for Sales Profit

For lessors, US GAAP retains a distinct classification between direct financing leases and sales-type leases. Only sales type-leases permit up-front recognition of profit. IFRS has no such distinction, so up-front sales profit is recognised on all finance leases.

Lessee Accounting for Variable Lease Payments

Under IFRS16, lessees will have to remeasure variable lease payments whenever there is a change in cash flows arising from a change in the underlying rate; whereas under US GAAP lessees will only need to remeasure the payments when there is another change, such as in lease term.

Accounting for Credit Losses

Although not yet finalised, ASC825-15 will not have the same three-stage model as IFRS9 and, on credit-impaired contracts, non-accrual will be permitted instead of recognising income on the carrying value of the asset net of the loss allowance.

Next Steps

Now that the final lease accounting standards have been published, both lessors and lessees need to be thinking actively about their implementation. If comparative accounts are required, the implementation date is very soon indeed.

For lessors, the small number of changes delivered by the final lease accounting standards hopefully means that a full-scale systems project will not be necessary, although changes may still be significant for some lessors with head leases or service-inclusive contracts. The changes to credit loss accounting are perhaps more likely to require sizeable changes, potentially across several systems in the IT estate.

Each lessor's approach to the new standards will differ, depending on portfolio and existing systems support. When assessing the changes required, any off-system processes and calculations must also be considered. If the required changes to existing systems are considerable then it may be more cost-effective to consider a new system. Many businesses are behind the IT curve and risk being left behind in terms of customer satisfaction, product offering, efficiency and flexibility. Invasive changes will require considerable testing, especially from comparatively small finance teams, so businesses will want to maximise the benefits of the disruption.

For lessees, the capitalisation of almost all leases will undoubtedly change their decision making process, and lessees' accounting for leases could become much more complex, especially for those companies with current operating leases only. Lessors may need to support their customers in understanding the proposals so, for example, the finance team should be ensuring that the sales team is conversant in the new standards, and point-of-sale software could be enhanced to support this.

If implementing a new system is the most cost-effective option, selecting and implementing the new system may take many months, and it needs to be live and reconciled in advance of the application of the new standard. Lessors and lessees need to be considering their approach to the changes forthwith. CHP Consulting's industry knowledge and experience supporting clients in systems change projects, both using its proprietary ALFA Systems and third party software, make us impeccably placed to assist.

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