Leaseurope

The Voice of Leasing and Automotive Rental in Europe

Leaseurope tips for firms in Europe adopting IFRS 16 when accounting for their equipment and vehicle leases

Tips for preparers

INTRODUCTION

- All of our tips are aimed at routine vehicle and equipment leasing in Europe. Separate considerations will apply for property and high value or complicated leases.
- The tips are focused on first-time implementation rather than subsequent reporting.
- The matters to consider relevant to each tip are greatly simplified. Preparers will need to study the details of the Standard and its Guidance (including the Illustrative Examples) before reaching any conclusions.
- Preparers should discuss options in advance with their auditors. The tips are intended to provide constructive input to those discussions.
- Where exclusions and simplification options are applied, preparers will need to consider the additional disclosure requirements that apply.
- Nothing in our tips is designed to, in any way, avoid the new accounting rules. The tips draw attention to simplifications and options that the IASB has deliberately included and expects to be used where appropriate.

TIP

01

Consider if leases are immaterial

- Leases must be reported usinag IFRS 16 only if they are material to the financial statements, i.e. if not doing so, it could influence decisions that users of the accounts make (BC86).
- The IASB published new guidance, the IFRS Practice Statement 2 - Making Materiality Judgements, in September 2017.
- To assess qualitative factors, the new guidance suggests firms should assess whether 'primary users' of the accounts (usually investors) could reasonably be expected to be influenced by the information.
- Some firms may conclude that their investors are unlikely to be influenced by information on minor, non-core assets, such as printers or small company car lease contracts.

Some IFRS users may conclude certain equipment leases could not influence investors' decisions and do not need to be recognised and measured using IFRS 16

TIP

02

Consider using incremental cost of borrowing (and keeping it simple)

- If the implicit interest rate can be readily determined, then the lessee should discount the lease payments using it. Often this will not be practicable.
- For former equipment operating leases the lessee is unlikely to have the data available to apply the implicit interest rate. A rate obtained from a lessor will reflect the lessor's assumptions, not the lessee's.
- Similar problems may apply to many former equipment finance leases (e.g. where there is any residual value in the lease).
- If it implicit rate cannot be readily determined, the lessee is required to use the incremental borrowing rate. This is determined on a lease by lease basis. For a single firm, with standard vehicle and equipment leases that have similar assets, durations and contract terms, the rate should not vary significantly between contracts.
- Lessees might therefore wish to discuss with their auditors a simplified approach of relying on a standard incremental borrowing rate for similar leases, unless there is a reason to change it (e.g. different asset types, lease durations, changes in interest rates).

Firms may conclude that for routine equipment and vehicle leases, it is appropriate to use a standard incremental rate of borrowing across all relevant contracts.

TIP

03

Consider using one of the two portfolio options

- The Standard allows lessees to apply the Standard to a portfolio of leases with similar characteristics, if the lessee reasonably expects the effects on the financial statements will not differ materially from applying the Standard to individual leases (B1).
- Lease contracts with the same lessor entered into at or near the same time, should be treated as a single contract when certain criteria are met (B2). There is then no test of whether the lessee reasonably expects the effects of doing so not to differ materially from apply the Standard to individual leases.
- The IASB's illustrative example 11 suggests lessees should have a good basis for judging that the effects of working at a portfolio level should not be material. The example does not suggest a need for a lessee to provide quantitative evidence (e.g. financial modelling) to prove this to be the case.

The portfolio approach may reduce the administration involved in lease accounting significantly and can be used based on a 'reasonable expectation' (rather than firm evidence) that the effects will be immaterial.

TIP
04

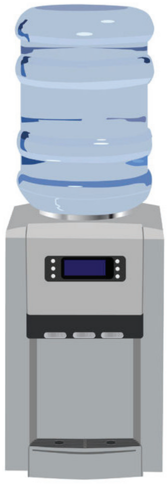
Consider excluding low value assets

- IFRS 16 permits preparers to not recognise a right-of-use asset and liability for leases of low-value assets where the underlying assets, when new, are individually of low value (the IASB had in mind a value under around US$5,000 at 2015 prices).

- Various conditions apply (see BC 98-104) and a disclosure note must be provided where the exemption is applied. Firms may wish to consider their existing fixed asset capitalisation policies.

- The IASB's illustrative example 11 includes examples:
  - Leases of IT equipment for use by individual employees
  - Leases of office furniture and water dispensers

- The exemption may be applied on a lease-by-lease basis (e.g. some PCs may be low value, when others are not).



Although it is very likely that low value assets will be immaterial, there is no requirement to evidence this, providing the relevant criteria are met (although firms are likely to still want to consider overall materiality).

TIP
05

Consider leaving goods and services combined

- Lessees may choose not to separate non-lease components from lease components and treat the whole amount as the lease rental. For example, vehicle maintenance may be left combined with vehicle rental.

- This needs to be decided by class of underlying assets.

- The effect will be to increase the value of the recognised right-of-use asset and liability, compared to separating the components of a contract. However as the methodology used can be explained in the notes to the accounts (or elsewhere) this may not be any problem.

- This will simplify the accounting for some firms, compared to having to separate the lease and non-lease parts of the rental payments.

Leaving goods and services combined may prove effective in avoiding unnecessary administrative cost.

TIP
06

Consider whether assets are substitutable

- A contract is only a lease if there is an identified asset.
- There may not be an identified asset in some circumstances, including where the asset is 'substitutable'.
- The asset might be substitutable if the lessor can change assets and benefit from doing so, throughout the lease. (B14-19).
- The lessor's right to substitute must be 'substantive'. The rules on this are very complicated! For example, the rationale for substitution (i.e. the benefit to the lessor) needs to exist from the start of the contract and not be reliant on unexpected developments.
- Assets are most likely to be substitutable if this is a key feature of the arrangement for the equipment (for example, some shared car scheme arrangements might qualify).

New types of service contracts that use equipment or vehicles, that offer different benefits and risks compared to traditional leases, may be outside of the scope of IFRS 16.

TIP
07

Use the transition options to speed implementation

- Lessees are not obliged to assess all leases in advance of starting the transfer into IFRS 16. Existing leases are 'grandfathered'. This means when a contract was considered a lease under the 'old' standard, it is accepted as a lease under IFRS 16. More importantly, if an existing contract was not a lease under the 'old' standard, it is not a lease under the new standard either.
- During transition, leases with similar remaining tenors may be grouped together as a (temporary) portfolio and be treated using the same discount rate. A split along the company's currently reported asset classes suffices

Many of the more complicated aspects of IFRS 16 will only apply to future leases. These can be discussed with lessors to make future accounting as simple as possible.