Applying IFRS in Financial Services

IASB issues new leases standard - financial services

April 2016
What you need to know

- The IASB has issued a new leases standard that will require lessees to recognise assets and liabilities for most leases.

- Lessees will apply a single accounting model for all leases (with certain exemptions).

- Lessor accounting is substantially unchanged and the IAS 17 classification principle has been carried over to the new standard.

- Financial services entities will need to evaluate the effects of the standard, if any, on their applicable capital requirements.

- The changes to customers will affect the information used by financial services entities to assess credit risk. Also, the customers’ appetite for leasing as a method of financing their businesses may change.

- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.
Overview

Financial services entities may need to change some of their lease accounting practices as a result of IFRS 16 Leases, the new leases standard issued by the International Accounting Standards Board (IASB). The new standard will significantly change the accounting for leases by lessees and could have far-reaching implications for financial services entities’ balance sheets and, as a consequence, regulatory capital requirements.

IFRS 16 requires lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Lessees must apply a single model for all recognised leases, but will have the option not to recognise ‘short-term’ leases and leases of ‘low-value’ assets. Generally, the profit or loss recognition pattern for recognised leases will be similar to today’s finance lease accounting, with interest and depreciation expense recognised separately in the statement of profit or loss. Therefore, the accounting for leases will have an impact on the net interest margin of financial services entities, while also reducing profits in the earlier years.

For financial services lessees, recognising lease-related assets and liabilities could have significant financial reporting and business implications (e.g., financial services entities may reassess their needs when negotiating lease terms and payments for assets such as properties). In addition, it will be important for financial services lessees to monitor how right-of-use assets will be treated for regulatory capital requirements.

Lessor accounting is substantially unchanged from current accounting. As with IAS 17 Leases, IFRS 16 requires lessors to classify their leases into two types: finance and operating leases. Lease classification determines how and when a lessor recognises lease revenue and what assets a lessor records. However, the profit or loss recognition pattern for lessors is not expected to change.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted provided the new revenue standard, IFRS 15 Revenue from Contracts with Customers, has been or is applied in the same date as IFRS 16. Lessees must adopt IFRS 16 using either a full retrospective or a modified retrospective approach.

Our forthcoming Applying IFRS, A closer look at the IASB’s new leases standard, will provide an in-depth discussion of the requirements of IFRS 16, including further details of the technical accounting topics and concepts discussed in this publication. In addition, our IFRS Practical Matters, Leases make their way onto the balance sheet: Navigating the journey for a smooth landing (EYG No. AU3725) is designed to help entities to understand the business impacts of the new standard. Refer to that publication for further information about the impacts of IFRS 16 and the steps entities should be taking to apply it.

This publication summarises the key implications for financial services entities. The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our guidance.
1. Key considerations

1.1 Scope and scope exclusions

IFRS 16 applies to leases of all assets, except for the following:

- Leases to explore for or use non-regenerative resources
- Leases of biological assets held by a lessee
- Service concession arrangements
- Licences of intellectual property granted by a lessor
- Rights held by a lessee under certain licensing agreements (e.g., motion picture films, patents, copyrights)

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

1.2 Definition of a lease

IFRS 16 defines a lease as a contract, or part of a contract, that conveys the right to use an asset (i.e., the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of the identified asset.

The concept of an identified asset is generally consistent with the ‘specified asset’ concept in IFRIC 4 Determining whether an Arrangement contains a Lease. An identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a floor of a building). A contract does not involve the use of an identified asset if, at inception, a supplier has the substantive right to substitute the asset throughout the period of use. A supplier’s right to substitute an asset is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising the right to substitute the asset.

In most cases, determining whether there is an identified asset is relatively straightforward. For example, an arrangement may involve the dedicated use of office space in a building. However, in other cases, this evaluation may require judgement, particularly when determining whether the supplier has a substantive substitution right.

A customer presumes that the substitution right is not substantive when the customer cannot readily determine whether a substitution right is substantive. No presumption for suppliers is necessary because they generally have sufficient information to make such a determination.
Illustration 1 — Substitution rights

Scenario A
Assume that an electronic data storage provider (supplier) provides services, through a centralised data centre, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and determines, at inception of the contract, that it is permitted to, and can easily substitute, another server without the customer’s consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Analysis: The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier’s operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

Scenario B
Assume the same facts as in Scenario A except that Server No. 9 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

Analysis: Because the supplier does not have the practical ability to substitute the asset, and there is no evidence of economic benefit to the supplier for substituting the asset, the substitution right is non-substantive, and Server No. 9 would be an identified asset. In this case, neither of the conditions of a substantive substitution right is met. As a reminder, both conditions must be met for the supplier to have a substantive substitution right.

How we see it
Entities will need to carefully review their agreements to determine whether a data storage provider’s substitution rights are substantive. For example, financial services entities may limit a supplier’s practical ability to substitute assets when the servers require the storage of sensitive customer information (e.g., customer financial information, patient medical history).
Illustration 2 — Identified asset

Financial services entity A borrows gold, to cover a short sale, from financial services entity B for a period of two years. Financial services entity A is required to return the same quantity of gold, but not the same gold bars. Financial services entity A pays financial services entity B CU100 for the use of the gold for the two-year period.

Analysis: Because the lessee is not required to return the same asset that was delivered at the commencement of the arrangement, but instead an asset of the same quantity and type, there is no identified asset and, therefore, the arrangement is not a lease.

A contract conveys the right to control the use of an identified asset if, throughout the period of use, the customer has the right to both:

- Obtain substantially all of the economic benefits from the use of the identified asset
- Direct the use of the identified asset

A customer can obtain economic benefits from the use of an identified asset, either directly or indirectly (e.g., holding, using, subleasing the asset). The economic benefits include the asset’s primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits), but other tax benefits, such as those related to the ownership of the asset (e.g., excess tax depreciation benefits), are not considered economic benefits of use.

A customer has the right to direct the use of an identified asset only if either:

(a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use

Or

(b) The relevant decisions about how and for what purpose the asset is used are predetermined and:

a. The customer has the right to operate the asset, or direct others to operate the asset in a manner that it determines, throughout the period of use, without the supplier having the right to change those operating instructions

Or

b. The customer designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use

In making this assessment, entities consider the decision-making rights that are most relevant to changing how and for what purpose an asset is used throughout the period of use (i.e., the decision-making rights that most significantly affect the economic benefits that can be derived from use of the underlying asset). The most relevant decision-making rights might include the right to change the type or quantity of output produced by the asset, when or whether output is produced and where the output is produced, throughout the period of use.
1.3 Short-term leases recognition exemption
Lessees can make an accounting policy election, by class of underlying asset, to apply a method similar to current operating lease accounting to leases that have a lease term of 12 months or less and do not contain a purchase option (short-term leases). That is, short-term leases are not recognised on the balance sheet and the related lease expense is recognised on a straight-line basis over the lease term or another systematic basis.

1.4 Leases of low-value assets recognition exemption
Lessees also can make a lease-by-lease election to apply a method similar to current operating lease accounting to leases for which the underlying asset is of low value (low-value assets). To be a low-value asset, a lessee must be able to benefit from the asset on its own or together with other resources that are readily available to the lessee. In addition, a low-value asset must not be dependent on, or highly interrelated with, other assets. At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, in the amount of US$5,000 or less.

1.5 Identifying and separating lease and non-lease components and allocating contract consideration
Contracts may contain the right to use multiple assets (e.g., a building and equipment). The right to use each asset will be considered a separate lease component if both: (1) the lessee can benefit from the use of the underlying asset either on its own or together with other resources that are readily available to the lessee; and (2) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are accounted for under other standards by lessees (unless they make the policy election described below) or as contracts subject to IFRS 15 by lessors.

Lessees will allocate contract consideration to the lease and non-lease components of a contract on a relative stand-alone price basis, maximising the use of observable information when stand-alone prices are not readily available. Lessees can also elect, by class of underlying asset, to account for each lease and non-lease component as a single lease component.

Lessors will be required to apply IFRS 15 to allocate contract consideration between the lease and non-lease components of a contract.

How we see it
Identifying non-lease components of contracts may change practice for some lessees. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases will be recognised on the balance sheet under IFRS 16, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.
2. **Lease classification**

Lessors will classify all leases in the same manner as under IAS 17, distinguishing between two types of leases: finance and operating.

Lessees, however, will apply a single accounting model for all leases, with options not to recognise short-term leases and leases of low-value assets.

3. **Lessee accounting**

3.1 **Initial recognition**

IFRS 16 requires lessees to recognise all leases on the balance sheet, except for short-term leases and leases of low-value assets if they choose to apply those exemptions. At the commencement date of a lease, a lessee will recognise a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset). Lessees will measure the lease liability using the interest rate implicit in the lease, if that rate is readily determinable. If that rate is not readily determinable, the lessee will use its incremental borrowing rate. Lessees will measure the right-of-use asset at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee’s initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

3.2 **Subsequent measurement**

Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. When the right-of-use asset is depreciated on a straight-line basis, this will generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.

4. **Lessor accounting**

IFRS 16 requires lessors to account for operating leases using an approach that is substantially unchanged from IAS 17. That is, lessors will continue to recognise the underlying asset and lease payments will be recognised as income over the lease term either on a straight-line basis or another systematic basis that is more representative of the pattern of use.

Lessors will be required to account for finance leases also using an approach that is substantially unchanged from IAS 17. That is, lessors will derecognise the carrying amount of the underlying asset, recognise a lease receivable and recognise, in profit or loss, any selling profit.

5. **Other considerations**

5.1 **Variable lease payments**

Financial service entities may have a considerable number of real estate leases as a lessee. In some jurisdictions, it is common for the lease payments of real estate to vary based on changes in an index or rate, such as a consumer price index (CPI). Variable lease payments that depend on an index or a rate will be included in the lease payments and measured using the prevailing index or rate at the measurement date (e.g., the lease commencement date for initial

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1 At the commencement date, the sum of lease payments receivable and the unguaranteed residual value, discounted at the interest rate implicit in the lease.
measurement). Variable lease payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset, will not be included as lease payments. These payments will be recognised in profit or loss when they are incurred (by a lessee) or earned (by a lessor), similar to today’s accounting.

Under IFRS 16, lessees are required to remeasure the lease liability in certain circumstances, including when there is a change in future lease payments resulting from a change in an index or rate used to determine those payments. When the lease payments increase, the liability will increase with a corresponding change in the right-of-use asset. The depreciation on the right-of-use asset will be updated prospectively. Lessees will be required to remeasure the lease liability to reflect the revised lease payments only when there is a change in the cash flows (i.e., when an adjustment to the lease payments takes effect). For example, if the contractual lease payments change every two years and the change is linked to a change in the CPI during the two-year period, a lessee would reassess the lease liability every two years when the contractual payments change, not each time the CPI changes.

Absent a lease modification, lessors will not be required to remeasure the lease receivable for variable lease payments that depend on an index or rate.

5.2 Sale and leaseback transactions

Because lessees will be required to recognise most leases on the balance sheet (i.e., all leases except for short-term leases and leases of low-value assets if they choose to apply those exemptions), sale and leaseback transactions will no longer provide lessees with a source of off-balance sheet financing.

IFRS 16 requires seller-lessees and buyer-lessors to use the definition of a sale in IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. If control of the underlying asset passes to the buyer-lessee, the transaction will be accounted for as a sale and lease by the seller-lessee and a purchase and lease by the buyer-lessee. If not, the transaction will be accounted for as a financing by both parties.

Financial services entities have historically entered into sale-leaseback transactions, in part, to manage capital requirements. The benefits of sale-leaseback transactions under IFRS 16 may further be influenced by the regulatory treatment of the lessee’s right-of-use asset, which is discussed below.

**How we see it**

The new determination of whether a sale has occurred in a sale and leaseback transaction is a significant change from current practice for seller-lessees. We generally expect fewer transactions to be accounted for as sales and leasebacks under IFRS 16 than under IAS 17.
5.3 Capital requirements – presentation in the balance sheet

Many financial services entities are subject to regulations that require them to hold a certain amount of capital relative to their assets and, in some cases, certain off-balance sheet commitments. Today, there is generally no requirement to hold capital associated with operating leases, as operating leases are not recognised on the balance sheet.

Under IFRS 16, right-of-use assets may be shown separately on the balance sheet or may be presented within the same line item as the corresponding underlying assets as if they were owned (e.g., PP&E). The decrease of right-of-use assets is described as depreciation in IFRS 16. This ability to show a lease of tangible assets within PP&E rather than as intangible assets and to show the decrease of right-of-use assets as depreciation may influence regulators’ views on the regulatory capital treatment. The effect on liabilities may also affect other regulatory measures, such as leverage ratios.

5.4 Influence on financial services entity’s customers

Entities with significant operating lease commitments will experience a large increase in the gross balance sheet. This is likely to be applicable for a financial services entity’s customers in industries in which operating lease contracts currently play a fundamental role (e.g., telecommunications, transport, retail and mining).

How we see it

• Financial services entities will need to evaluate the potential effects of IFRS 16 on their applicable capital requirements and understand how it might affect their investment and credit decisions. Banks with large portfolios of leased branch premises, in particular, are likely to be affected. However, the ability to show such leased assets within PP&E may influence regulators to require a capital requirement for leased assets that is consistent with that for PP&E, rather than a 100% capital deduction as is generally required for intangible assets.

• Customers may wish to negotiate with their financial services entity, either to allow for more headroom in their debt covenants, or to allow for the continued use of current lease accounting in the covenant calculations. Financial services entities should consider how their business practices may change as a result of such negotiation requests. Because of the change in accounting treatment, some customers may find leasing less advantageous and so may wish to finance their businesses in a different manner.
Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their leases will be affected. Two critical first steps of the assessment process include: (1) identifying the sources and locations of an entity’s lease data; and (2) accumulating that data in a way that will facilitate the application of the new standard. For entities with decentralised operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility of different operational, economic and legal environments. Entities will also need to ensure that they have the processes, including internal controls, and systems in place to collect the necessary information to implement IFRS 16.

- Financial services entities that are subject to regulatory requirements will need to monitor the actions of prudential regulators in response to the new standard.

- Financial services entities may need to amend criteria and processes used to monitor credit risks to their customers. Some financial services entities may choose to continue to use their own calculations for leases, instead of the numbers produced under the requirements of the new standard.

- Financial institutions should assess the consequences of the new standard for their customers and, in turn, the business impact for those institutions.
Appendix A: Lessee accounting

Bank XYZ (Lessee) enters into a three-year lease of branch office space in a shopping centre. Bank XYZ agrees to make the following annual payments at the end of each year: CU10,000 in Year 1, CU12,000 in Year 2 and CU14,000 in Year 3. For simplicity, there are no purchase options, payments to the lessor before the lease commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of 4.235%). Bank XYZ uses its incremental borrowing rate because the rate implicit in the lease cannot be readily determined. Bank XYZ depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Bank XYZ would recognise the right-of-use asset and lease liability:

<table>
<thead>
<tr>
<th>Right-of-use asset</th>
<th>CU33,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>CU33,000</td>
</tr>
</tbody>
</table>

To initially recognise the right-of-use asset and lease liability

The following journal entries would be recorded in Year 1:

<table>
<thead>
<tr>
<th>Interest expense</th>
<th>CU1,398</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>CU1,398</td>
</tr>
</tbody>
</table>

To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)

<table>
<thead>
<tr>
<th>Depreciation expense</th>
<th>CU11,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU11,000</td>
</tr>
</tbody>
</table>

To record depreciation expense on the right-of-use asset (CU33,000 ÷ 3 years)

<table>
<thead>
<tr>
<th>Lease liability</th>
<th>CU10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU10,000</td>
</tr>
</tbody>
</table>

To record lease payment

A summary of the accounting for the lease contract (assuming no changes due to reassessment, lease modification or impairment) is, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash lease payments</td>
<td>CU 10,000</td>
<td>CU 12,000</td>
<td>CU 14,000</td>
</tr>
<tr>
<td>Lease expense recognised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>CU 11,000</td>
<td>CU 11,000</td>
<td>CU 11,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>1,398</td>
<td>1,033</td>
<td>569</td>
</tr>
<tr>
<td>Total periodic expense</td>
<td>CU 12,398</td>
<td>CU 12,033</td>
<td>CU 11,569</td>
</tr>
<tr>
<td>Balance sheet</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>CU 33,000</td>
<td>CU 22,000</td>
<td>CU 11,000</td>
</tr>
<tr>
<td>Lease liability</td>
<td>(33,000)</td>
<td>(24,398)</td>
<td>(13,431)</td>
</tr>
</tbody>
</table>

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.
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