Lease by lessee – discover the IFRS16 disclosures

Case study

[Excerpt from publication]

June 2019
In January 2016 the International Accounting Standards Board (IASB) issued IFRS16 “Leases”, thereby starting a new era of lease accounting – at least for lessees. Whereas under the previous guidance in IAS17 “Leases”, a lessee had to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet), the new model requires the lessee to recognise almost all lease contracts on the balance sheet; the only optional exemptions are for certain short-term leases and leases of low-value assets. For lessees that have entered into contracts classified as operating leases under IAS17, this could have a significant impact on the financial statements.


This case study publication aims to concentrate on the disclosure aspect of the new standard for the lessee. Only incidental subleases are presented to indicate that the new lease model for lessee may impact also accounting for subleases, nevertheless this publication is not designed for lessors.

We have deliberately selected a company with a relatively simple business model – a manufacturer of furniture and equipment sold through its own retail chain. We have provided the company’s background, followed by IAS17 disclosures and then presented extracts from the 2019 financial statements that incorporate the requirements of IFRS16. This is an example of the impact and disclosures of IFRS16 and, therefore, should not be perceived as being a comprehensive source of knowledge on IFRS16 or disclosure requirements.

We hope you will find this case study useful and it will help you better understand the difference between the old and new disclosure requirements.
1. Overview of the Company and its previous lease disclosures

On the following pages we present details of the Company’s business. We have deliberately selected a Company with relatively simple operations. The extract from the directors’ report is followed by IAS17 disclosures. In the final part of this section, we have summarised the impact of IFRS16. Whilst the Company identified many differences on the adoption of the new standard, the list is not exhaustive and other companies may identify different adjustments arising from the adoption of IFRS16.

Commentary

Marta Madejska
Director
Information about the Company

The Company is a furniture manufacturer in Poland. The products are sold through 25 own-brand stores located in major European cities.

All the stores are in the leased properties. The manufacturing plant is owned by the Company but is located on the plot of land which it uses based on a land lease agreement. The Company also leases a fleet of delivery vans to transport goods from the factory to the central warehouse and to the stores. The Company has some incidental subleases.

The Company prepares its financial statements in accordance with EU IFRS.

All leases were classified as operating leases under IAS17. The extracts from the financial statements relating to the Company’s lease arrangements are presented below. Comparative information has been omitted.

For the purpose of financial reporting, the Company assumes that the total change in equity/net profit of EUR 150 thousand would be of material importance to investors and, therefore, it determined that the adjustments identified in respect of individual balance sheet items in excess of EUR 15 thousand (i.e. 10% of the overall materiality level) are always recognised in the financial statements.

Disclosures relating to leases in the Company’s financial statements for the year ended 31/12/2018

Note 10. Operating leases (extract from the financial statements)

Accounting policies

Leases in which substantially all the risks and rewards of ownership are not transferred to the lessee are classified as operating leases.

The Company is a lessee in operating lease arrangements. Payments made under operating leases (net of any incentives received from the lessor) are charged to profit or loss on a straight-line basis over the period of the lease. Contingent rents are recognised as an expense when incurred.

The Company is a sublessor of certain assets leased under head operating lease contracts. Those subleases are classified as operating leases. Lease income is recognised on a straight-line basis over the lease term.

The Company does not have any leases classified as finance leases.

The lease where the Company is a lessee

The Company uses the following assets based on operating lease arrangements: retail stores, an office building, a plot of land, delivery vans, other small equipment (e.g. computers, mobile phones).

The leases have varying terms, termination and renewal rights. The main lease terms are summarised below:

- Retail stores have a non-cancellable lease term between 5 and 8 years. The contracts contain an option to renew the lease. The lease payments are a fixed amount, plus percentage of sales exceeding a predetermined level.
- The land lease agreement is for 99 years with a cancellation period of 3 months. All payments are variable based on the fair value of the leased land.
- The office building has a non-cancellable lease term of 10 years with an option to renew the contract. The lease payments are fixed, adjusted for inflation.
- The vans are leased for 1 year with an option to renew the lease.
- Small equipment (e.g. computers, mobile phones) is leased for a fixed period of two years with the purchase option at fair value.

The Company subleases certain of those assets under operating lease agreement to the related party.
The table below presents minimum lease payments in relation to non-cancellable operating leases where the Company is a lessee:

<table>
<thead>
<tr>
<th>(in EUR'000)</th>
<th>31/12/2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future minimum lease payments in relation to non-cancellable operating leases are payable as follows:</td>
<td></td>
</tr>
<tr>
<td>Within one year</td>
<td>3,150</td>
</tr>
<tr>
<td>Later than one year but not later than five years</td>
<td>12,383</td>
</tr>
<tr>
<td>Later than five years</td>
<td>10,859</td>
</tr>
<tr>
<td>Total</td>
<td>26,392</td>
</tr>
</tbody>
</table>

Not included in the above commitments are contingent rental payments which may arise in the event that sales generated by the stores exceed a pre-determined level. The contingent rent is 1% of sales revenue from the excess sales. The whole rent payable for the land lease is excluded from the minimum lease payments disclosed above as all payments are contingent rent based on the fair value of the land. The annual payment for the last financial year amounts to EUR 70 thousand.

The table below presents the lease expense in relation to operating leases which is recognised in profit or loss for the 12-month period ended 31/12/2018:

<table>
<thead>
<tr>
<th>(in EUR’000)</th>
<th>Selling costs</th>
<th>Administrative expenses</th>
<th>2018 Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental expense relating to operating leases:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum lease payments</td>
<td>3,014</td>
<td>260</td>
<td>3,274</td>
</tr>
<tr>
<td>Contingent rent</td>
<td>191</td>
<td>-</td>
<td>191</td>
</tr>
<tr>
<td>Total operating lease expense</td>
<td>3,205</td>
<td>260</td>
<td>3,465</td>
</tr>
</tbody>
</table>

The following items resulting from operating lease contracts are recognised in the statement of financial position:

<table>
<thead>
<tr>
<th>(in EUR’000)</th>
<th>31/12/2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other assets</td>
<td></td>
</tr>
<tr>
<td>Prepaid rent in operating lease contracts (lease of stores)</td>
<td>510</td>
</tr>
<tr>
<td>Other liabilities</td>
<td></td>
</tr>
<tr>
<td>Accrual for the rent free periods in operating lease contracts (lease of office buildings)</td>
<td>20</td>
</tr>
</tbody>
</table>

None of the Company’s leases were determined to be onerous.

**The lease where the Company is a lessor**

The Company is as a lessor in incidental situations. The Company currently subleases part of its office space and some of its computers to a related party. Income from these leases amounts to EUR 40 (2017: EUR 39). The future minimum lease payments in relation to non-cancellable operating leases are as follows:

<table>
<thead>
<tr>
<th>(in EUR’000)</th>
<th>31/12/2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Future minimum lease payments in relation to non-cancellable operating leases are payable as follows:</td>
<td></td>
</tr>
<tr>
<td>Within one year</td>
<td>47</td>
</tr>
<tr>
<td>Later than one year but not later than five years</td>
<td>164</td>
</tr>
<tr>
<td>Later than five years</td>
<td>126</td>
</tr>
<tr>
<td>Total</td>
<td>331</td>
</tr>
</tbody>
</table>

None of the Company’s leases were determined to be onerous.
If you found this publication of interest and would like to find out:

- how the Company prepared the analysis and determined the right-of-use assets and lease liabilities as at the date of the transition to IFRS 16, i.e. 1 January 2019;
- which practical expedients were applied by the Company;
- how the Company prepared the reconciliation of operating lease commitments disclosed as at 31 December 2018 when applying IAS 17 to the lease liabilities recognized as at 1 January 2019 under IFRS 16;
- how to prepare information (to be included in the financial statements as at 31 December 2019) on the impact of IFRS 16 in accordance with the requirements of IAS 8 and guidelines issued by ESMA;
- how to prepare selected disclosures that will become the standard disclosures required by IFRS 16 in each reporting period (and how such an illustrative note looks like);
- how the new standard impacts the alternative performance measures used by the Management,

please do not hesitate to contact us – we will be pleased to provide you with the electronic version of the entire case study free of charge.

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If you would like to attend a workshop where this case study is discussed step by step, or have such a workshop organized and delivered by us inhouse in your own company, please contact:

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**Overview of the Company and its previous revenue recognition policy**

**PwC Tools**

**IFRS16 myLease Manager**
Application for managing lease contracts and calculating liabilities, right-of-use assets, interest, and depreciation in accordance with the new standard.

**myLease Manager in 5 easy steps:**

1. **Easy contract recording**, either manually, or through imports from MS Excel (with an option to attach source documents as PDFs or other files)

2. **A user-friendly interface** which enables modifications of input data during the lifetime of contracts. Also, modifications of contracts can be traced and reported.

3. **System validation of input data**

4. **Automatic calculation** of liabilities and values of individual right-of-use assets, interest, and depreciation

5. **User-friendly reporting**, ready to use in financial statements

**Advantages of implementing myLease Manager**

- **Quick implementation**: it takes only one month to implement myLease Manager
- **Easy to use**: user-friendly interface enables easy data entry and fast modifications
- **Multilingual**: application is available in Polish and English
- **Error-free**: data validation minimises the risk of errors
- **Saving time and resources**: application automatically calculates liabilities and values of individual right-of-use assets, interest, and depreciation
- **Flexibility**: simultaneous access by many users
- **Full data security**: user access control system
- **Full IFRS16 compliance**: implementation is delivered by a joint team of accounting, auditing, and IT experts
Estimation of discount rates
We ensure comprehensive assistance in estimating discount rates using our expert knowledge and access to market data sources

Our services comprise:

1. Support in estimating discount rates for the purposes of an implementation project or impairment test.

As part of the project, we determine methodologies, discuss the assumptions and main calculation parameters with the company. We estimate the rates based on market data and the Company’s internal data, using the calculation models determined in cooperation with the client, and summarize the results of calculations in a summary report. We will provide you with information on the components of a given discount rate.

2. Continuous cooperation in respect of updating discount rates for subsequent balance sheet dates.

Cooperation in subsequent years is based on updating estimations, taking into account changes in the market data and in the client’s business. The client receives the data necessary for financial reporting at specific balance sheet dates in the agreed periods.


Methodology workshops help clients to understand the principles and methods for estimating discount rates so as to enable them to perform independent calculations.
From the author,

This is our third publication in a series of publications relating to disclosures resulting from new standards. The preparation of meaningful and comprehensive disclosures is a challenging task, therefore we present you with a publication which is aimed at helping you in the preparation of your first disclosures under IFRS 16. We hope you find this publication useful.

The previous publications issued in 2018 cover disclosures required by IFRS 9 “Financial Instruments” and IFRS 15 “Revenue from Contracts with Customers”. Both publications are available on www.pwc.pl. Some other PwC publications or resources mentioned below on this page may be of assistance to you.

Publications and PwC resources relating to IFRS, which may be useful in the preparation of financial statements for 2019

- IFRS Illustrative consolidated financial statements
- IFRS Disclosure checklist
- Inform - online resource. Authoritative literature for IFRS and PwC’s guidance
- IFRS 9, Financial Instruments. Understanding the basics
- Revenue from contracts with customers – discover the IFRS 15 disclosures
- Not only for banks - Discover IFRS 9 in the world of corporates

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