

IFRS 16: TACKLING CONTRACT CHALLENGES

01 – INTRODUCTION

In January 2016, the International Accounting Standards Board (IASB) issued IFRS 16 Leases, a new International Financial Reporting Standard (IFRS). “IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, i.e. the customer (‘lessee’) and the supplier (‘lessor’)”¹, replacing International Accounting Standard IAS 17. Under IAS 17, when a lease was economically similar to purchasing the underlying asset, the lease was classified as a finance lease and reported on a company’s balance sheet. All other leases were classified as operating leases and therefore not reported on a company’s balance sheet. The result was confusion, perhaps some degree of creativity, and an overall lack of clarity and transparency of lease reporting.

IFRS 16 and the corresponding ASC842 for US GAAP, brings the vast majority of leases on the balance sheet for reporting purposes. Virtually every large organization uses rental or leasing as a means to obtain access to assets, and therefore, will be affected by the new standard. The deadline, set by the IASB, to have this transition completed is January 1st 2019.

Companies with operating leases that need to move to on-balance sheet leases, will appear to be more asset-rich, but also more heavily indebted. Some reported performance measures such as operating profit, Earnings Before Interest and Taxes (EBIT) and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) would improve, with no change in the underlying cash flows or business activity due to leased assets being removed from operating expenses and moved to the balance sheet.

The first steps in IFRS 16 compliance include answering the following questions.

- Do I know where all my contracts are?
- Which of my contracts contain leases?
- Are systems and processes in place to manage my legacy and go forward agreements?
- What data will I need from my lease contracts to create my compliance plan?
- What tools and expertise is available to help me?
- Will we have enough time?

This effort will also trigger other business decisions about the use of leases, renegotiation of leases, and further scrutiny on acquiring assets.

“Overall, it has been estimated that IFRS 16 will push \$2.86 TN of value onto the balance sheets of organizations”

Financial Times,
Jan 2016

05 – HOW SEAL HELPS WITH IFRS 16 COMPLIANCE

An initial and critical aspect of IFRS 16 compliance is understanding what is held within your lease agreements. This includes whether lease components are included in other types of agreements, the specific terms and conditions within leases, and if leases have non-lease components included. Organizations must analyze lease elements such as term, values, specific obligations at the end of the term, residual values, etc., and also whether or not there are maintenance or other service components bundled in too. Under IFRS 16, both lessees and lessors are required to separate lease components from non-lease components in their contracts.

If an organization has 1,000s of lease agreements, this is a monumental task.

Seal Contract Discovery and Analytics helps automate the discovery of contracts, extraction of data points and prepares contracts for review and the extraction of lease data. Seal can identify leases versus other types of agreements, and extract numerous data elements to ensure organizations get a clear picture of the lease data buried inside each document. Compared to 100% manual review, it is faster, less costly, far more accurate and repeatable should the parameters change.

Seal uses an optimized combination of artificial intelligence technologies, that is highly trained and tuned to fully understand contract documents and the language they hold.

Seal may also be trained by business users for improved speed and accuracy, of specialized custom data extractions to capture specific information from across large portfolios of contracts. It can dig deep into lease contracts and find the services, maintenance, ancillary, or renewable components that will likely need to be separated and restructured with each asset/service provider under IFRS 16.

Seal includes a comprehensive reporting and data visualization tool, providing statistics and metrics from across the entire set of contracts. These can be shared and used to make business decisions on the best approaches to IFRS 16 compliance.

Sample of lease terms that can be extracted by Seal:

- *Active agreements*
- *Contracting parties*
- *Lease clauses*
- *Lease term*
- *Lease values*
- *Pricing/Payment basis*
- *Asset control*
- *Termination term*

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