ICAEW KNOW-HOW
FINANCIAL REPORTING FACULTY

IFRS 16 LEASES

IFRS FACTSHEET - EXTRACT

IFRS FACTSHEET

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IFRS 16 Leases
IFRS 16 *Leases* sets out principles for the recognition, measurement, presentation and disclosure of leases. This factsheet provides an overview of IFRS 16 with a focus on lessee accounting and answers some frequently asked questions about the standard.

Key regulations for this factsheet
This factsheet includes links and references to key regulations. There's a summary of the links, and guidance on how to use them, on page 2.

Section 1

Introduction

The publication of IFRS 16 *Leases* realised the IASB's long-standing goal of bringing all significant leases on-balance sheet for lessees. The standard replaced the previous leases standard – IAS 17 *Leases* – and related interpretations.

For lessees, IFRS 16 removes the long-standing distinction between 'finance leases' and 'operating leases' and introduces a single lessee accounting model that – with some limited exemptions for short-term leases and leases of low-value assets – will apply to all leases.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019, with earlier application permitted provided IFRS 15 *Revenue from Contracts with Customers* is also applied.

The implementation of IFRS 16 has resulted in significant change for many lessees, particularly those that under IAS 17 had a significant number of material operating leases. The application of the standard has important implications for the information systems, processes and internal controls of such entities.

In contrast, there are no significant changes to the lessor accounting model, with IAS 17's requirements being carried forward into IFRS 16 substantially unchanged. Intermediate lessors, however, face significant changes as a result of the standard.

Section 2

Links to regulations

Using the links and margin notes in this document

The margin notes in this factsheet identify relevant sections of standards and other regulations – these sections cannot be considered in isolation when applying them in practice.

You might find it useful to download relevant section(s) of the standard(s) so that you can refer to them when using this document.

Make sure that you use the right version of the regulations or standards

Standards and regulations are often updated and amended, and may have transitional provisions. It is important to use the right version, and to make sure that it applies to the relevant time period. The standards below are linked to the faculty's standards tracker which shows when standards were amended, and when amendments come into effect. Links are then provided to the version of the standard relevant to specific time periods. To use the links in the standards tracker it is strongly recommended that you are first logged into the Financial Reporting Faculty, and also logged into eIFRS.

Regulations and guidance
IFRS 16 *Leases*
IFRS 1 *First-time Adoption of International Financial Reporting Standards*
IFRS 7 *Financial Instruments: Disclosures*
IFRS 9 *Financial Instruments*
IFRS 15 *Revenue from Contracts with Customers*
IAS 1 *Presentation of Financial Statements*
IAS 7 *Statement of Cash Flows*
IAS 16 *Property, Plant and Equipment*
IAS 17 *Leases*
IAS 36 *Impairment of Assets*
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
IAS 38 *Intangible Assets*
IAS 40 *Investment Property*
IAS 41 *Agriculture*
IFRIC 4 *Determining whether an Arrangement contains a Lease*
IFRIC 12 *Service Concession Arrangements*
SIC-15 *Operating Leases – Incentives*
SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

Section 3

Overview

Which standards have been withdrawn?

IFRS 16 superseded IAS 17 *Leases* together with the related interpretations IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

Why was it necessary to replace the approach set out in IAS 17?

IAS 17 *Leases* classified leases as either 'finance leases' or 'operating leases'. If a lease was classified as a finance lease, it appeared on the balance sheet of the lessee, along with a related lease liability. If it was classified as an operating lease, the asset and liability did not appear on the lessee's balance sheet, with rental costs expensed in the profit or loss account over the lease term.

These differing treatments could be confusing for users of financial statements as economically similar transactions were accounted for differently. They would also lead to entities 'structuring' lease arrangements to achieve a preferred accounting treatment.

How does IFRS 16 address problems with IAS 17's lease accounting?

IFRS 16 introduces a single lessee accounting model that requires assets and liabilities arising from almost all major lease arrangements to be recognised on-balance sheet, meaning that investors should no longer need to make arbitrary adjustments to an entity's accounts to adjust for off-balance sheet items. Moreover, comparability should be improved as there will be less opportunity to structure a lease to achieve a particular accounting outcome.

How, in a nutshell, does the lessee accounting model work?

IFRS 16 introduces a 'right of use' model under which lessees recognise an asset reflecting their right to use the leased asset for the lease term and a lease liability reflecting their obligation to make lease payments. Both the asset and the liability are recognised on-balance sheet at the commencement of the lease.

Does this approach apply to all leases?

No. While this approach applies to most major leases, there are important exceptions for short-term leases and for leases of low-value assets. Certain specific leases are also beyond the scope of the standard (see below for details).

Did anything change for lessors?

IFRS 16 substantially carries forward the lessor accounting requirements of IAS 17. A lessor therefore continues to classify its leases as operating leases or finance leases and to account for these two types of lease differently. Intermediate lessors, however, face significant changes as a result of the standard. Additionally, IFRS 16's definition of a lease applies to both lessees and lessors, albeit that it is not radically different from IAS 17's previous definition.

Who is most affected by IFRS 16?

The impact varies from sector to sector and from entity to entity. It is likely to be most pronounced in those business sectors – such as transport, retail, real estate, financial services, mining and construction – in which it was common for entities to have a significant number of material off-balance sheet leases. Entities with significant leased premises are particularly affected.

How does this affect lessees' financial statements?

The most significant effect of the standard is the increased number of both lease assets and lease liabilities recognised on lessees' balance sheets. This is resulting in significant changes to some key financial metrics such as gearing, and some debt covenants have been affected (if not based on 'frozen GAAP').

There is also an impact on the numbers reported in profit or loss. The typical straight-line operating lease expense has been replaced with a depreciation charge on the lease asset and an interest expense on the lease liability. For an individual lease, this has typically led to a higher total expense being recognised in the early years as, although the depreciation charge will normally be straight-line, the interest expense is front-loaded with a higher interest payable charge in the early years when there is a bigger liability outstanding.

Perhaps less obviously, entities that under IAS 17 had material off-balance sheet leases report higher operating profits when compared to the amounts reported under IAS 17. This is because a lessee presents the implicit interest in former off-balance sheet lease payments as part of finance costs whereas, under IAS 17, the entire expense was included as part of operating costs. EBITDA increases as both the interest cost and the depreciation charge are excluded when calculating it whereas under IAS 17, no adjustment was made for the operating lease expense.

The change in lease accounting does not, of course, cause a change in total cash flows, excluding any tax implications, because there is no change to the economics. There may, however, be a change in how cash flows appear in the cash flow statement. Many entities under IAS 17 classified cash outflows associated with operating leases as operating cash flows, meaning that the adoption of IFRS 16 results in a reduction in amounts classified as operating cash outflows and a corresponding increase in amounts classified as financing cash outflows. However, some entities classify interest payable as an operating cash flow, in which case this component of the leasing cash flows would remain as an operating item.

Did IFRS 16 fully converge with US GAAP?

While it was once hoped that the IASB and the FASB would come up with identical lease standards, they ultimately failed to find a single solution that was acceptable to their respective stakeholders. They have, therefore, in some respects gone their separate ways. While this will be disappointing to some, their respective models still have a lot in common. For example, they agree on the key requirement for leases to be shown on the lessee's balance sheet, how to define a lease and how lease liabilities should be measured.

But there are also some important differences, most notably in relation to how and when lessees recognise expenses. As noted above, the IASB approach typically leads to higher total expense in the early years. In contrast, the FASB approach, for certain leases, results in an overall straight-line expense.

Unlike the IASB, the FASB does not offer an exemption for leases of low value items.

Are there any tax implications?

There may be some tax implications depending on the tax jurisdiction in which an entity operates. Similarly, there may be some deferred tax implications. The tax and deferred tax implications resulting from the adoption of IFRS 16 are beyond the scope of this factsheet.

Practical tip: UK tax

On 6 July 2018, HMRC published a policy paper on the impact of IFRS 16 on tax rules and draft legislation. The draft legislation became part of the Finance Bill 2018-19, which was agreed by both Houses and received Royal Assent on 12 February 2019. UK entities should refer to the legislation and HMRC's policy paper and any other guidance available on gov.uk.

Contacts and further help

Factsheets for faculty members

This factsheet is part of a series designed to provide practical help for Financial Reporting Faculty members in exercising their professional judgement.

The faculty cannot offer interpretations of standards or give views on the application of standards to particular companies or transactions.

The faculty's standards trackers

To check for current standards and recent amendments go to the faculty's standards trackers at: icaew.com/frfstandardstracker.

Factsheets

Topics covered by other factsheets include:

- 2020 IFRS Accounts
- IFRS 9 Financial Instruments - overview
- Applying IAS 36 Impairment of Assets

A complete list of factsheets can be found here:
icaew.com/frffactsheets

Factsheet comments and suggestions

To comment on factsheets, or to suggest topics that you'd like to see covered by factsheets, email us at frfac@icaew.com

Faculty resources icaew.com/frf

Resources published by the Financial Reporting Faculty may be found at icaew.com/frf. Resources include online access to the faculty's publications, webinar recordings and other guidance such as FAQs and the standards trackers. Faculty members also have full access to the IASB's eIFRS resource, including full texts of the standards.

The Financial Reporting Faculty
The faculty aims to help members keep up to date with the implications of new standards, regulations and practice in financial reporting.
Our international community of financial reporting professionals also contribute to the ICAEW's work in influencing the development of financial reporting concepts, standards and regulation.

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