FINANCIAL REPORTING FACULTY

FAQ

8 MARCH 2016

IFRS 16 LEASES

The Financial Reporting Faculty answers your initial questions on the IASB's new leases standard

The IASB issued IFRS 16 *Leases* in January 2016, bringing their long-running project to improve the financial reporting of leases to a close.

1. **Why was it necessary to change the way in which leases are accounted for?**

   IFRS reporters currently account for leases under IAS 17 *Leases*, which classifies leases as either ‘finance leases’ or ‘operating leases’. If a lease is classified as a finance lease, it appears on the balance sheet of the lessee (ie, the company leasing the asset), along with a related lease liability. If it is classified as an operating lease, the asset and liability are off-balance sheet, with rental costs expensed in the profit and loss account over the lease term.

   These differing treatments can be confusing for users of financial statements as economically similar transactions can be accounted for differently. It can also lead to entities ‘structuring’ lease arrangements to achieve a preferred accounting treatment.

2. **How does the new standard address problems with today’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 for the first time, meaning that investors will no longer need to make arbitrary adjustments to a company’s accounts to adjust for off-balance sheet items. Moreover, comparability will be improved as there will be less opportunity to structure a lease to achieve a particular accounting outcome.

3. **How does the new lease accounting model work?**

   IFRS 16 introduces a ‘right of use’ model under which lessees will 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 will be recognised on-balance sheet at the commencement of the lease.

   The value of the right-of-use asset is calculated as:

   - the present value of the lease payments, discounted at the rate the lessor charges the lessee or, if this cannot be readily determined, the lessee’s incremental borrowing rate; plus
   - any initial direct costs; plus
   - any lease payments made to the lessor before the commencement date; less
   - any lease incentives received.

   This asset will then be amortised over the life of the lease and tested for impairment where appropriate. A lessee can choose to revalue such assets.

   The lease liability is calculated at the present value of the lease payments, discounted at the rate the lessor charges the lessee or, if this cannot be readily determined, the lessee’s incremental borrowing rate. In subsequent years the reported liability is increased by the unwinding of the discount and reduced by lease payments made to the lessor.

4. **Will this approach apply to all leases?**

   No. While this approach will apply to most major leases, there are important exceptions for leases with a term of less than 12 months and for low value leases.

5. **Does anything change for lessors?**

   IFRS 16 substantially carries forward the lessor accounting requirements of IAS 17. A lessor will therefore continue to classify its leases as operating or finance and to account for these two types of leases differently.

6. **Does the new standard change the definition of a lease?**

IFRS 16 defines a lease as a contract that conveys to the customer the right to use an asset for a period of time in exchange for consideration. An entity assesses whether a contract contains a lease on the basis of whether the customer has the right to control the use of an identified asset for a period of time

While these requirements are somewhat different from those in IAS 17, conclusions about whether or not a contract contains a lease are not expected to change in the majority of cases.

7. **Does IFRS 16 apply to service contracts?**

IFRS 16 does not apply to service contracts. Nor does it change the way in which services are accounted for. However, this is a challenging area for those preparing financial statements as lease and services are often combined in a single contract. In such circumstances, the lessee will need to separate the contract into its lease and service components and apply the lease accounting requirements only to the former.

8. **Are there any new disclosure requirements?**

Yes. There are significant new disclosure requirements designed to help users better understand an entity's leasing activities. Additional time will need to be spent collecting the information required and crafting these disclosures.

9. **What is IFRS 16's effective date?**

The new standard is effective for accounting periods beginning on or after 1 January 2019. Early adoption is permitted, provided IFRS 15 *Revenue from Contracts from Customers* is also applied. However, EU preparers will not be able to apply either standard until they are endorsed by the European Commission.

10. **What transition arrangements are provided?**

Entities have the option of either full retrospective application or a modified retrospective approach. If the latter is applied, relief is given from certain provisions on transition eg, an entity is not required to recognise lease assets and lease liabilities for leases with a term ending within 12 months of the date of the initial application of IFRS 16.

11. **What will be the impact of the new standard?**

The impact will vary from sector to sector and from company to company. It is likely to be most pronounced in those business sectors – such as transportation, real estate, mining and construction – where it is common for companies to have a significant number of material off-balance sheet leases. Companies with significant leased premises – such as retailers – will be similarly affected.

The most significant effect of the new standard will be the increased number of both leased assets and lease liabilities recognised on lessees' balance sheets. This will result in potentially significant change to some key financial metrics such as gearing and performance ratios, meaning that some debt covenants could be affected. Moreover, it could affect the cost of borrowing for some entities. Lessees that are financial institutions may also find that their regulatory capital is affected.

Perhaps less obviously, IFRS reporters that currently have material off-balance sheet leases are also likely to report higher operating profits and EBITDA (earnings before interest, taxation, depreciation and amortisation) when compared to the amounts reported today. This is because a lessee will present the implicit interest in former off-balance sheet lease payments as part of finance costs whereas, today, the entire expense is included as part of operating costs. However, the IASB believes that profit before tax is not likely to change significantly for lessees holding a portfolio of leases.

12. Is there anything I need to do now?

While the effective date of 2019 may seem a long way off, it is essential that businesses begin their preparations sooner rather than later.

All listed businesses with significant leased assets will have to consider sooner rather than later how the new standard will impact on systems and processes and on their reported numbers. Moreover, lease or buy decisions may require new strategies to achieve the preferred accounting treatment.

The potential implications go beyond a mere change in accounting. For example, bank covenants, employee compensation arrangements, dividend planning and taxation may be affected. Finance teams and others within the organisation are likely to need training to get them up to speed with the new requirements. The standard may have important implications for information systems, processes and internal controls, while contracts, bonus plans and other arrangements may need reviewing.

Any material financial reporting effects anticipated should be communicated at an early stage to investors and other key stakeholders.

13. What happened to idea of type A and type B leases?

The exposure draft published in May 2013 proposed a 'dual expense' model. Under this approach almost all leases would have been recognised on-balance sheet but the expense recognised in profit or loss would have depended on whether or not the lessee consumed a 'more than insignificant' part of the underlying asset during the life of the lease. If they did, as is typically the case for leases of vehicles and equipment, the expense profile would have been similar to today's finance leases, with costs front-loaded during the early years of the lease. If they didn't, typically the case for property leases, expenses would have been recognised on a straight-line basis.

Many respondents complained that this model – with its mysteriously named type A and type B leases – was not only overly complex, but also conceptually flawed. The IASB agreed. This approach was therefore dropped from the final standard. The IASB instead returned to a simplified version of the proposals issued in August 2010.

14. Is IFRS 16 fully converged 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 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. While the IASB decided to abandon the 'dual expense' model, the FASB is sticking with a version of the dual model, albeit with the dividing line between type A and type B leases drawn in a slightly different place.

The actual impact of the differing expense recognition models may not be as dramatic as one may first think. The IASB is confident that businesses with a large number of leased properties will find that things balance out across the portfolio, meaning that the expense under IFRS wouldn't be all that different to the expense under US GAAP.

15. What is ICAEW doing to help companies make the transition to IFRS 16?

The new leasing standard will form a key focus of Financial Reporting Faculty activities in 2016/17. A webinar is being held on 22 March 2016, featuring presentations by the faculty's Eddy James and Peter Hogarth, partner at PwC, and leasing will feature at various faculty and ICAEW Academy of Professional Development updates and workshops.

A joint one day conference in London with the IFRS Foundation on the requirements and implications of the new standard is planned for 7 October 2016.

A more detailed factsheet for faculty members is under development and the full text of the standard is available on-line to faculty members.

The faculty will continue to monitor the need for additional resources and commentary, including through our popular Talk Accountancy blogs.

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