# IFRS 16 - LEASES

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Financial Reporting Faculty updates you on IFRS 16 *Leases* which replaced IAS 17 *Leases.* IFRS 16 *Leases* came into effect for accounting periods beginning on or after 1 January 2019.

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## *1. How, in a nutshell, does the lessee accounting model work?*

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.

It 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.

## *2. Has the definition of a lease changed?*

Yes. IFRS 16 defines a lease as a contract that 'conveys the right to control the use of an identified asset for a period of time in exchange for consideration'.

To assess whether a contract is or contains a lease, an entity must assess whether, throughout the period of use, the customer has both:

- The right to obtain substantially all the economic benefits from use of the identified asset; and
- The right to direct the use of the identified asset.

## *3. How does the liability and asset model work for lessees?*

The lease liability is initially 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.

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

- the amount of the initial measurement of the lease liability, as described above;
- any lease payments made to the lessor before the commencement date, less any lease incentives received;
- any initial direct costs incurred by the lessee; and
- an estimate of any costs of dismantling, removing or restoring the underlying asset or restoring the site on which it is located when appropriate.

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

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

No. While this approach will apply to most major leases, there are important exemptions for leases with a term of less than 12 months and for low value leases. Certain specific leases are also beyond the scope of the standard.

### *5. Has anything changed for lessors?*

IFRS 16 substantially carries forward the lessor accounting requirements of IAS 17. A lessor therefore continues to classify its leases as operating or finance leases and to account for these two types of leases differently. Intermediate lessors, however, face significant changes as a result of IFRS 16. 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.

### *6. Does IFRS 16 apply to service contracts?*

No. IFRS 16 does not apply to service contracts; nor does it change the way in which services are accounted for. This is a challenging area for those preparing financial statements as a lease and related services – such as maintenance of the asset – are often combined in a single contract. In such circumstances, the lessee will normally need to separate the contract into its lease and non-lease components. However, there is a practical expedient which permits an entity to elect to not separate non-lease components.

### *7. Have disclosure requirements changed for lessees?*

Yes. There are significant disclosure requirements with the objective of helping users better understand an entity's leasing activities and their impact on its financial position, financial performance and cash flows.

### *8. 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 – where it was common for entities to have a significant number of material off-balance sheet leases. Entities with significant leased premises are particularly affected.

### *9. How will this impact 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.

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.

### *10. Does the IFRS 16 definition of a lease have to be applied retrospectively?*

Applying the IFRS 16 lease definition retrospectively to all leases could be both challenging and time-consuming. The standard therefore provides a practical expedient that allows an entity to 'grandfather' its previous assessments of which contracts are leases or contain a lease. However, this does not mean that contracts previously identified as operating leases can stay off-balance sheet (subject to the exemptions described above).

### *11. Are there any other transition reliefs available to lessees?*

Lessees have the option of either full retrospective application or a modified retrospective approach. Whatever approach is taken must be applied consistently to all leases. If the modified retrospective approach is applied, the lessee does not restate its comparative amounts. Instead, the cumulative effect of initially applying the standard is taken to equity at the date of initial application ie, the beginning of the annual reporting period in which an entity first applies the standard.

### *12. Will FRS 102 be updated for IFRS 16?*

While harmonisation of FRS 102 with IFRS is a long-term aim, the FRC has indicated they will not be incorporating the principles of IFRS 16 into FRS 102 at this time. Further evidence-gathering and analysis needs to be undertaken by the FRC before they determine the appropriate timetable and approach to reflect the principles into FRS 102.

### *13. What is ICAEW doing to help companies make the transition to IFRS 16?*

The Financial Reporting Faculty will continue to produce a range of resources to guide members through the changes. A factsheet on IFRS 16 Leases is available which provides further information and practical tips. Additional guidance, including webinars, can be found at icaew.com/ifrs16. The faculty will continue to review the need for further information for ICAEW members.





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