BY
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IFRS 16 Leases - time for your Flight to Finally Land on the Balance Sheet!!

Robert Kirk provides us with an overview of the new leasing standard which will impact the balance sheet of all entities using IFRS.

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Sir David Tweedie, the former chairperson of the International Accounting Standards Board (IASB) always longed for the day when the aircraft operated by the airlines he flew would finally land on the balance sheets of those operators. He now has his wish. IFRS 16 *Leases* has finally been published albeit with a long transition period as it will only become compulsory for accounts commencing on or after the 1st January 2019.

Current Standard – IAS 17 Leases

At present IAS 17 has an artificial distinction between operating and finance leases with the former merely requiring the rental payments to be charged to profit and the latter requiring both an asset and corresponding liability to be reported on the Statement of Financial Position (SOFP).

In practice, there is a huge amount of subjectivity involved in making the distinction between the two types of leases and this has led to most leases being classified as operating as clearly it reduces the gearing impact of having lower borrowings on the SOFP.

Unfortunately it means that under IAS 17 many leases involving large assets such as aircraft and property are not being fairly reported on the SOFPs of those companies having control over the use of those assets. The current standard therefore fails to reflect the substance of these arrangements.

As a result the United States' Financial Accounting Standards Board (FASB) and the IASB have been working on a revised standard to replace the existing requirements in IAS 17 and its US equivalent. Unfortunately the two bodies have not emerged with identical standards as the US have adopted the dual model for former operating leases of property whereas the IASB have adopted a single model for dealing with all leases on the grounds of reducing both the cost of implementation and complexity.

The New Definition of a Lease

Both the IASB and FASB have agreed on a new definition of a lease as follows:

> *A contract is, or contains, a lease if it conveys the **right to control** the use of **an identified asset** for **a period of time** in exchange for consideration. [IFRS 16:9]*

A company must assess 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.

The new definition effectively moves the 'battlelines' away from operating versus finance leases (as there is no longer that distinction in IFRS 16) to whether the contract is merely a service contract and not a contract providing the lessee with control over an asset.

The IASB has published a number of illustrative examples to aid preparers make that distinction but undoubtedly similar subjective judgments to IAS 17 will have to be taken. Service contracts are treated exactly as operating leases and expensed to profit and loss.

One example might help to illustrate this problem:

> A retailer is given a contract to rent specific space in a shopping mall whilst another a contract to rent non specific space decided by the owners which could be moved to another location at the legal owners whim. The former is a lease contract but the latter is a service contract and only the former would record an asset and liability on balance sheet.

A lessee can apply IFRS 16 to a portfolio of leases with similar characteristics if its effect would not be materially different from applying the standard to individual leases within that portfolio.

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Separating Components of a Contract

For a contract that contains a lease component and additional lease and non-lease components, such as the lease of an asset and the provision of a maintenance service, lessees must allocate the consideration payable on the basis of the relative stand-alone prices, which has to be estimated if observable prices are not readily available. However, as a practical expedient, a lessee may elect, by class of underlying asset, not to separate the non-lease components from lease components and instead account for all components as a lease.

Exclusions from Lease Accounting

The new standard recognises that the cost of compliance could be excessive for small lease agreements so IFRS 16 has introduced two exceptions to having to use the normal lease accounting rules.

Leases of assets and liabilities for

(a) short-term leases (ie leases of 12 months or less) and

(b) leases of low-value assets (for example, a lease of a personal computer)

These will continue to be expensed through profit and loss

Lease Accounting under IFRS 16

For those familiar with finance lease accounting there is very little difference between IAS 17 and IFRS 16 in terms of the accounting treatment. It does refer to the fact that lessees are given a right to use a leased asset but it will be analysed under property etc and not intangible assets.

Lessees will:

(a) recognise lease assets (as a separate line item or together with property, plant and equipment) and lease liabilities in the balance sheet initially measured at the present value of unavoidable lease payments;

(b) recognise depreciation of lease assets and interest on lease liabilities in the income statement; and

(c) present the amount of cash paid for the principal portion of the lease liability within financing activities, and the amount paid for the interest portion within either operating or financing activities, in the cash flow statement.

The inclusion of unavoidable payments means that a lessee must consider the non-cancellable period for which a lessee has the right to use an underlying asset, plus:

(a) periods covered by an extension option if exercise of that option by the lessee is *reasonably certain*; and

(b) periods covered by a termination option if the lessee is *reasonably certain* not to exercise that option

Thus the calculations are not the same as IAS 17 (for finance leases) as variable elements are currently excluded in that standard.

In order to assess *reasonably certain* – lessees must consider all facts and circumstances to create an economic incentive to exercise or not exercise an option.

To help in the transition period a lessee can either apply IFRS 16 with full retrospective effect or alternatively not restate comparative information but recognise the cumulative effect of initially applying IFRS 16 as an adjustment to opening equity at the date of initial application

For those readers who are involved with US GAAP unfortunately the above approach only applies to non property leases. In the US former operating property leases will be capitalised similarly initially. However, subsequently, there will be no depreciation charge nor interest expense. Instead the actual rental paid/accrued will be charged to profit. (the dual model approach).

The IASB have illustrated the differences between the two approaches in the following table:

			IFRS 16	US GAAP model[5]	
				Former ON balance sheet leases	Former OFF balance sheet leases
Balance sheet					
1	*Recognition*	All leases on balance sheet	✓	✓	✓
		Exemption for short-term leases	✓	✓	✓
		Exemption for leases of low-value assets	✓	–	–
2	*Measurement*	Lease liabilities on a discounted basis	✓[6]	✓[6]	✓[6]
		Initial lease asset = lease liability	✓	✓	✓
3		Depreciation of lease assets	Typically straight-line	Typically straight-line	Typically increasing[7]
4	*Presentation*	Lease liabilities	IAS 1[8]	Separate presentation (from former off balance sheet leases)	Separate presentation (from former on balance sheet leases)
5		Lease assets	PPE *or* own line item[9]		
Income statement					
6		Operating costs	Depreciation	Depreciation	Single expense
		Finance costs	Interest	Interest	–
Cash flow statement					
7		Operating activities	Interest[10]	Interest	Interest and principal
		Financing activities	Principal	Principal	–

Source: IASB: Project summary and feedback statement IFRS 16 Leases January 2016

Disclosures in the Notes

For material leases, IFRS 16 like IAS 17, requires a company to provide a breakdown of the expense related to leases in the notes to the financial statements. However, unlike IAS 17, a company is also required to provide information about lease assets by class of asset being leased, and the total amount of lease cash outflows. This information is required to provide a complete picture of a company's leasing activities to investors.

In addition, IFRS 16 relies on the requirements of IFRS 7 Financial Instruments: Disclosure for the disclosure of a maturity analysis of lease liabilities. This means that the same approach a company takes to analyse its other financial liabilities should also apply to lease liabilities.

IFRS 7 requires a company to use judgement in determining which time bands should be disclosed to provide useful information to investors, whereas IAS 17 prescribed time bands of less than one year, between one and five years, and more than five years.

For leases that contain complex features (for example, variable lease payments, extension options and residual value guarantees), IFRS 16 also requires a company to disclose material company-specific information that is not covered elsewhere in the financial statements (if any).

Lessor Accounting

There is little change for lessors. Applying IFRS 16, a lessor continues to classify its leases as operating leases or finance leases and to account for those two types of leases differently. The IASB were not overly concerned about lessor accounting and it was felt that the cost of making any substantial changes to lessor accounting would outweigh the benefits at present. However, IFRS 16 does require lessors to provide enhanced disclosures about their risk exposure, particularly residual value risk.

It will, of course result in the same asset being recorded twice - once in the lessee's SOFP but also in the SOFP of the lessor.

The likely Impact of IFRS 16

The IASB have carried out extensive fieldwork on the likely impact of the new standard. Certainly some sectors will be considerably effected – the airlines and retail industries in particular.

At the same time as the publication of IFRS 16 in January 2016 the IASB published a 104 page effects analysis to give readers some idea of the likely impact of the standard.

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The IASB provided an excellent summary of the likely impact on profit and loss as shown:

	IAS 17		IFRS 16
	Finance leases	Operating leases	All leases
Revenue	x	x	x
Operating costs *(excluding depreciation and amortisation)*	---	*Single expense*	---
EBITDA			⇧⇧
Depreciation and amortisation	*Depreciation*	---	*Depreciation*
Operating profit			⇧
Finance costs	*Interest*	---	*Interest*
Profit before tax			⇔

Source: IASB: Effects Analysis IFRS 16 Leases January 2016

From the above it can be seen that the change in accounting treatment for former operating leases could actually increase the EBITDA ratio as previously the rental expense would have been deducted in arriving at EBITDA but the new depreciation and interest charges will be excluded. Overall, however, there will be limited impact on profits before tax.

In terms of its impact on the cash flow statement instead of showing the rental payments as operating cash outflows the repayment to the lessor will be split between interest paid and the repayment of the loan which will increase financing outflows. The interest element can go to either operating or financing outflows.

The IASB has also published an illustrative example concerning the possible impact on an average retailer as follows:

> Retailer is a food retailer with thousands of stores, both large and small. Retailer leases a large proportion of its retail space using off balance sheet leases. Those leases are predominantly longer term leases for between 15 and 30 years.

Common ratios
(calculated based on reported information without adjustment)

	IAS 17	IFRS 16
Financial leverage		
[A] Debt (borrowings plus lease liabilities) to EBITDA	3.1	3.9
[B] Interest cover (EBITDA to net finance costs)	7.4	5.4
Performance		
[C] ROCE (Return On Capital Employed)	7.0%	6.7%

[EBITDA: operating profit plus depreciation and amortisation. Depreciation and amortisation is 3,601 (applying IAS 17) and 5,334 (applying IFRS 16).]

[ROCE: Return = operating profit; Capital employed = equity plus borrowings plus lease liabilities]

Illustration 2: Retailer

Balance sheet	**IAS 17**	**IFRS 16**
Property, plant and equipment	44,521	44,521
Lease assets	958	18,757
Other	26,703	26,703
Total non-current assets	72,182	89,981
Total current assets	38,086	38,086
Total assets	**110,268**	**128,067**
Borrowings	22,533	22,533
Lease liabilities	697	21,233
Other liabilities[81]	57,714	57,264
Total liabilities	**80,944**	**101,030**
Equity	29,324	27,037
Total liabilities and equity	**110,268**	**128,067**
Income statement	**IAS 17**	**IFRS 16**
Revenue and other income	164,181	164,181
Cost of sales	(141,937)	(140,764)
Gross profit	**22,244**	**23,417**
Operating costs	(16,222)	(16,222)
Operating profit	**6,022**	**7,195**
Net finance costs	(1,293)	(2,393)
Profit before tax	**4,729**	**4,802**
Income tax	(1,161)	(1,161)
Profit for the year	**3,568**	**3,641**
Cash flow statement	**IAS 17**	**IFRS 16**
Operating activities	5,312	7,117
Investing activities	(3,283)	(3,283)
Financing activities	(2,236)	(4,041)
Total cash outflow	**(207)**	**(207)**

Source: IASB: Effects Analysis IFRS 16 Leases January 2016

This illustration clearly shows the impact on the SOFP and one can see the dramatic increase in borrowings and its effect on debt/ equity ratios. Many financial analysts already try to prepare their own pro forma SOFPs by attempting to show operating leases on their revised SOFPs so they may already have a firm idea of the overall impact of the new standard.

Effective Date and Transition

Reporting entities are required to apply IFRS 16 for all annual reporting periods beginning on or after 1 January 2019. However, earlier application is permitted if IFRS 15 Revenue from Contracts with Customers is also applied.

Conclusion

This new standard is probably one of the most controversial of international financial reporting standards published by the IASB. There are fears within the leasing sector that it could have severe economic consequences on their businesses and for many lessees it could have major repercussions on their gearing and borrowings agreements. It may result in the need to renegotiate of banking and other covenants.