Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

Lease accounting will never be the same again – IFRS 16 is finally out

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Introduction

On 13 January 2016, the International Accounting Standards Board (IASB) published IFRS 16 *Leases*, completing its long-running project to overhaul lease accounting. IFRS 16 will have a substantial impact on financial statements of lessees around the globe.

The new Standard, which is effective for accounting periods beginning on or after 1 January 2019, requires lessees to account for leases 'on-balance sheet' by recognising a 'right of use' asset and a lease liability. It will affect most companies that report under IFRSs and are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment. For many other businesses, however, exemptions for short-term leases and leases of low value assets will reduce the impact. The table below summarises the main changes at a glance.

	Main changes
Who is affected?	• entities that lease assets as a lessee or a lessor

What's the impact on lessees?	• all leases will be accounted for 'on-balance sheet', other than short-term and low value asset leases
	• lease expense will typically be 'front-loaded'
	• lease liability will exclude:
	    o option periods unless exercise is reasonably certain
	    o contingent payments that are linked to sales/usage

What's the impact on lessors?	• only minor changes from the current Standard, IAS 17 *Leases*

	Main changes
Are there other changes?	• a new definition of a lease may result in some arrangements previously classified as leases ceasing to be so, and vice versa • new guidance on sale and leaseback accounting • new and different disclosures
When are the changes effective?	• annual reporting periods beginning on or after 1 January 2019 • various transition reliefs • early application is permitted if IFRS 15 *Revenue from Contracts with Customers* is applied

Scope

IFRS 16 applies to all leases for both the lessee and lessor, except for a few scope exclusions. These exclusions are similar to IAS 17.

Definition of a lease

IFRS 16 largely retains the definition of a lease in IAS 17 but changes the guidance on how to apply it. This refinement was necessary as the removal of 'off-balance sheet' operating leases created a greater need for distinguishing a lease and a service contract.

In practice, the changes to the guidance on the definition in IFRS 16 are not expected to affect conclusions about whether contracts contain a lease for the vast majority of contracts. In addition, the new definition will only apply to new lease contracts and therefore there will be no need for businesses to reassess their existing leases when transitioning to IFRS 16.

The new lessee accounting approach

Subject to the optional accounting simplifications discussed below, a lessee will be required to recognise its leases on the balance sheet. This involves recognising:

- a 'right-of-use' asset and
- a lease liability.

The lease liability is initially measured as the present value of future lease payments. For this purpose, lease payments include fixed, non-cancellable payments for lease elements, amounts due under residual value guarantees, certain types of contingent payments and amounts due during optional periods to the extent that extension is 'reasonably certain'. The initial measurement of the right-of-use asset is based on the lease liability, with adjustments for any prepaid rents, lease incentives received and initial direct costs incurred.

In subsequent periods, the lease liability is accounted for similarly to a financial liability using the effective interest method. The right-of-use asset is accounted for similarly to a purchased asset and depreciated or amortised.

Optional accounting simplifications

IFRS 16 provides important reliefs or exemptions for:

- short-term leases (a lease is short-term if it has a lease term of 12 months or less at the commencement date. However, a lease cannot quality if it contains a purchase option. The use of this exemption is an accounting policy choice that must be made consistently for each class of underlying asset) and
- low-value asset leases (the assessment of value is based on the absolute value of each leased asset when new and therefore requires judgement. In the Basis for Conclusions which accompanies the Standard, however, the IASB notes that they had in mind leases of assets with a value when new of around US$5,000 or less. Accordingly, leases of assets such as low value IT equipment, office equipment and furniture would typically qualify, while vehicle leases would not. The use of this exemption is an accounting policy choice that can be made on a lease-by-lease basis).

If these exemptions are used, the accounting is similar to operating lease accounting under the current Standard IAS 17 *Leases*. Lease payments are recognised as an expense on a straight-line basis over the lease term or another systematic basis (if more representative of the pattern of the lessee's benefit).

Presentation

IFRS 16 requires lessees to either present right-of-use assets separately from other assets on the balance sheet or disclose separately in the notes. Likewise, lessees are required to either present lease liabilities separately from other liabilities on the balance sheet or disclose separately in the notes. In the income statement, lessees need to show interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. In the statement of cash flows, cash payments for the principal portion of the lease liability are presented within financing activities, cash payments for the interest portion are presented either within operating or financing activities (in accordance with IAS 7 *Statement of Cash Flows*).

Lessor accounting

IFRS 16's requirements for lessor accounting are similar to IAS 17's. In particular:

- the distinction between finance and operating leases is retained
- the definitions of each type of lease, and the supporting indicators of a finance lease, are substantially the same as IAS 17's
- the basic accounting mechanics are also similar, but with some different or more explicit guidance in a few areas. These include variable payments; sub-leases; lease modifications; the treatment of initial direct costs; and lessor disclosures.

Disclosure

IFRS 16 requires different and more extensive disclosures, both quantitative and qualitative, about leasing activities than IAS 17. The objective of the disclosures is to provide information that enables users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases.

Effective date and transition

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Early application is permitted for entities that apply IFRS 15 at or before the date of initial application of IFRS 16.

In terms of transition, IFRS 16 provides lessees with a choice between two broad methods:

- full retrospective application – with restatement of comparative information in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
- partial retrospective application – without restating comparatives. Under this approach the cumulative effect of initially applying IFRS 16 is recognised as an adjustment to equity at the date of initial application. If a lessee chooses this method, a number of more specific transition requirements and optional reliefs also apply.

US Convergence

The new leases standard started out as a joint project between the IASB and the US Financial Accounting Standards Board (FASB). However, as the project progressed the two Boards have reached different decisions in some areas. The outcome is that the new leasing standard in the US will differ from IFRS 16 in some aspects. FASB is expected to issue its new leases standard in early 2016.

Australian context

The Australian Accounting Standards Board (AASB) is expected to consider the issuance of the equivalent Australian Standard, AASB 16 *Leases*, at its 23-24 February board meeting.

Business impact

Bringing all leases on-balance sheet is controversial. The IASB has therefore made compromises to reduce the controversy, in particular exemptions for short-term and low value asset leases. As a result, businesses that lease only assets such as printers and laptops will face only limited impact. For businesses that lease 'big-ticket' assets, such as property and high-value equipment, this will however be a major change. Industries such as aviation, retail, travel and leisure, and transport are expected to be affected most by IFRS 16.

For companies with material off balance sheet leases, the most significant effect of IFRS 16 on the balance sheet will be an increase in lease assets and lease liabilities. Accordingly, key financial ratios derived from a company's reported assets and liabilities are expected to change (for example, leverage ratios). The changes could also result in some companies no longer complying with debt covenants when IFRS 16 is applied if those covenants are linked to a company's IFRS financial statements without adjustments for off balance sheet leases.

The cost of implementing IFRS 16 is likely to be significant for companies with material off balance sheet leases, however the significance of the cost will vary depending on the size of a company's lease portfolio, the terms and conditions of those leases and the systems already in place to account for leases applying IAS 17.

Whatever your views on the new Standard, businesses would be well-advised to start an impact analysis sooner rather than later.