

## Monthly Newsletter

**IFRS 16 replaces IAS 17 and all related interpretations, and completes the IASB's project to improve the financial reporting of leases.**

### **Why a new standard?**

IAS 17 made it difficult for investors and others to get an accurate picture of a company's lease assets and liabilities, particularly for industries such as airline, retail and transport sectors. Many entities also had lease commitments that did not appear on their balance sheets.

The somewhat arbitrary distinction between finance and operating leases in the books of lessees meant that investors and others had to estimate the effects of a company's off balance sheet lease obligations, which in practice often led to overestimating the liabilities arising from those obligations.

### **The definition of a lease**

IFRS 16 defines a lease as a contract that conveys to the customer ("Lessee") the right to use an asset for a period of time in exchange for consideration. A company 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.

### **Key provisions**

For a lessee, IFRS 16 eliminates the classification of leases as either operating leases or finance leases. All leases are now treated the same way similar to finance leases as per IAS 17. Lease are capitalised by recognising the present value of lease payments and showing them as assets. A financial obligation is also recognised, representing the entity's obligation to make future lease payments.

For the lessor accounting requirements as per IAS 17 will be substantially carried forward. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently.

### **Exemptions**

A company does not have to recognise assets and liabilities for leases with a duration of 12 months or less, or leases of low value assets.

**The most significant effect of this standard will be an increase in lease assets and financial liabilities. This will alter key ratios for those companies with significant off balance sheet leases.**

### **Changes to the balance sheet**

The new standard will affect both the balance sheet and related ratios, such as debt/equity ratios. Depending on the particular industry and the number of lease contracts previously classified as

operating leases under IAS 17, the new approach will result in a significant increase in debt on the balance sheet.

### **Changes to the income statement**

For companies with significant IAS 17 operating leases, the expense related to the straight lining of those leases will be replaced with a depreciation charge included within operating costs, and an interest expense on lease liabilities. Due to the fact that the interest charges will decrease as the financial liability decreases, the total expense relating to that lease decreases as the individual lease matures.

### **Changes to the cash flows**

Changes in accounting requirements do not change the cash flows, however the classification of these flows will change within the cash flow statement. Under IAS 17, expenses relating to leases were classified as operating expenses and included as part of operating activities in full. Under IFRS 16, these principal repayments will be classified as financing activities, and only the interest payments may be classified as operating activities (if the entity's policy is to present them as such), typically these would also be financing activities. Payments for short-term or low value leases are presented within operating activities.

### **Sale and leaseback transactions**

An entity must apply the requirements of IFRS 15 for determining when a performance obligation is satisfied to determine when the transfer of an asset is accounted for as a sale.

If an asset transfer satisfies IFRS 15's requirements to be accounted for as a sale the seller measures the right-of-use asset at the proportion of the previous carrying amount that relates to the right of use retained. Accordingly, the seller only recognises the amount of gain or loss that relates to the rights transferred to the buyer.

### **Effective date**

IFRS 16 is effective from 1 January 2019. A company can choose to early adopt, but only if it also applies IFRS 15 *Revenue from contracts with customers*.

### **Start preparing now**

Entities should ensure that they have begun to implement systems and processes to identify all lease contracts, and to determine their what constitutes low value in the industry and country, as well as to capture the information needed to determine the measurement of the right-of-use asset and the lease liability and to consider the new disclosure requirements to come.