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INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) 16: LEASES

IFRS 16 Leases was issued on 13 January 2016; it replaces IAS 17 Leases. The new Standard is effective from 1 January 2019: early application is permitted, provided the recently issued revenue Standard, IFRS 15 Revenue from Contracts with Customers is also applied. IFRS 16 requires all leases to be reported on a company's balance sheet as assets and liabilities.

For IASB, the issuance of IFRS 16 Leases, completes a convergence project that resulted in similar conclusions in some areas of lease accounting, but some differences in accounting for lessees. The US Financial Accounting Standards Board's (FASB's) leases standard is also complete and is in production, with publication expected in February.

Both boards agreed to substantially carry forward the existing accounting requirements for lessors. But for lessees, IASB decided on a single model for all lease recognition, while FASB has decided on a dual model.

Under FASB's model, lessees will account for most existing capital leases as finance leases, recognizing amortisation of the right-of-use asset separately from interest on the lease liability, while most existing operating leases will be accounted for by lessees as operating leases, recognising a single total lease expense. IASB's model requires lessees to account for all leases as finance leases, with amortisation of the right-of-use asset recognised separately from interest on the lease liability.

IFRS 16 defines a lease as a contract

that conveys to the customer, the 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. The requirements relating to the definition of a lease in IFRS 16 have been changed somewhat from those in IAS 17 in response to feedback received. However, those changes are not expected to affect conclusions about whether contracts contain a lease for the vast majority of contracts: in other words, a lease under IAS 17 is generally expected to be a lease under IFRS 16.

IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently.

For lessees, IFRS 16 states that all leases result in the lessee obtaining the right to use an asset at the start of the lease and, if lease payments are made over time, also obtaining financing. IFRS 16 eliminates the classification of leases as either operating leases or finance leases for a lessee, as required by IAS 17. Instead all leases are treated in a similar way to finance leases applying IAS 17: IFRS 16 introduces a single lessee accounting model. Applying that model, a lessee is required to recognise: (a) assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value, for example, a lease of a personal computer; and (b) depreciation

of lease assets separately from interest on lease liabilities in the income statement. IFRS 16 does not require a company to recognize assets and liabilities for leases of 12 months or less. Leases are 'capitalised' by recognising the present value of the lease payments and showing them either as lease assets (right-of-use assets) or together with property, plant and equipment. If lease payments are made over time, a company also recognises a financial liability representing its obligation to make future lease payments. For companies with material off balance leases, IFRS 16 changes the nature of expenses related to those leases – that is, in the books of the lessee. IFRS 16 replaces the typical straight-line operating lease expense for those leases applying IAS 17 with a depreciation charge for lease assets (included within operating costs) and an interest expense on lease liabilities (included within finance costs). This change aligns the lease expense treatment for all leases. Although the depreciation charge is typically even (that is, if the straight line method of depreciation is used), the interest expense reduces over the life of the lease as lease payments are made. This results in a reducing total expense as an individual lease matures. The difference in the expense profile between IFRS 16 and IAS 17 is expected to be insignificant for many companies holding portfolio of leases that start and end in different reporting periods.

The changes in accounting required by IFRS 16 do not change the amount of cash transferred between the parties to a lease.

Consequently, IFRS 16 will not have any effect on the total amount of cash flows reported. However, IFRS 16 is expected to have an effect on the presentation of cash flows related to former off balance sheet leases.

IFRS 16 is expected to reduce operating cash outflows, with a corresponding increase in financing cash outflows (as required by paragraph 32 of IAS 7 Statements of Cash Flows) compared to the amounts reported applying IAS 17. This is because, applying IAS 17, companies presented cash outflows on former off balance sheet leases as operating activities: applying IFRS 16, principal repayments on all lease liabilities are included within financing activities. Interest payments can also be included within financing activities, depending on the way the company has chosen to classify this line item.

IFRS 16 does not change accounting for services. Although leases and services are often combined in a single contract, amounts related to services are not required to be reported on the balance sheet. IFRS 16 is required to be applied only to leases, or lease components of a contract.

FASB and the IASB agreed on the key issue of bringing leases onto balance sheets, on the definition of a lease, and how lease liabilities should be measured. The boards initiated the project to improve lease accounting in response to concerns about a lack of transparency about companies' lease obligations.

In 2005, the US Securities and Exchange Commission estimated that US public companies may have had approximately \$1.25 trillion of off-balance-sheet leases. IASB estimates that listed companies around the world currently have around US\$3.3 trillion of lease commitments, that is future payments that

have to be made in respect of leases, and that over 85% of those commitments do not appear on companies' balance sheets. IASB estimates that almost half the listed companies using IFRS or US GAAP will be affected by these lease accounting changes: analysis of some retailers that have gone into liquidation or through a reorganization shows that the value of off balance sheet leases was almost 66 times the value of on balance sheet debt.

"These new accounting requirements

beginning after 15 December 2018. For private companies, FASB's standard will take effect for annual periods beginning after 15 December 2019.

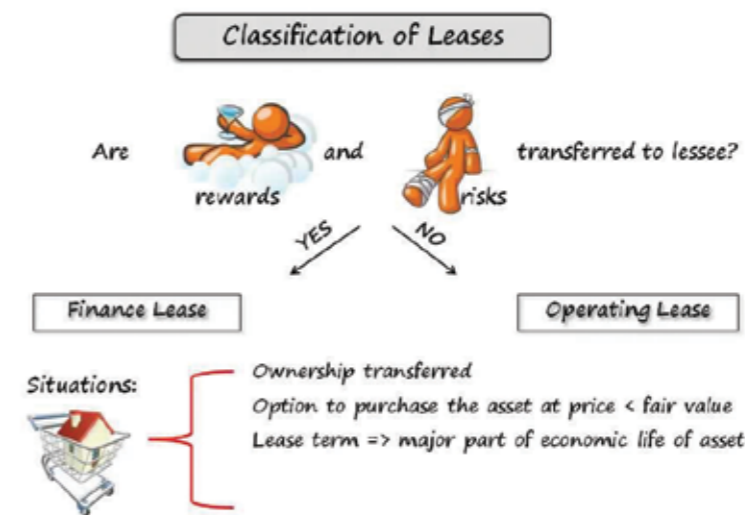
IASB points out that the biggest change introduced by IFRS 16 is that leases will be brought onto companies' balance sheets, increasing the visibility of their assets and liabilities. IFRS 16 removes the classification of leases as either operating leases or finance leases, for the lessee – the lease customer – treating all leases as finance leases.

IASB claims that the benefits of the new standard are that there will be a more faithful representation of a company's assets and liabilities, there will be improved comparability between companies that lease and companies that borrow to buy assets and the new IFRS removes the need for most investors, credit rating agencies and others to make adjustments to balance sheets – analysis shows that common-practice adjustments often over-estimate, but sometimes under-estimate, the value of off balance sheet leases.

IASB received over 1,700 comment letters on the one Discussion Paper and the two Exposure Drafts that it published during the standard-setting process. IASB indicates that some industry sectors will be

more affected by the new Standard than others. Airlines, retailers and travel and leisure companies are expected to be most affected: it was found that future payments of off balance sheet leases in these industries equate to almost 30% on average of the total assets on balance sheets. At the moment, there are also considerable variations between companies within an industry sector: for some airlines, the value of their off balance sheet leases is equivalent to more than 100% of the value of the airline's total assets.

You have plenty of time to adjust to the new thinking of IFRS 16 Leases.



These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company's often-substantial lease obligations