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Heads Up
Gearing up for change: IFRS 16 *Leases* finally issued

Contents

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"In summary"

On 13 January 2016, the International Accounting Standards Board (IASB) issued IFRS 16 *Leases* (the new Standard). The pervasive use of leases means we expect the changes to have an impact for most Australian entities and especially those with operating leases of property, aircraft, manufacturing equipment, mining equipment, and distribution and logistics services.

The new Standard is effective for reporting periods beginning on or after 1 January 2019, which means that for many Australian entities the changes will be effective for 30 June 2020 year-ends. Early application is permitted only if the entity also applies the new Revenue Standard, IFRS 15 *Revenue from Contracts with Customers*.

The new Standard introduces three main changes:
1. Enhanced guidance on identifying whether a contract contains a lease.
2. A completely new lease accounting model for lessees that requires lessees to recognise all leases on balance sheet, except for short-term leases and leases of low value assets.
3. Enhanced disclosures.

Lessor accounting will not change significantly.

More specifically, the new lessee model:
- **Balance sheet:** Initially recognises lease assets and liabilities on the balance sheet at the present value of future lease payments.
- **Income statement:** Recognises amortisation of lease assets and interest on the lease liabilities over the lease term. The overall effect on profit will depend on the portfolio of leases an entity holds. However in the earlier years of a lease, it is expected that the profit will be lower as a result of higher interest accruing on the lease liability (akin to an amortising mortgage).
- **Cash flow statement:** Separates the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

As a result, the impacts of the new lessee model could be significant and may extend beyond the financial reporting implications, to areas such as gearing and loan covenants, systems and internal controls, remuneration schemes and drafting of contracts.

Early planning and establishment of proper implementation teams and plans may be necessary to ensure the Standard is implemented in a cost-effective manner.

In Australia, the Australian Accounting Standards Board (AASB) has yet to issue the Australian equivalent of this Standard. It is expected that the AASB will issue the Australian Accounting Standard that incorporates IFRS 16 without modification, as soon as practicable.

Introduction

After several years of consultation and debate the new leases Standard has finally been issued. The new model requires lessees to capitalise leases by initially recognising a lease asset and lease liability for the present value of future lease payments. This has been very controversial because of the impact on gearing and the potential cost of implementation which, in the eyes of some, exceeds the benefit.

The IASB however, believes that conceptually a lease provides the customer (lessee) leasing the assets with a right to use an asset and an obligation to make payments for that right. Users of financial statements also require greater transparency of the extent of off-balance sheet funding that has historically been obtained through leasing assets under operating leases. This publication provides a brief summary of the key changes of the new Standard.

Does a contract contain a lease?

Historically IFRIC 4 *Determining whether an Arrangement contains a Lease* (IFRIC 4) has provided guidance as to whether a contract contains a service or a lease. For example, where a customer contracts a logistics company to transport its products from one location to another, is this merely a transportation service or is the customer leasing the underlying truck?

This distinction was less important under the old standard because both operating leases and services were recognised off-balance sheet. However, with the new model all leases are captalised on balance sheet and therefore this distinction is important. Furthermore, a number of interpretational issues arose under IFRIC 4 and therefore the IASB has enhanced this guidance in the new Standard. While there are a number of similarities there are also a number of differences in the new guidance and therefore different conclusions could be reached. Entities will need to exercise careful judgement in assessing whether certain arrangements that have previously been viewed as service contracts are in fact leases under the new Standard.

The guidance on the definition of a lease is applicable to both lessees and lessors.

Lessee accounting model

Balance sheet

The new Standard requires a lessee to capitalise leases by recognising a right-of-use asset and a corresponding lease liability on the commencement date of the lease for all leases, except short-term and low value asset leases. Consequently, there is no longer a distinction between operating and finance leases for lessee accounting.

The lessee shall measure lease liabilities at the present value of future lease payments which shall include only economically unavoidable payments. Variable payments such as turnover rent or usage basis rentals are not included however, payments linked to an index or rate, such as the Consumer Price Index, are included based on the rate at the commencement date and remeasured when the cash flows change.

Lease liabilities will be presented on the balance sheet in accordance with the same requirements as for other financial liabilities.

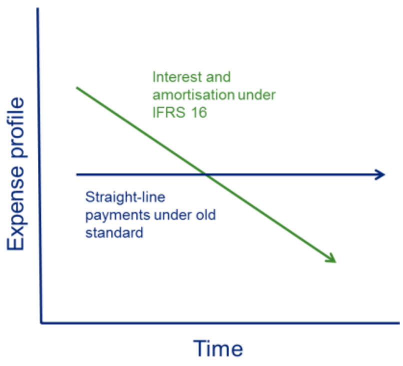
Initially lease assets shall be measured at the same amount as the lease liability. However, lease assets will also include costs directly related to entering into the lease. Incentives received before the commencement date of the lease from the lessor will be netted off against the asset. The lease asset will be amortised in a similar way to other assets such as property, plant and equipment.

Lease assets will be presented together with other owned assets based on the nature of the underlying asset (e.g. owned property, plant and equipment) or as a separate line item.

Short-term leases are those with a lease term of less than 12 months. Low value assets are items such as desktop and laptop computers, office furniture and telephones. Lessees can elect to continue to apply existing operating lease accounting to such leases by expensing the rental cost on a straight-line basis.

Income statement

Under the operating lease model in the current Standard (IAS 17 *Leases*), lease payments form part of operating expenses and are included in earnings before interest, tax, depreciation and amortisation (EBITDA). Under the new Standard the implicit interest in the lease liability shall be presented as part of finance cost (i.e. not part of EBITDA). Furthermore, the amortisation of the lease asset will also not form part of EBITDA. Therefore EBITDA will increase.



The overall effect on profit before tax will depend on the portfolio of leases an entity holds. However, in the earlier years of a lease, it is expected that profit before tax will be lower as a result of higher interest accruing on the lease liability.

Cash flow statement

The nature of the lease payments will be reflected in the cash flow statement by presenting:

- the principal portion of the lease liability cash flows as part of financing activities; and
- the interest portion of the lease liability in accordance with the IAS 7 *Statement of Cash Flows* requirements related to other interest paid i.e. either operating or financing.

Disclosures

The expanded disclosure requirements under the new Standard are likely to require entities to capture additional information, which in turn may drive the system and process changes that may be needed. For example, lessees will have to disclose quantitative information about the amortisation expense of the right-of-use assets, the interest expense on lease liabilities and the expenses relating to variable lease payments not included in lease liabilities. Lessees will also have to disclose qualitative information about a lessee's leasing activities to provide users with information that enables them to assess the amount, timing and uncertainty of cash flows arising from leases.

Transition

The new Standard provides a number of accounting policy choices, practical expedients and exemptions when transitioning from IAS 17. These choices could have a significant impact on the quantum of lease liabilities recognised on the balance sheet and interest and amortisation costs recognised in the income statement. Therefore, sufficient time should be allowed to properly analyse these options and make the most appropriate choices.

US GAAP

The US equivalent standard has been issued by the Financial Accounting Standards Board (FASB). Although the new Standard and the new FASB requirements have much in common they are not the same.

The main difference relates to leases that are currently classified as operating leases. Under the new FASB requirements, operating leases will also be recognised on balance sheet, measured in the same way as under the new Standard at initial recognition. However, a single lease expense will be recognised on a straight-line basis over the lease term. There is no separation of a finance cost and the entire lease expense is an operating expense. The related cash flows will be included in operating activities. In addition, the FASB model does not include a low value asset exemption. The FASB's requirements are also effective from 1 January 2019.

Australian-specific considerations

In Australia, the AASB is expected to issue the Australian Accounting Standard incorporating the new Standard without modification, as soon as practicable. Once the new Standard is issued in Australia, it will be mandatorily effective for reporting periods beginning on or after 1 January 2019, which means that for many Australian entities the changes will be effective for 30 June 2020 year-ends.

Call to action

The new Standard brings more than just accounting changes. Recognition of the lease liabilities on balance sheet will cause more attention to be focused on leases at Board and management levels. This includes consideration of whether the leases are the most effective means of obtaining the right to use the asset and whether such assets should be bought rather than leased.

Entities also need to consider a number of other commercial implications, such as:

- Systems requirements;
- Covenants on existing loans and borrowing arrangements;
- Drafting of existing legal agreements;
- Existing remuneration schemes, bonuses and share-based payments; and
- Education of stakeholders.

Although the effective date of the Standard is three years away, it is strongly recommended that entities use this intervening period to analyse the new requirements, consider the wider implications of the changes and consequently make any required changes to their systems and processes in order to meet the new requirements. Early planning and establishment of proper implementation teams and plans will be necessary to ensure the Standard is implemented in a cost-effective manner.

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