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Accounting Alert

Financial Reporting Standards

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IASB releases new Standard on leases

Executive summary

On January 13, 2016, the IASB released IFRS 16, *Leases*, completing its long-running project on lease accounting. IFRS 16 will require lessees to account for leases 'on-balance sheet' by recognizing a 'right to use' asset and a lease liability.

IFRS 16 also:

- changes the definition of a lease
- sets requirements on how to account for the asset and liability, including complexities such as non-lease elements, variable lease payments and option periods
- provides exemptions for short-term leases and leases of low value assets
- changes the accounting for sale and leaseback accounting
- introduces new disclosure requirements

The Standard is effective for periods on or after January 1, 2019, with early application permitted in certain circumstances.

Introduction

The IASB has published IFRS 16, *Leases,* completing its long-running project on lease accounting.

The new Standard, which is effective for accounting periods beginning on or after January 1, 2019, requires lessees to account for leases 'on-balance sheet' by recognizing a 'right of use' asset and a lease liability. It will affect most companies that report under IFRS 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 summarizes the main changes at a glance.

	Main Changes
Who's 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:
	  ○ option periods unless exercise is reasonably certain
	  ○ contingent payments that are linked to sales/usage

What's the impact on lessors?	• only minor changes from the current Standard, IAS 17, *Leases*
Are there other changes?	• a new definition of a lease will 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 periods beginning on or after January 1, 2019 • various transition reliefs • early application is permitted if IFRS 15, *Revenue from Contracts with Customers* is applied

Definition of a lease

Because the new lease accounting model brings many more leases 'on-balance sheet', the evaluation of whether a contract is (or contains) a lease becomes even more important than it is today.

Under IFRS 16, a lease is defined as: 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. A contract is, or contains, a lease if:

- fulfilment of the contract depends on the use of an identified asset; and
- the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

In practice, the main impact of IFRS 16's new definition and supporting guidance is likely to be on contracts that are not in the legal form of a lease but involve the use of a specific asset and may therefore contain a lease.

Lessee accounting

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

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

The lease liability is initially measure 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'.

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

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)
- low-value asset leases (the assessment of value is based on the absolute value of the leased asset when new and therefore requires judgment. 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).

If these exemptions are used, the accounting is similar to operating lease accounting under the current Standard IAS 17, *Leases*. Lease payments are recognized 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).

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

Effective date and transition

IFRS 16 is effective for annual periods beginning on or after January 1, 2019. Early application is permitted for entities that apply IFRS 15, *Revenue from Contracts with Customers*, at or before the date of initial application of this standard.

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 Esimates and Errors*
- *partial retrospective application* – without restating comparatives. Under this approach, the cumulative effect of initially applying IFRS 16 is recognized 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.

P&A Grant Thornton view

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 a limited impact. For businesses that lease 'big-ticket' assets, such as property and high-value equipment, this will however be a major change. Whatever your views on the new Standard, businesses would be well-advised to start an impact analysis sooner rather than later.

Questions about this communication should be referred to Mabel Comedia at extension 260 or Jerald Sanchez at extension 332.