FAREWELL TO ALL THAT

THE BIGGEST CHANGE TO ACCOUNTING AND REPORTING SINCE INTERNATIONAL ACCOUNTING STANDARDS BRINGS AN END TO OFF-BALANCE-SHEET LEASING ARRANGEMENTS – AND CORPORATES WILL NEED TO PREPARE. HENRY WILSON EXPLAINS

In January, the IASB issued IFRS 16, *Leases*, the long-awaited new accounting standard for leases. It supersedes IAS 17 and will be effective for annual reporting periods beginning on or after 1 January 2019. As anticipated, lessees will no longer distinguish between operating leases and finance leases, and will report leased assets on balance sheet, essentially treating all leases as finance leases.

Lessor accounting will be largely unchanged, aside from the impact of revised guidance on lease definition and certain additional disclosure requirements. Later this year, the IASB's equivalent body in the US, the FASB is expected to issue a new US accounting standard for leases, broadly aligned with IFRS 16, but retaining the distinction between operating leases and finance leases for profit-and-loss and cash-flow reporting.

Lease definition

IFRS 16 defines a lease as a contract that 'conveys the right to control the use of an identified asset for a period of time in exchange for consideration'. This is similar to the current definition, set out in IAS 17 and interpreted in IFRIC 4 (a document produced by the International Financial Reporting Issues Committee), but IFRS 16 provides new guidance on the concept of control as follows:

A customer has the 'right to control the use of an asset' if:
- the customer has the right to obtain substantially all of the economic benefits from use of the asset; and
- the customer has the 'right to direct the use of the asset'.

A customer has the 'right to direct the use of an asset' if:
- the customer has the right to direct how and for what purpose the asset is used; or
- decisions about how and for what purpose the asset is used are predetermined and:
  - the customer has the right to operate/direct operation of the asset; or
  - the customer designed the asset in a way that predetermines how and for what purpose it will be used.

An asset is an *identified asset* if it is explicitly or implicitly specified in the contract. An asset will not be an identified asset if the supplier has a right to substitute the asset, and exercising that right is both practically feasible and of economic benefit to the supplier.

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An identified asset must also be physically distinct; the floor of a building could be an identified asset, but not capacity in a pipeline.

As with IAS 17, certain types of leases are excluded, such as exploration leases and leases of intangible assets.

The vast majority of arrangements, which are currently classified as leases under IAS 17, are expected to be leases under IFRS 16.

Lease payments include: fixed (or in-substance fixed) payments; payments that vary with an index or benchmark rate; the cost of exercising a purchase or termination option if reasonably certain to be exercised; and expected payments under residual value (RV) guarantees.

Lease term is the non-cancellable period together with any periods covered by an extension option reasonably certain to be exercised by the lessee (or a termination option reasonably certain not to be exercised).

Reporting under IFRS 16

Under the new standard, leases will be reported on balance sheet as a right-of-use asset ('lease asset') and a lease liability. For leases of low-value items (indicative threshold $5,000) and leases whose term is one year or less, lessees may elect *not* to apply the new requirements and simply recognise lease payments as an expense over the lease term.

Lease assets will be evaluated as the present value of the lease payments discounted at the interest rate implicit (IRI) in the lease, or, if that cannot be determined, by the lessee's incremental borrowing rate (IBR), being the rate of interest the lessee would pay to borrow over a term similar to the lease term and with a similar security.

Lease rental profit and loss will be split into depreciation and interest expense. Depreciation will typically be straight-line, but interest expense, and therefore, total lease expense, will be higher at the start of a lease and lower at the end (see Diagram 1, Chart 1). Over the term of a lease, the total expense recognised will equal total lease rental, and so for companies with a portfolio of evenly distributed leases, IFRS 16 will not impact lease expense.

Lease rental cash flows will be split into interest paid and debt repayment. At the start of a lease, when interest is higher, debt repayment will be less than depreciation and so the value of the lease asset will be less than the amount of lease liability. Only at the end of the lease will the value of the lease asset equal the value of the lease liability (see Diagram 1, Chart 2). So, for companies with a portfolio of leases, at any point in time lease liabilities will exceed lease assets and equity will be reduced under IFRS 16.

Impact on key metrics

IFRS 16 will have a significant impact on the balance sheets of those companies with a material amount of lease commitments – for a sample of 14,000 listed companies, the ratio of the average present value of future lease payments to total assets was 5%, for airlines and retailers it was greater than 20%. The impact on key financial metrics is shown in Table 1, below.

Rating agencies already treat operating leases as financing and adjust cash flow and debt accordingly. IFRS 16 will allow lease commitments to be evaluated with greater precision, which for many companies will actually improve rating agency metrics.

DIAGRAM 1: LEASE RENTAL

Chart 1: Lease expense profile

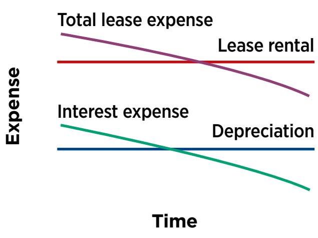
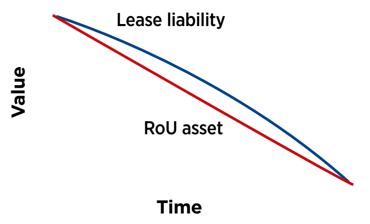


Chart 2: Lease asset and liability profile



Transition rules

IFRS 16 will apply from the date of initial application (DIA), which is the beginning of the first annual reporting period starting on or after 1 January 2019. For contracts that are already in place at DIA, companies may elect to continue to apply (to *all* such contracts) IAS 17/IFRIC 4 to identify leases.

Companies may also elect to apply, to their portfolio of leases, a full retrospective approach (ie as if IFRS 16 had been in place in prior reporting periods) or a modified retrospective approach with the cumulative effect of applying IFRS 16 recognised at the DIA.

Under the modified retrospective approach:

- Comparatives are not restated;
- Lease liabilities are measured at the DIA as remaining lease payments discounted at the lessee's IBR;
- Lease assets are measured at the lessee's choice and on a lease-by-lease basis at:
  - An amount equal to lease liability (adjusted for any prepayments or accruals); or
  - An amount calculated as if IFRS 16 had been in effect from lease commencement, but discounted using the lessee's IBR at the DIA; and
- Lessees may elect *not* to apply the new requirements to leases that end within 12 months of the DIA.

For practical reasons, many companies are likely to take the modified retrospective approach, calculating lease assets for the more significant leases as if IFRS 16 had applied from lease commencement, thereby reducing lease asset values and future depreciation. Under the modified approach, however, discounting (at IBR) is still likely to be lower than under the full retrospective approach (at IRI).

Actions required

The impacts of applying IFRS 16 are far-reaching and for many companies this will be the biggest change to accounting and reporting since the adoption of IFRS.

Discount rates will need to be derived for new and modified leases, and amounts expected to be paid under RV guarantees will need to be estimated. For leases whose rentals are linked to an index, lease liabilities will have to be recalculated when the index changes.

New processes will be needed, not just to collate the additional information required by IFRS 16, but also to ensure the completeness and accuracy of data that had previously been used only for stand-alone annual disclosure. New software will be needed to hold lease data centrally and to integrate it into general ledger accounting. Systems and processes will need to be able to deal with leases entered into during the transition period, reported initially under IAS 17 and then under IFRS 16.

For most leases, the new rules mean that keeping assets off balance sheet will no longer be a reason for leasing them; leasing will need to be justified in terms of RV risk transfer and/or the cost and availability of leasing as a competitive source of funding. By highlighting the financial commitments made through leasing, the new rules will also encourage companies to reduce these commitments, for example, through short-term leases or minimising the fixed element of lease payments.

Treasury departments will play a key role in modelling the impact of IFRS 16 on financial metrics; communicating these changes to investors, analysts and rating agencies; reviewing the impact on financial metrics in debt covenants; revisiting financial frameworks, including gearing targets; amending governance and planning procedures to accommodate lease capital expenditure and financial liabilities; and revising company-leasing strategies.

TABLE 1: IMPACT ON FINANCIAL METRICS

Metric	IAS 17	IFRS 16	Impact
RCOP	Lease rentals	Depreciation	Increase
Operating cash flow	Lease rentals	Interest paid	Increase
EBITDA	Lease rentals	Nil	Increase
Fixed assets	Nil	PV commitments	Increase
Financial liabilities	Nil	PV commitments	Increase
Equity			Decrease
Gearing			Increase

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