IFRS 16 – CHALLENGES AND SOME GENERAL ASPECTS OF NEW LEASE STANDARD

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The International Accounting Standards Board (IASB or Board) issued IFRS 16 Leases (IFRS 16 or the new standard), which requires lessees to recognise assets and liabilities for most leases. For lessors, there is little change to the existing accounting in IAS 17 Leases.

IFRS 16 is the result of the joint project initiated by the IASB together with the U.S. national standard-setter, the Financial Accounting Standards Board (FASB), to address concerns raised by users of financial statements in respect of reduced comparability between financial statements due to the very different accounting applied to operating and finance leases and limitations in the information provided on operating leases and on entities’ exposure to risks arising from lease arrangements.

To address those concerns, the two boards decided to develop a new approach to lessee accounting that requires a lessee to recognise assets and liabilities for the rights and obligations created by leases (with some limited exceptions) and to enhance the required disclosures on leases.

The project’s original aim was the production of a converged IFRS and U.S. GAAP standard. However, the IASB and FASB reached different conclusions on a number of issues including the recognition and presentation of expenses by lessees. As a result, the FASB’s leasing standard (due for publication early in 2016) will differ from IFRS 16 in several respects.

The new standard will be effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 Revenue from Contracts with Customers, has been applied, or is applied at the same date as IFRS 16.

Leasing is an important and widely used financing solution. It enables companies to access and use property and equipment without incurring large cash outflows at the start.

It also provides flexibility and enables lessees to address the issue of obsolescence and residual value risk. In fact sometimes, leasing is the only way to obtain the use of a physical asset that is not available for purchase.

Under IAS 17, lessees account for lease transactions either as operating or as finance leases, depending on complex rules and tests which, in practice, use ‘bright-lines’ resulting in all or nothing being recognised on balance sheet for sometimes economically similar lease transactions.
If the lease was classified as operating, then the lessees did not show neither asset nor liability in their balance sheets – just the lease payments as an expense in profit or loss.

But, some operating leases were non-cancellable, and therefore, they represented a liability (and an asset) for the lessees. This liability was hidden from the readers of the financial statements, as it was not presented anywhere.

There were disclosures in the notes to the financial statements were mandatory, but frankly – who, except for auditors, ever reads the notes to the financial statements?

New IFRS 16 removes this discrepancy and puts most leases on balance sheet. The impact on a lessee’s financial reporting, asset financing, IT, systems, processes and controls is expected to be substantial. Many companies lease a vast number of big-ticket items, including cars, offices, power plants, retail stores, cell towers and aircraft.

Therefore, lessees will be greatly affected by the new leases standard. The lessors’ accounting largely remains unchanged. However they might see an impact to their business model and lease products due to changes in needs and behaviours.

Impact on lessee:

- The new standard will affect virtually all commonly used financial ratios and performance metrics such as gearing, current ratio, asset turnover, interest cover, EBITDA, EBIT, operating profit, net income, EPS, ROCE, ROE and operating cash flows. These changes may affect loan covenants, credit ratings and borrowing costs, and could result in other behavioural changes. These impacts may compel many organisations to reassess certain ‘lease versus buy’ decisions.

- Balance sheets will grow, gearing ratios will increase, and capital ratios will decrease. There will also be a change to both the expense character (rent expenses replaced with depreciation and interest expense) and recognition pattern (acceleration of lease expense relative to the recognition pattern for operating leases today).

- Entities leasing ‘big-ticket’ assets – including real estate, manufacturing equipment, aircraft, trains, ships, and technology – are expected to be greatly affected.

- The cost to implement and continue to comply with the new leases standard could be significant for most lessees. Particularly if they do not already have an in-house lease information system.

Impact on lessor
• Lessees and lessors may need to consider renegotiating or restructuring existing and future leases.
• Business and legal structures supporting leases should also be reassessed to evaluate whether these continue to be effective;
• Lessor accounting remains largely unchanged from IAS 17 however, lessors are expected to be affected due to the changed needs and behaviours from customers which impacts their business model and lease products.

Scope of new standard
The new Lease Standard applies to all leases, including leases of right of use assets in a sublease, with the exception of specific items covered by other standards, namely:

• leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
• contracts within the scope of IFRIC 12 Service Concession Arrangements;
• for lessors, licences of intellectual property within the scope of IFRS 15 Revenue from Contracts with Customers; and
• for lessees, leases of biological assets within the scope of IAS 41 Agriculture and rights held under licensing agreements within the scope of IAS 38 Intangible Assets for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Lessees are permitted, but not required, to apply IFRS 16 to leases of other intangible assets.

However, the definition of a lease is different from the current IFRIC 4 guidance and might result in some contracts being treated differently in the future.

IFRS 16 includes detailed guidance to help companies assess whether a contract contains a lease or a service, or both. Under current guidance and practice, there is not a lot of emphasis on the distinction between a service or an operating lease, as this often does not change the accounting treatment.

The analysis starts by determining if a contract meets the definition of a lease. This means that the customer has the right to control the use of an identifiable asset for a period of time in exchange for consideration.

Example Lease vs service standard
Company XXZ rents some space in the warehouse for storing your goods. Company enters into a 3-year rental contract. The owner of that warehouse offers 2 options:

Option 1 Company XXZ will occupy a certain area of 35 cubic meters, but the specific place will be determined by the owner of the warehouse, based on actual usage of the warehouse and free storage.

Option 2 Company A will occupy the unit n. 13 of 35 cubic meters in the sector A of that warehouse. This place is assigned to Company XXZ and no one can change it during the duration of the contract.

Both contracts look like lease contracts, and indeed, in both cases, Company XXZ would book the rental payments as expenses in profit or loss under older IAS 17.

Under new IFRS 16, there should be assess whether these contracts contain lease as defined in IFRS 16.

The first thing to look at is whether an underlying asset can be identified. The first contract does not contain any lease, because no asset can be identified.

The reason is that the supplier (warehouse owner) can exchange one place for another and you lease only certain capacity. Therefore, you would account for rental payments as for expenses in profit or loss.

The second contract does contain a lease, because an underlying asset can be identified— you are leasing the unit n. 13 of 35 cubic meters in the sector A.

Therefore, Company XXZ needs to account for this contract as for the lease and it means recognizing some asset and a liability in the balance sheet.

It should be noted that the Standard does not provide a definition of services; however, the Basis for Conclusions provides some considerations made by the IASB to distinguish leases from services.

For example, it indicates that leases create rights and obligations that are different from those that arise from service contracts. This is because the lessee obtains and controls the right-of-use asset at the time that the underlying asset is made available for use by the lessee, on the other hand, in a service contract, the customer does not obtain an asset that it controls at commencement of the contract.

To help entities determine whether a contract is, or contains, a lease, the Standard provides the following flowchart:
Is there an identified asset?

Yes

Does the customer have the right to obtain substantially all of the economic benefits of the asset throughout the period of use?

Yes

Does the customer, the supplier, or neither party, have the right to direct how and for what purpose the asset is used throughout the period of use?

Neither, how and for what purpose the asset will be used is predetermined

Does the customer have the right to operate the asset throughout the period of use, without the supplier having the right to change those operating instructions?

No

Did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use?

Yes

The contract contains a lease

No

The contract does not contain a lease
Identifying and separate lease and non-lease components

Currently, many arrangements embed an operating lease into the contract or operating lease contracts include non-lease (e.g. service) components. However, many entities do not separate the operating lease component in the contracts because the accounting for an operating lease and for a service/supply arrangement generally have a similar impact on the financial statements today.

Under the new leases standard, lessee accounting for the two elements of the contract will change because leases will have to be recognised on the balance sheet.

Both lessees and lessors are required to separate lease components from non-lease components in their contracts if both of the following criteria are met:

a. The lessee can benefit from use of the asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and

b. The underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract.

After the identification of lease and non-lease components, payments should be allocated as follows:

- Lessors should apply the guidance in IFRS 15 Revenue from Contracts with Customers when allocating the transaction price to separate components. Allocation is based on the relative standalone selling prices (SSP). If no observable information is available, entities are required to estimate the SSP.
- Lessees should separate lease components from non-lease components unless they apply the accounting policy election described below. Activities that do not transfer a good or service to the lessee are not components in a contract. Allocation of payments should be similar to lessors as described above.

Lessee accounting of lease

Lessees are required to initially recognise a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term.

The lease liability is measured at the present value of the lease payments to be made over the lease term. The right-of-use asset is initially measured at
the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee’s initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are permitted to make an accounting policy election, by class of underlying asset, to apply a method like IAS 17’s operating lease accounting and not recognise lease assets and lease liabilities for leases with a lease term of 12 months or less (i.e., short-term leases). Lessees also are permitted to make an election, on a lease-by-lease basis, to apply a method similar to current operating lease accounting to leases for which the underlying asset is of low value (i.e., low-value assets).

Lessees accrete the lease liability to reflect interest and reduce the liability to reflect lease payments made. The related right-of-use asset is depreciated in accordance with the depreciation requirements of IAS 16 Property, Plant and Equipment. For lessees that depreciate the right-of-use asset on a straight-line basis, the aggregate of interest expense on the lease liability and depreciation of the right-of-use asset generally results in higher total periodic expense in the earlier periods of a lease.

Lessor Accounting

The accounting by lessors under the new standard is substantially unchanged from today’s accounting in IAS 17. Lessors classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases: operating and finance leases.

For operating leases, lessors continue to recognise the underlying asset.

For finance leases, lessors derecognise the underlying asset and recognise a net investment in the lease similar to today’s requirements. Any selling profit or loss is recognised at lease commencement.

For operating leases, lessors recognise lease income on either a straight-line basis or another systematic basis that is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

For finance leases, lessors recognise interest income for the accretion of the net investment in the lease and reduce that investment for payments received. The net investment in the lease is subject to the derecognition and impairment requirements in IFRS 9 Financial Instruments.

**The effective date of IFRS 16 Leases is 1 January 2019**

The new leases standard permits early application but it can’t be applied before an entity also adopts IFRS 15 Revenue from Contracts with Customers.

A lessee has to choose either a full retrospective approach or a modified retrospective approach to transition to the new standard. The selected approach has to
be applied to the entire lease portfolio.

Lessees and lessors are not required to reassess whether an existing contract contains a lease upon transition, i.e. if an entity concluded under IAS 17 Leases that the contract is not a lease, an entity does not have to reassess the contract in accordance with IFRS 16.

List of Literature:

5) Lease standard is changing - https://www.pwc.com/gx/en/services/audit-assurance/assets/IFRS%2016%20New%20Leases%20web.pdf