

IFRS 16 Leases

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Summary

On 13 January 2016, the IASB issued IFRS 16 *Leases*, which supersedes IAS 17 *Leases*, IFRIC 4 *Determining whether an Arrangement contains a Lease*, SIC 15 *Operating Leases-Incentives* and SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

IFRS 16 eliminates the classification by a lessee of leases as either operating or finance. Instead all leases are treated in a similar way to finance leases in accordance with IAS 17. Under IFRS 16, leases are recorded on the balance sheet by recognising a liability for the present value of its obligation to make future lease payments with an asset (comprised of the amount of the lease liability plus certain other amounts) either being disclosed separately in the statement of financial position (within right-of-use assets) or together with property, plant and equipment. The most significant effect of the new requirements will be an increase in recognised lease assets and financial liabilities.

There are some exemptions. IFRS 16 contains options which do not require a lessee to recognise assets and liabilities for a) short term leases (i.e. leases of 12 months or less, including the effect of any extension options) and b) leases of low-value assets (for example, a lease of a personal computer).

IFRS 16 clarifies that a lessee separates lease components and service components of a contract, and applies the lease accounting requirements only to the lease components.

IFRS 16 includes various transitional provisions, many of which are based on the date of initial application (the start of the annual period in which IFRS 16 is adopted). They include provisions relating to: a) adopting a fully retrospective or modified retrospective approach; b) measurement for the right-of-use assets; and c) applying the short term exemption to leases for which the lease term ends within 12 months of the date of initial application.

For entities with significant leases, the application of IFRS 16 is likely to have significant effects on financial metrics, including financial ratios. For leases previously classified as operating leases, the following are expected: a) higher asset base, which will affect ratios such as asset turnover; b) higher financial liabilities, which will affect leverage; c) higher operating profit, which will affect ratios based, for example, on EBITDA. In contrast, for leases previously classified as finance leases the changes will not be significant.

IFRS 16 applies to annual periods commencing on or after 1 January 2019. Earlier adoption is permitted, but only IFRS 15 *Revenue from Contracts with Customers* is also adopted. IFRS 16 has yet to be endorsed for use in the European Union.

The IASB worked jointly with the FASB on the leases project and both Boards have reached the same conclusions in many areas of lease accounting, including requiring leases to be reported on the balance sheet, how to define a lease and how lease liabilities are measured. Both standard setters have also substantially carried forward existing lessor accounting requirements. However, in some areas the IASB and the FASB have reached different conclusions about the recognition and presentation of expenses related to leases in the income statement and of cash flows in the cash flow statement.

STATUS

Final

EFFECTIVE DATE

Periods beginning on or after 1 January 2019. Early application is permitted if IFRS 15 *Revenue from Contracts with Customers* is also applied. Not yet endorsed for its application in the EU

ACCOUNTING IMPACT

Wide and potentially very significant on assets and liabilities (for lessees only)

Background

In 2005, responding to concerns about the lack of transparency of information about lease obligations, the IASB and the FASB initiated a project to improve the accounting for leases. To meet this objective, the IASB and the FASB agreed that a customer (lessee) leasing assets should recognise assets and liabilities arising from those leases. The rationale is that at the start of a lease a lessee obtains the right to use an asset for a period of time and, if payments are to be made over time, incurs a liability to make lease payments.

The distinction between operating and finance leases in existing guidance made it difficult for investors to compare companies. It meant that investors and others had to estimate the effects of a company's off balance sheet lease obligations. The significance of the missing information varied by industry and region and between companies. However, for many companies, the effect on reported assets and financial leverage was substantial.

The new leases Standard has been subject to multiple rounds of public consultation and extensive deliberations, and replaces accounting requirements introduced more than 30 years ago that are no longer considered appropriate.

Identifying a lease

A lease is defined by IFRS 16 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'*.

At inception, an entity assesses whether the contract is, or contains, a lease. It is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

An entity reassesses whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.

For a contract that is, or contains, a lease, an entity accounts for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in IFRS 16 that permits an entity not to separate non-lease components from lease components. If this practical expedient is not applied, non-lease components are accounted for applying other applicable Standards.

Scope of IFRS 16 Leases

IFRS 16 applies to all leases except for:

- (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- (b) leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee;
- (c) service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*;
- (d) licences of intellectual property granted by a lessor within the scope of IFRS 15 *Revenue from Contracts with Customers*; and
- (e) rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

A lessee may, but is not required, to apply IFRS 16 to leases of intangible assets other than those described under (e) above.

Recognition exemptions

A lessee may elect not to apply the recognition requirements to following leases:

- (a) short term leases; and
- (b) leases for which the underlying asset is of low value

If a lessee elects to apply the recognition exemptions for the leases mentioned above, the lease payments are recognised as an expense on either a straight-line basis over the lease term, or another systematic basis if this is more representative of the pattern of the lessee's benefit.

Lessee accounting

Initial measurement

At the commencement date of a lease, a lessee measures the right-of-use asset at cost. Cost is comprised of:

- (a) the initial measurement of the lease liability
- (b) any lease payments made before the commencement date less any lease incentives received
- (c) initial direct costs incurred by the lessee
- (d) an estimate of any costs that the lessee will incur in dismantling and removing the asset, asset restoration and restoring the site on which the asset is located.

The lease liability is measured at the present value of the lease payments that are not paid at the commencement date. The lease payments are discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses the its incremental borrowing rate.

Subsequent measurement

After the commencement date, a lessee measures the right-of-use asset by applying the depreciated cost model, unless it applies the fair value model in IAS 40 *Investment Property* to its investment property or if its right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16 *Property, Plant and Equipment*. In that case a lessee may elect to apply that revaluation model to all of the right-of use assets that relate to that class of property, plant and equipment.

After the commencement date, the lease liability is remeasured by:

- (a) increasing the carrying amount to reflect interest on the lease liability;
- (b) reducing the carrying amount to reflect the lease payments made; and
- (c) remeasuring the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments.

Lessor accounting

IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17 *Leases*. A lessor classifies each of its leases as either an operating lease or a finance lease.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Sale and Leaseback

The requirements in IFRS 15 are applied in determining whether the transfer of an asset is accounted for as a sale of that asset.

Transfer of the asset is a sale

If the requirements of IFRS 15 are met, the transaction will be accounted for as a sale/purchase and a lease by both the lessee and the lessor.

Transfer of the asset is not a sale

In this case the transaction will be accounted for as a financing by both the seller-lessee and the buyer-lessor.

Disclosures

IFRS 16 requires enhanced disclosures by both lessees and lessors. These, combined with amounts disclosed in the primary statements, are intended to enable users of financial statements to assess the effect that leases have on an entity's financial position, financial performance and cash flows.

Transition

Lessees:

A lessee applies IFRS 16 to its leases either:

- (a) retrospectively to each prior reporting period presented applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
- (b) retrospectively with the cumulative effect of initially applying IFRS 16 being recognised at the date of initial application.

This election is required to be applied consistently to all of an entity's leases in which it is a lessee.

Lessors:

A lessor is not required to make any adjustments on transition for leases in which it is a lessor and accounts for those leases by applying IFRS 16 from the date of initial application (unless it is an intermediate lessor).

Effective date

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019.

Earlier application is permitted for entities that apply IFRS 15 *Revenue from Contracts with Customers* on or before the date of initial application of IFRS 16.

IFRS 16 is yet to be endorsed for application in the European Union.



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