IFRS 16—Leases
New leasing standard significantly changes how lessees account for operating leases

At a glance

In January 2016 the IASB (International Accounting Standards Board) issued IFRS 16 *Leases* after more than a decade of extensive consultation.

The changes under IFRS 16 are significant and will predominantly affect lessees, who will soon be required to recognise most lease liabilities and assets on balance sheet. This long awaited standard, does away with the current operating/finance lease distinction, and its revision is a response to extensive criticism that the current leasing rules failed to provide a clear and comparable picture of a company's true financial exposure.

When is the new standard effective?

IFRS 16 will replace IAS 17 *Leases* for financial reporting periods beginning on or after 1 January 2019.

What's the impact on lessees?

While the new rules are expected to impact many companies worldwide, the biggest impact is expected to be in the retail, aviation, mining and transport sectors. However, it is only lessee accounting that is being substantially reformed, with the lessor accounting requirements contained in IFRS 16's predecessor, IAS 17 *Leases* remaining largely unchanged in its replacement.

The main impact on lessees is that almost all leases go on balance sheet. This is because the balance sheet distinction between operating and finance leases is removed for lessees. Instead, under the new standard an asset (the right to use the leased item) and a financial liability to pay rentals are recognised. The only exemptions are short-term and low-value leases.

To measure a lease, the lease term and lease payments must be established –both are defined more broadly under IFRS 16 than under the previous standard. Specifically, the lease term now includes extension periods if it is reasonably certain the lessee will extend the lease, while lease payments now include certain variable payments such as CPI increases and purchase options which are reasonably certain to be exercised.

The income statement will also be affected because the total expense is typically higher in the earlier years of a lease and lower in later years, similar to a mortgage where the interest expense is high until the capital is significantly reduced. Additionally, operating expense will be replaced with interest and depreciation so key metrics like EBITDA will be affected.

Is there any impact on lessors?

The distinction between operating leases and finance leases remains for lessors, which means there is generally no fundamental change to lessor accounting from the previous standard.

While the new standard does not have fundamental financial reporting implications for lessors, it may affect the way they do business ; for example, through shorter lease terms. Lessors may find themselves under pressure to provide more transparent lease information to their lessees to facilitate their lease accounting.

Are more disclosures required?

The new standard requires more extensive disclosures – both qualitative and quantitative –than the previous standard. Additional disclosures are expected to assist investors and analysts to better understand lease arrangements.

Next steps

Although the effective date of the new standard is 1 January 2019, numerous contracts have long lease terms and widespread implication. The identification and assessment of contracts involve significant resources and time commitment. Entities should commence the assessment immediately and take appropriate actions.

Contacts

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