

# *The new lease standard* IFRS 16 “Leases”



In January 2016, the International Accounting Standards Board (IASB) issued IFRS 16 “Leases”, the new standard on lease contracts that will replace the old IAS 17 “Leases”. IFRS 16 is effective for reporting periods beginning on or after 1 January 2019 for IFRS reporters. This standard has not been adopted in Indonesia but we think it is likely that it soon will be.

Leasing is an important financial solution used by many organisations. It enables companies to use property, plant and equipment without needing to incur large initial cash outflows.

Under existing rules, lessees generally account for lease transactions either as off-balance sheet operating leases or as on-balance sheet finance leases. The new standard requires lessees to recognise nearly all leases on the balance sheet, which will reflect their right to use an asset for a period of time and the associated liability to pay rentals. Accordingly, this new lease accounting standard is expected to have a significant impact on lease accounting by lessees. Meanwhile, the accounting model for lessors largely remains unchanged. However, lessors are expected to be affected due to the change in needs and behaviours from customers/lessees.

## **Why did the lease accounting standard need to be changed?**

In 2005, the US Securities and Exchange Commission (SEC) estimated that US public companies may have approximately US\$1.25 trillion of off-balance sheet leases. Responding to concerns about the lack of transparency of information about lease obligations, the IASB and Financial Accounting Standards Board (FASB) initiated a project to improve the lease standard. They agreed that a lessee should recognise assets and liabilities arising from those leases. This is because at the start of a lease, a lessee obtains the right to use an asset for a period of time and incurs a liability to make lease payments.

## **What is the new model under IFRS 16?**

The distinction between operating and finance leases is eliminated for lessees, a new lease asset (representing the right to use the leased item for the lease term) and lease liability (representing the obligation to pay rentals) are recognised for all leases. A lessee should initially recognise a right-of-use asset and lease liability based on the discounted payments required under the lease, taking into account the lease terms as determined according to the new standard.

However, IFRS 16 does not require a lessee to recognise assets and liabilities for:

- short-term leases (i.e. leases of 12 months or less)
- leases of low-value assets (for example: a lease of a personal computer)

The lessor's accounting does not change and lessors continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating leases. For financing arrangements or sales, the balance sheet reflects a lease receivable and the lessor's residual interest, if any.

The key elements of the new standard and the effect on financial statements are as follows:

- A "right-of-use" model replaces the "risks and rewards" model. The lessee is required to recognise an asset and liability at the inception of a lease.
- All lease liabilities are to be measured with reference to an estimate of the lease term. Determining the lease term will require judgment, which was often not needed before for an operating lease.

- Contingent rentals or variable lease payments will need to be included in the measurement of lease assets and liabilities when these depend on an index or a rate or where in substance they are fixed payments.
- A lessee should reassess the lease terms only upon the occurrence of a significant event or a significant change in circumstances that are within the control of the lessee.

## **What does IFRS 16 mean for a lessee's financial position and income?**

The most significant effect of the new requirements will be an increase in lease assets and financial liabilities. Accordingly, for lessees with material off-balance sheet leases, there will be a change to key financial metrics derived from the lessees' reported assets and liabilities (for example, leverage ratios).

From a profit or loss perspective, operating leases are typically expensed on a straight line basis under the old IAS 17. The standard replaces the straight-line operating lease expense for those leases applying IAS 17 with a depreciation charge for the lease asset (included within operating costs) and an interest expense on the lease liability (included within finance costs).

Depreciation is likely to be on a straight-line basis. However, interest is higher in the initial years. This will have the effect of front-loading expenses in the profit or loss which will reduce over the life of the lease as lease payments are made.

In addition, as a result of the change in the attributes of items charged to the profit or loss, EBITDA (earnings before interest, tax, depreciation and amortisation) are expected to increase for lessees with material off-balance sheet leases.

## **Which industries are most affected?**

It is expected that IFRS 16 will significantly affect the following industries:

- Retailers
- Airlines
- Professional services
- Health care
- Wholesale
- Telecommunication
- Transport and logistics
- Entertainment
- Real estate and equipment lessors

## Where to go from here?

As highlighted above, the new lease standard is effective for annual periods beginning on or after 1 January 2019. An entity is permitted to adopt the standard early, but it cannot 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. If a lessee elects the “modified retrospective approach”, it does not restate comparative information. Instead, the cumulative effect of applying the standard is recognised as an adjustment to the opening balance of retained earnings at the date of initial application.

A lessor is not required to make any adjustments on transition and shall account for leases applying the new standard from the date of initial application.

Questions that affected entities may have include:

- How will the change affect the lessee’s key financial ratios/metrics such as gearing ratio, asset turnover, interest cover, EBITDA, operating profit, net income and operating cash flows?
- Will the change in the standard have an impact on the lessee’s covenants, credit ratings and borrowing costs?
- How ready are lessees in planning their communications with their stakeholders and analysts?
- How might this change affect the structure of existing and future leases as well as the decisions of “lease versus buy”?
- Are there any unexpected tax consequences as a result of the new standard?
- Will the current IT system and setting be capable to support the change?
- How might this change affect the internal setting of financial budget and management’s key performance indicators?

The earlier you begin to understand what impact the new standard may have on your organisation the better prepared you will be to iron out potential issues and reduce implementation costs and compliance risks.



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