



IFRS 16 LEASES

IFRS 16 brings major changes for lessees and will have a significant effect on any entity that has entered into material amounts of what are currently accounted for as operating leases. In contrast, for lessors, the accounting requirements have largely been carried forward unchanged from IAS 17.

The key headline for lessees, which is widely understood, is that in most cases a lease will result in an asset being capitalised (a 'right of use' asset) together with the recognition of a liability for the corresponding lease payments. This will result in changes to key financial ratios and has the potential to affect borrowing costs and result in breaches of banking covenants.

A less well known effect is that the definition of a lease is tightly drafted, meaning that the scope of contracts which fall within the scope of IFRS 16 can be significantly greater than expected. A careful review of all contracts is needed, in particular those which involve the provision of a service which requires the use of an associated asset. As an example, companies in the natural resources sector may enter into contracts for the supply of serviced oil rigs; in such cases, the contract is likely to contain a lease of an oil rig.

The guidance in IFRS 16 is aligned with the new revenue recognition guidance in IFRS 15. This is relevant for sale and leaseback transactions, where it is considerably less likely that a sale and leaseback will be recorded, with the asset being retained on balance sheet and the proceeds of the 'sale' being recorded as a loan. Entities that have entered into sale and leaseback transactions may wish to consider adopting IFRS 16 early, to align this with the earlier effective date of IFRS 15.

As well as grossing up the balance sheet for previously unrecognised assets and liabilities, IFRS 16 will affect the geography of the income statement. Instead of an operating lease charge being included within operating expenses, there will be a depreciation charge relating to the right of use asset, and an interest expense relating to the lease liability. For those entities that use EBITDA (or a similar measure) as a key performance indicator, IFRS 16 will automatically lead to an increase in reported profitability. However, in comparison with IAS 17 (under which operating lease expenses are typically charged on a straight line basis over the lease term), under IFRS 16 the total expense (depreciation and interest) will be higher in the first part of a lease in comparison with later periods. This is because in the earlier periods, the lease liability (and related interest charge) will be higher.

Transition

On transition, there is a choice of two approaches:

- Fully retrospective application, under which IFRS 16 is applied to each prior reporting period with these being restated
- A cumulative catch up approach under which IFRS 16 is applied on a retrospective basis with the cumulative effect being recognised as an adjustment on 1 January 2019 with comparative information not being restated.

There are also practical expedients relating to the measurement of lease liabilities and leased assets that will be reported on transition. However, care is needed because decisions taken about how an entity transitions to IFRS 16 will affect future financial statements for a period of years. For example, right of use assets can be measured on the basis of data available as at the date of initial application of IFRS 16, which may be more straightforward than retrospective restatement. However, this is likely to result in assets being measured at higher amounts than they would using historical data, which will result in higher future depreciation charges.

It is therefore important that the choices available on transition are considered early, with the best use being made of available cost savings while at the same time finding the right balance between the cost of adoption and the financial reporting of a lessee's leased asset portfolio.

What questions should I be asking?

For the adoption of IFRS 16, questions which should be asked include:

Project management, Board sponsorship and communication with those charged with governance:

- What is the plan for transition?
- Which transitional approach and options are being adopted and why?
- What is the timeline?
- Who is responsible?
- What resources are available?
- What sponsorship does the project have at executive board level?
- How has the audit committee been briefed?

Detailed effects:

- Which leases will be brought on balance sheet?
- Which service contracts contain a lease?
- What will the effect be on borrowings and key ratios?
- If EBITDA or similar is a key performance indicator, or it is used as the basis for performance bonuses or share-based payments, what will the effect be?
- How will brokers and analysts react?
- What changes are required to systems and processes?



Find out more

If you would like to speak to us about any of these changes and determine how they may impact you, please get in touch with our team of experts who will be happy to help.



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