IFRS 16 Introduces a New Way of Looking at Leases

by Wayne Bartlett

IFRS 16 on Leases is one of the more recent standards in the IFRS toolbox (in fact, if one ignores IFRS 17 on Insurance Contracts which is quite specialist in nature it is the most recently-released Standard that impacts on a wide range of entities).

In terms of timing it came out not long after IFRS 15, Revenue from Contracts with Customers, in itself a major event and marking a period of intense activity on the part of the standard-setters, the International Accounting Standards Board (IASB). IFRS 16 has a major impact on the accounting policies adopted by those who have leased assets (which are now in the new jargon called 'right of use assets'). It impacts on the accounting practices of both those who use the leased assets (the lessee) and those leasing them out (the lessor). In this article I'll focus on the lessee on the grounds that there are likely to be more readers who are using leased assets than those working for someone who legally owns them.

The major impact on the accounting policies of lessors concerns the 'balance sheet' (statement of financial position) treatment of leases. In the past only finance leases, where the majority of the financial benefits obtained from leased assets were enjoyed by the lessor, were capitalised on the balance sheet of lessors and those which were essentially short-term operating leases were not. That situation has now changed and all leases, with a few exceptions which will be discussed below, are now capitalised.

Why change?

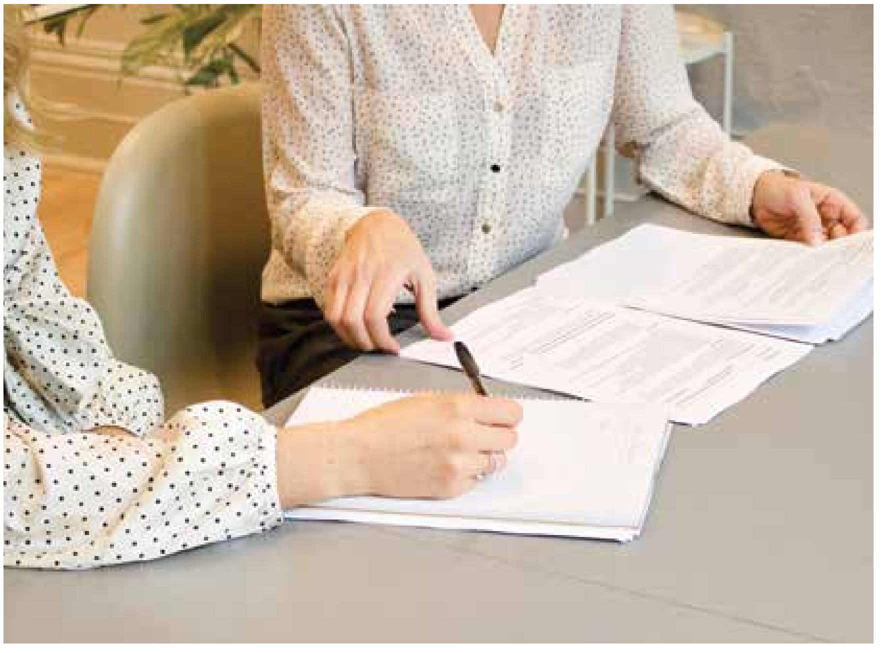
I remember reading at the time that the main reason for this significant change was that investors were very unhappy that balance sheets were being seriously understated by the non-inclusion of all leases regardless of their nature.

Leasing is a very popular way of obtaining the use of an asset when you do not have the ready money to buy it outright; or perhaps alternatively when you do not see the point in buying one because you only want it for a limited time. There are a wide range of assets that might be involved. At one extreme they can be very substantial assets.

I used to work for a government Ministry in London which operated out a massive leased building which it was leasing over a period of decades and the accumulated cost of that as you might imagine was enormous. At the other extreme lessees might obtain items as mundane as photocopiers or vending machines on a lease; much smaller and less expensive assets in the scheme of things.

Investors however had expressed ongoing unhappiness at the fact that a huge collective value of leases were being left off balance sheet with operating leases not being included. After a decade of consultation it seems that the IASB accepted the argument that the non-inclusion of operating leases on balance sheets was conceptually flawed. So too did the standard-setter for US GAAP, the Financial Accounting Standards Board (FASB), who were involved in a joint project with the IASB on the subject of leases.

At around the same time that the IASB replaced the pre-existing lease standard IAS 17 with IFRS 16, their US counterparts replaced their own pre-existing Standard, ASC 840, with ASC 842. There are a few differences in the detail between IFRS 16 and ASC 842 but there is also a substantial degree of commonality between the two.



Impact of the changes

So let's look at the accounting for leases under IFRS 16. The Standard came into effect for all accounting periods beginning on or after 1 January 2019 so it is still pretty new. It largely mirrors the accounting treatment that was used just for finance leases in the past (a finance lease being one where the major portion of the risks and rewards of ownership are transferred to the lessee from the lessor) but is now applied to all 'right of use' assets whether or not they would have been treated as finance or operating leases in the past.

When gaining access to a leased asset, the lessee should capitalise in on their balance sheet, treating it in exactly the same way as it would if it had acquired it outright by purchasing it with its own funds. It should also set up a liability in the balance sheet. So in a simple example if Lessee A leases an item of machinery from Lessor B for a full cost looking at all capital outflows it expects to pay for the asset over its life of €600,000, then that is the amount it would capitalise as a right of use asset in its balance sheet. At the same time it would establish a lease liability for the same amount.

That's straightforward enough but what happens on an ongoing basis after that? As far as the asset side is concerned, it would be depreciated over its life. The 'life' is measured not by the overall life of the asset taken as a whole but the length of the lease. It might for example normally have an expected useful economic life of ten years but the lease is only for six, in which case that would be the life applied for depreciation purposes, i.e. on a straight-line basis €100,000 per annum. One thing to note is that if there is an option to extend the lease and the lessee anticipates at the inception of the lease taking it up then that period of its life should also be accounted for. So if hypothetically the same lease has a two-year extension option for a further €40,000 then we would now capitalise an amount of €640,000 in the balance sheet for the right of use asset and depreciate it over eight years rather than six, i.e. a charge of €80,000 per annum on a straight-line basis.

The other side of the accounting is the liability. When payments for leases are made then they will include both a payment for the capital element of acquiring the right to use the asset and also a financing charge. The latter should be accounted for as effectively an interest charge in the financial statements that we prepare and be included as expenditure in the income statement for the year in question. The capital element should be offset against the lease liability in the balance sheet; except for the amounts due to be paid in the next accounting period these would be included as a non-current liability. Over time in theory, and if you have done the accounting correctly, both the asset value and the liability should eventually diminish to zero as you depreciate the asset and reduce the liability via payments.

The exceptions to the rule

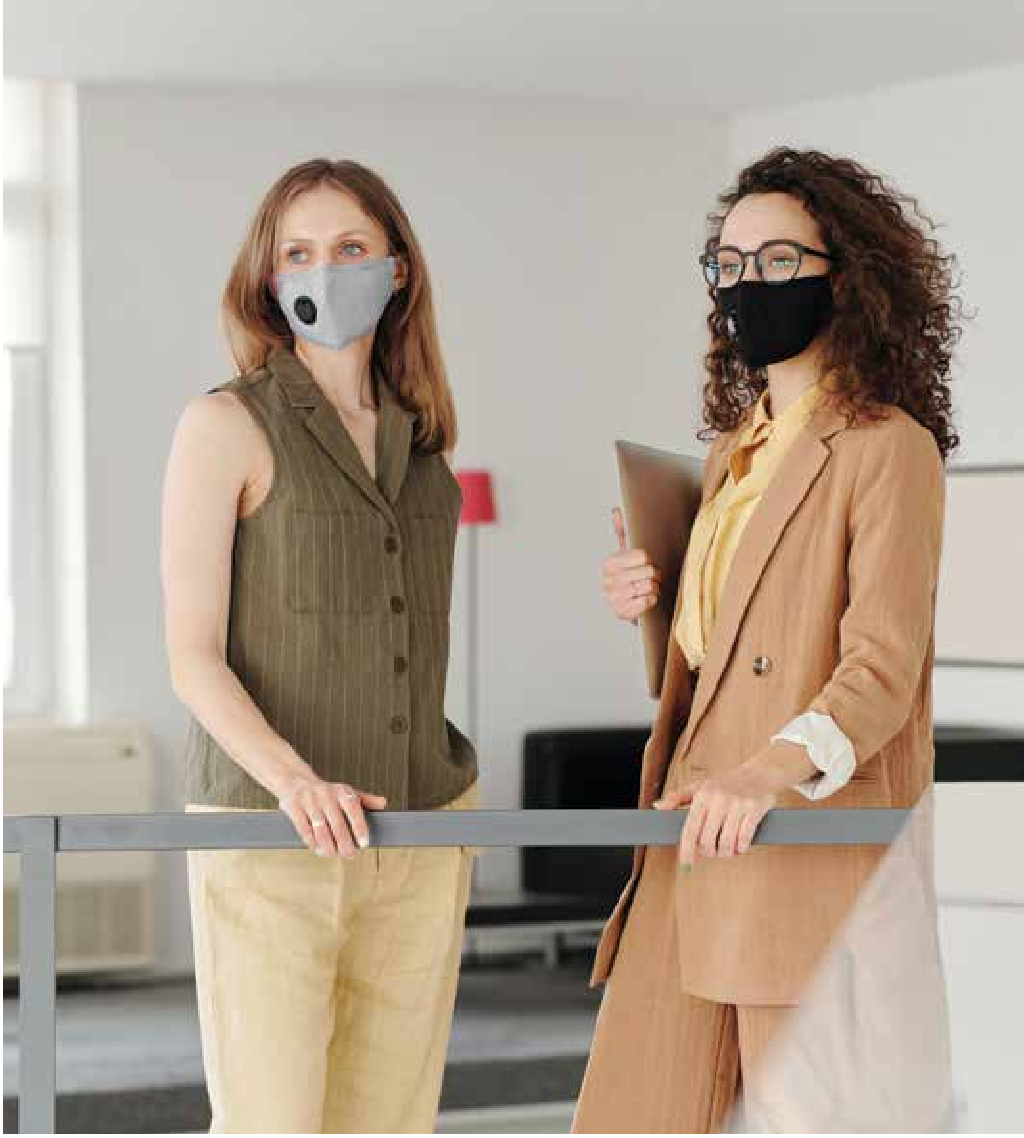
So what are the exceptions to the general rule that all leases must now be capitalised on the financial statements of the lessee? There are two of them and they are both elections, i.e. they are not mandatory but may be applied if the financial statement preparer so wishes. The first concerns short-life leases: these are defined as leases which have at their commencement date a life of twelve months or less. The second concerns low value leases. Although the definition of 'low value' is not specifically defined, the International Accounting Standards Board (IASB) notes in the Basis for Conclusions that accompanies IFRS 16 that it initially had in mind that 'small value' would be considered as assets that had an underlying lease payments involved should be recognised on a straight-line basis over the life of the lease or a similar systematic basis.

A point of detail however is that if the exemption for short life assets is taken up then it must be applied to all leased assets in a particular class whereas if the low value exemption is used than it can be applied on a lease-by-lease basis.

How much this impacts on your own particular business will naturally depend on your own specific lease profile. It could be that if you only have leases they may be for low value or short life assets, in which case the only issue is that you have to decide whether to apply the exemptions and if so ensure that you apply and communicate your chosen policy properly.

Conversely the effect could be significant in which case the key thing is that you should understand the updated rules and ensure that the accounting for them is reflected in your financial statements. Being on top of the details of all the items that you have acquired the right to use through leases is important and will require close working between accountants and those who are responsible for arranging lease deals within the entity: it would be fairly easy if care is not taken for leases to fall through reporting gaps and be missed. If nothing else, getting the new style of accounting right is critically important for keeping auditors and ultimately investors and other stakeholders happy.

It would be unfortunate if after taking a decade to design and agree the new rules, they do not after all have the desired effect.



Covid-19 impacts on IFRS 16

One final point to note is that Covid-19 has had a very specific impact on IFRS 16. Many businesses have benefited from rent concessions on the back of the pandemic and the IASB have introduced an amendment to IFRS 16 to take account of these.

Normally a change to lease conditions such as reduced or deferred rent would require a restatement of the lease with a recalculation of the relevant asset or liability and the resulting discounted cash flows. However the amendment gives the reporting entity the option of not doing so.

Instead the resultant rent decreases would be accounted for as a one-off benefit to profit or loss. If this election is made, then a note to this effect must be included in the affected financial statements along with clear disclosure of the impact on profit or loss for the relevant period. The promptness with which this amendment has been made emphasises the dramatic potential impact of the pandemic and the significant impact it could make on those entities who have large leases on their balance sheets. It is another reminder of just how material the fallout from the pandemic might be on leasing as well as of course on many other areas of the financial statements.

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