iNews

A PKF Eastern Africa IFRS update newsletter

Edition 1, Feb 2019

Lease accounting under IFRS 16

In January 2016 the IASB abolished the need for classification of leases as either finance or operating (for lessees) which previously resulted in assets and obligations related to operating leases being left out of the balance sheet. Other than for short term leases and leases of low value assets, lessees will present all leased assets and obligations on the balance sheet with effect from 1 January 2019.

The present value of lease payments including any directly related costs will be presented as lease assets (right-of-use assets), depreciated over the lease term. The corresponding obligation too will be shown in the liabilities section of the financial statements of the lessees.

In the financial statements of lessors, leases are still classified as operating or finance leases, and are accounted for separately. The main change for lessors is the additional disclosure of information on the risks relating to its residual interest in leased assets.

Where an entity previously had a number of leases, there may be a significant change in the nature of expenses related to those leases, as the operating lease expense will be replaced by the depreciation expense for the leased asset and the interest expense on the lease liability.

The right to control the use of an asset has now become the underlying parameter for the determination of whether a lease exists and therefore whether the leased assets will be recognised on the financial statements or not and this emanates from how the contract is designed.

Present value of leased payments + Lease payments prior to inception + Initial direct costs + Asset retirement obligation** - Lease incentives received

Right of use asset

On first applying IFRS 16, entities need not reassess existing contracts to determine whether the contract contains a lease. The entity is allowed to apply IFRS 16 to contracts that were previously identified as a lease under IAS 17 and vice-versa. However all such leases need to be re-measured for purposes of the new on balance sheet lease accounting model of IFRS 16.

Present value of lease payments + Present value of expected payments at the end of the lease = Lease liabilty

When new contracts are entered into, entities will have to determine whether they contain a lease or whether they are service contracts. Often, contracts contain both a right to use the asset and a service agreement. Where this is the case, entities can separate the contract into its component elements, often requiring the use of judgement.

IFRS 16 also provides guidance on the rate to be used to determine the present value of the lease liability. This rate is normally the rate of interest implicit in the lease agreement and where not determinable, the incremental rate of borrowing.

What does management need to do?

IFRS 16 may impact entities differently;

1. For entities with significant operating leases, IFRS 16 will result in a reduction in reported equity, the degree of which is dependent upon:
    a. the significance of leasing to the entity;
    b. the time remaining on the leases; and
    c. the discount rate applied.
2. Entities with operating leases may also find that they will report a higher operating profit because the implicit interest in lease liabilities is now shown as part of finance costs.
3. Regulated institutions with significant operating leases could find their regulatory capital and other ratios being affected.
4. There will be no change in total cash flows but, following from the above, there will be a reduction in operating cash outflows and an increase in financing cash outflows.
5. The higher asset and liability base will affect ratios such as asset turnover and gearing, whereas the higher operating profit will affect ratios such as EBITDA, which excludes the interest component of the lease liability. Interest cover ratios will be negatively impacted.
6. Entities with material operating leases may incur costs and delays in measuring leased assets and liabilities at the present value of future lease payments due to the need to determine a discount rate for each recognised lease. However, when first applying IFRS 16, entities are permitted to use the incremental borrowing rate for each portfolio of similar leases.
7. The requirements of IFRS 16 may impact borrowing covenants requiring early re-negotiation.

Impact	Balance Sheet	Profit/Loss	Ratios
↑	Financial assets; Financial liabilities	EBITDA; Operating profit; Finance costs	Debt/Equity; Leverage
↓	Net working capital	Earnings per share (in early years)	Current ratio; Asset turnover; Interest coverage

The application date of the standard is 1 January 2019. An entity can apply IFRS 16 before that date but only if it also applies IFRS 15, Revenue from Contracts with Customers.

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right solutions

There are a lot more issues involved in accounting for leases under the new standard than is presented in this article. Should you require further guidance, please contact your client service team.