International Financial Reporting Standard 16 - Leases

Historically, the accounting principles have always kept most leases off the books. Such lease commitments were only required to be disclosed as notes to the financial statements. In the year 2005, the US Security and Exchange Commission estimated that US public companies may have approximately USD 1.25 trillion of off-balance sheet leases[1]. This mammoth figure corroborated the global concern regarding the lack of transparency in the presentation of information about lease obligations. The International Accounting Standards Board (IASB), jointly with Financial Accounting Standards Board, initiated a project to bring about a paradigm change in the principles of lease accounting. This led to the issue of new standard IFRS 16 – Leases which becomes effective for annual periods beginning on or after 1 January 2019.

'Right-of-use' to be capitalized

Till date, the accounting principles required bifurcating of leases between finance lease and operating lease. The lease contracts, which necessarily let lessee enjoy the ownership rights as against the leasing rights, were classified as Finance lease. The present value of the payments made under finance lease were to be capitalized and depreciated over its life. As regards operating lease, entities were required to expense out the lease payments over the contract period.

IFRS 16 brings a change in accounting for leases especially the operating lease. The distinction between an operating lease and finance lease will now end. The standard infers that by entering into a lease contract, the lessee is virtually buying a 'right-of-use' asset over the contract period. Lessees are now initially required to recognize the 'right-of-use' as an asset and the corresponding lease liability. The amount of liability/capitalization shall be the present value of payments required under the contract over the lease term as determined under the standard.

The asset recognized as 'right-of-use' shall be then depreciated over the remaining period of the lease. The liability recognized shall be adjusted every year by a discounting factor and the actual lease payments.

1. https://www.sec.gov/news/studies/soxoffbalancerpt.pdf

Exceptions to the 'right-of-use' accounting

Since the accounting specified in IFRS 16 is complex, IASB has provided two exceptions to it:

Short-term lease

In case the lease term is less than 12 months, entities have an option to not recognize asset and liability. The lease payments will then be recognized as profit or loss on a straight-line basis.

Low-value assets

In case of leases for low value assets, entities are not required to recognize asset and liability as required under 'right-of-use' accounting. The 'basis of conclusion' document of IFRS 16 states that at the time of reaching a conclusion on an exemption, IASB had considered assets with a value of less than USD 5,000.

Other key considerations

- Definition of a lease under the standard is different from the current IFRIC 4 guidance. IFRS 16 gives a lot of guidance to assess whether a contract is of lease or service. This may lead to certain contracts getting covered within/outside the scope of the standard.
- There can be contracts which have a combination of lease and non-lease components. The non-lease components shall be accounted for separately unless the entity has applied practical expedients available in the standard.
- If 'right-of-use' asset belongs to the class of property, plant and equipment which is measured under the revaluation model as per IAS 16, the lessee has an option to choose between cost model or revaluation model for such class of 'right-of-use' assets.

Impact on the financial statements

Balance sheet & statement of profit and loss

- Instead of lease rent expense, there will now be a depreciation and interest expense in the statement of profit or loss.
- As against the straight-line charge over the lease period, there will be more charge to profit or loss in earlier periods than later.
- Companies that in the past reported no or negligible interest expense shall find numbers accumulating under this head post IFRS 16. This may have a direct impact on credit ratings affecting the capacity to borrow funds.
- There will also be an increase in assets and liabilities thereby making the balance sheet look heavier.

Key metrics

- Due to the shift in expense classification from lease rent (operating expenses) to finance costs and depreciation, the EBITDA and EBIT will increase.
- There will be a direct impact on the asset turnover ratio and the proprietary ratio. Coverage ratios, such as the interest coverage ratio and the debt service ratio, too shall stand impacted on account of the interest expense.
- While key performance metrics in the form of operating profit, earnings before interest and tax, earning per share will be impacted, all the resultant ratios derived from these metrics shall face altering impact as well.

Impact on the industries

Since almost all industries use lease arrangements in their routine business cycle, this standard will have an impact across all industries.

There are few businesses, like retail FMCG, transportation, professional services, airlines, telecommunications, etc. which will see larger impact than others due their heavy use of lease arrangements.

Transition

IFRS 16 allows two approaches for transitioning:

Full retrospective approach

Under this approach, entities need to apply new principles as if the standard has always been applied.

Cumulative catch-up approach

- Under this approach, the lease liability/asset is recognized as the present value of the remaining lease payments discounted using the incremental borrowing rate at the date of initial application. This approach does not require the restatement of comparative periods. Instead, the cumulative impact of applying IFRS 16 is adjusted in the current year's opening retained earnings.
- In case of leases which are expiring within 12 months from initial application, irrespective of the original term of the lease arrangement, entities need not recognize 'right-of-use' asset and lease liabilities. Instead, such a lease can be accounted for as short-term lease.
- In case if the lease was previously classified as a finance lease under IAS 17, the carrying amount of 'right-of-use' asset and the lease liabilities shall be the carrying amount of erstwhile asset and liability.

Over and above the two options, entities are allowed to apply a practical expedient whereby IFRS 16 principles will be applied only to those contracts which were identified as leases under IAS 17 – Leases (read with IFRIC 4). Hence, the contracts which were previously not identified as lease can stay out of the principles of IFRS 16.

Entities should carefully select the option, considering the various aspects like importance of comparable data, implementation costs, and the resultant impact on financial health.

Way forward

Entities, especially in industries significantly impacted, should have already assessed the impact by now. A typical approach for transitioning should be:

a. Appoint a transition group to carry out the process. The group should have representatives from the procurement, information technology, operations and real estate department.

b. Identify the lease agreements which will be covered under the IFRS. Assess data requirements and where these will need to be sourced from.

c. Assess the indicative impact on the business and financial health under both the transition approaches using high-level assumptions.

d. Involve the stakeholders to understand the importance of comparatives and implementation costs involved.

e. Develop a plan for transition, which shall include all changes required in systems and processes.

f. Make the changes required to the existing system architecture.

g. A detailed review of the lease contracts and collection of data.

h. Implement the new reporting process and identify the roadblocks in implementation.

The typically 'asset light' statements of financial position may put on some extra weight owing to IFRS 16. The clearly demarcated boundaries in the classic debate of 'lease versus buy' may start fading owing to the 'right-of-use' making way into the statement of financial position. Companies that rely on lease arrangements for their fixed assets will now appear asset-rich as well as indebted. The impact on the financial ratios and the increase in interest expenses may trigger breaches in loan covenants due to which the entities may need to re-negotiate with their lenders. Regulators may argue in favor of the merits of transparent reporting that IFRS 16 brings with it. However, it is the implementing lessee companies that have to incur both the cost and the impact of implementing the new standard.

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Our cross-functional teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, SKP has built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

We provide an array of solutions encompassing Consulting, Business Services, and Professional Services. Our solutions help businesses navigate challenges across all stages of their life-cycle. Through our direct operations in USA, India, and UAE, we serve a diverse range of clients, spanning multinationals, listed companies, privately owned companies, and family-owned businesses from over 50 countries.

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