IFRS 16 LEASES: AN OVERVIEW

Overview

Key Changes

- A single lesseee accounting model
  - A lessee accounts for all leases in the same way
  - No distinction between operating and finance leases
  - Recognize assets and liabilities for all leases (with limited exceptions)
  - All leases (with limited exceptions) will be accounted for in the same way as we currently account for finance leases
- No substantial changes to lessor accounting

IFRS 16 – At a glance

- **IFRS 16 will bring <u>$2.8trn worth of lease commitments</u> that are currently off balance sheet. These will be included in to the balance sheets of the world's listed companies as assets and liabilities**
- **The new standard, which comes into operation on 1-1-2019, will <u>affect around 50% of the world's listed companies</u>, particularly those in the airline, retail and travel/leisure sectors. Currently, the IASB says, the value of the off balance sheet leases of some airlines is <u>equivalent to more than 100%</u> of the value of the airline's total assets.**
- **Under IAS 17 the <u>understatement of long-term liabilities</u> by the heaviest users of off balance sheet leases is as high as 45% in Latin America, 32% in Asia/Pacific and Africa comes in at 27%.. The lowest understatement is in North America (22%) and Europe (26%).**

Why a new leasing standard?

- Currently analysts adjust financial statements for off-balance sheet leases

- Under IFRS 16, companies will bring these leases on balance sheet, using a common methodology

IFRS 16 – Main Features

LESSEE ACCOUNTING

- IFRS 16 introduces a **single lessee accounting model** and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.

- A lessee is required to recognise a **right-of-use asset** representing its right to use the underlying leased asset and a **lease liability** representing its obligation to make lease payments.

Main Features

- A lessee measures right-of-use assets similarly to other **non-financial assets** (such as property, plant and equipment) and lease liabilities similarly to other **financial liabilities**.
- As a consequence, a lessee recognises **depreciation** of the right-of-use asset and **interest** on the lease liability, and also classifies cash repayments of the lease liability into a **principal portion and an interest portion** and presents them in the statement of cash flows applying IAS 7 *Statement of Cash Flows.*

Main Features

- Assets and liabilities arising from a lease are initially measured on a **present value basis**.

- The measurement includes **non-cancellable lease payments** (including inflation-linked payments), and also includes payments to be made in **optional periods** if the lessee is reasonably certain **to exercise an option** to extend the lease, or **not to exercise an option** to terminate the lease.

Main Features

- IFRS 16 contains disclosure requirements for lessees.

- Lessees will need to apply **judgement** in deciding upon the information **to disclose** to meet the objective of providing a basis for **users** of financial statements **to assess the effect** that leases have on the financial position, financial performance and cash flows of the lessee.

Main Features

LESSOR ACCOUNTING

•IFRS 16 substantially carries forward the lessor accounting **requirements in IAS 17**.

•Accordingly, a lessor continues to classify its leases as **operating leases or finance leases**, and to account for those two types of leases differently.

Main Features

- IFRS 16 also requires **enhanced disclosures** to be provided by lessors that will improve information disclosed about a lessor’s risk exposure, particularly to **residual value risk**.

Effective Date

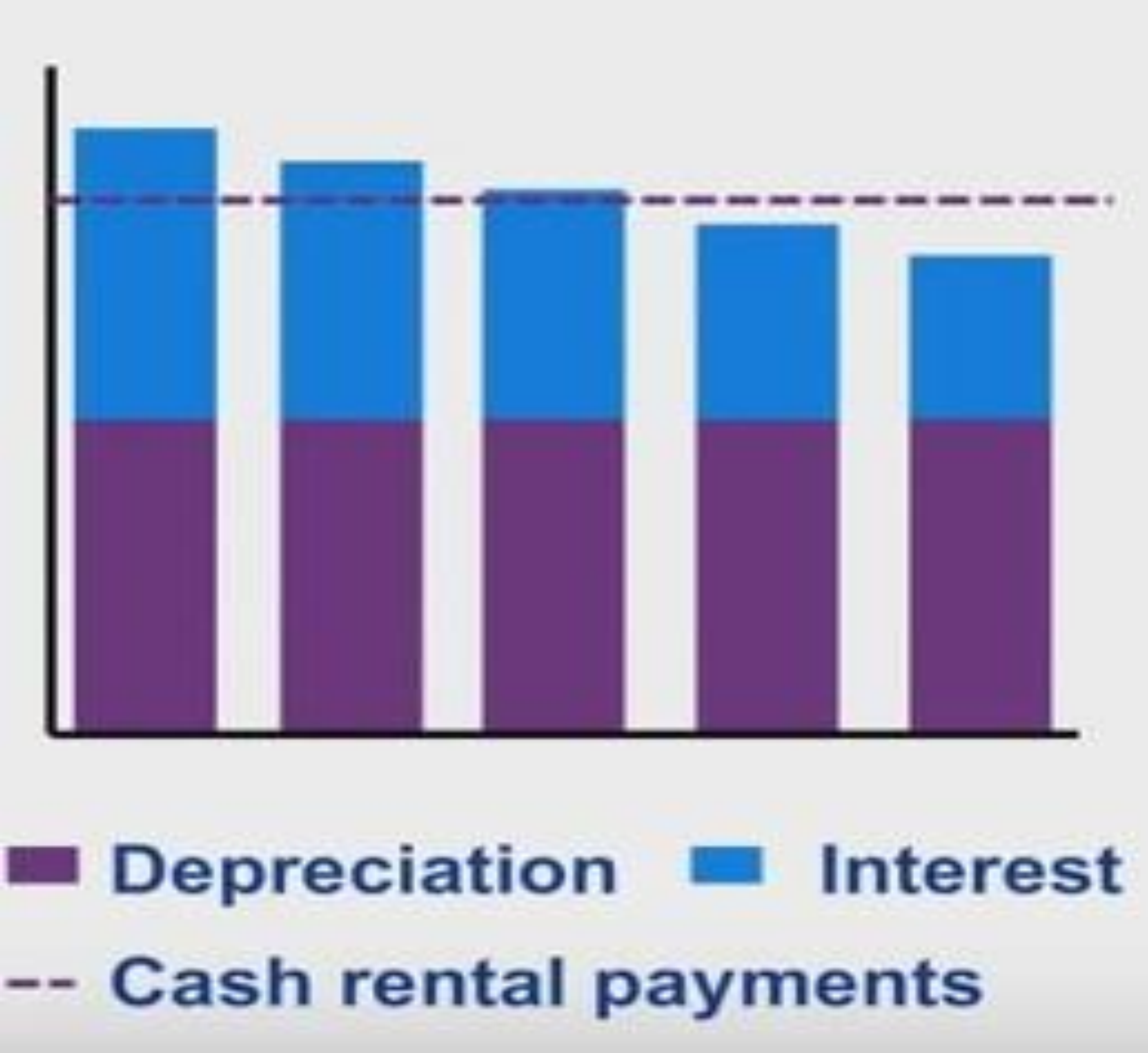
The big change for lessees

The end of the road for operating leases!

The new IFRS 16 Leases introduces **a single lessee accounting model** where all leases will be accounted for in a similar manner to the way in which finance leases are currently accounted for.

Impact on Statement of Profit and loss

Total lease expense will now be **<u>front-loaded</u>** even when cash rentals are constant



Impact on Statement of Financial position

Companies with operating leases will now appear to be **<u>more asset-rich</u>**, but also more **<u>heavily indebted</u>**

Reasons for issuing IFRS 16

- **<u>Greater transparency</u>** of the lessee's
  - Financial leverage, and
  - Capital employed

- **<u>Complete and understandable picture</u>** of an entity's leasing activities

- Address concerns around "**<u>off-balance sheet</u>**" finance through the use of operating leases

Financial impacts - Lessee

<u>Capitalization</u> of former operating leases

- Some financial ratios and measures will change for the worse
- But all companies will be impacted to some degree

Key Ratios/Measures	Effect of IFRS 16
EBITDA	+
Gross Margin	None
Operating Efficiency Ratio	+
Current Ratio	- (more liabilities)
Quick Ratio	- (more liabilities)
Net Worth	None
Debt/Equity Ratio	- (more debt plus less equity)
Return on Assets (RoA)	- (more assets plus front ended costs)
Return on Equity (RoE)	+/- (?) (less equity but front ended costs)

Conclusion

- Discussion

- Questions?