ON THE MARK



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# IFRS 16 - A lessee's perspective

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### *What's new?*

A major change is underway for the accounting of leases by lessees with the introduction of IFRS 16 - Leases ("IFRS 16") where many leases that were previously not reported on the balance sheet will now be included. These changes will have a significant impact on the financial position, earnings and EBITDA of entities, especially those that operate in capital intensive industries and use leasing as a method of financing. The new standards take effect for fiscal years beginning on or after January 1, 2019.

### *What is considered a lease?*

IFRS 16 defines a lease as a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. It does not matter if the lease is the entire contract or a component of another contract. Certain contracts contain a right to use multiple assets. In these situations, the right to use each underlying asset may be considered a separate lease component.

### *Which leases are subject to the new standards?*

IFRS 16 applies to all leases except:

1. leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
2. leases of biological assets within the scope of IAS 41 Agriculture held by a lessee;
3. service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements;
4. licences of intellectual property granted by a lessor within the scope of IFRS 15 Revenue from Contracts with Customers; and
5. rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

A lessee may, but is not required to, apply this standard to leases of intangible assets other than those described in 5 above.

### *What's changed?*

This new standard will require that all leases subject to the new standard be recorded on the statement of financial position as an asset and a liability. As a result of this, leases that were previously treated as operating leases under the existing standard will now be included on the statement of financial position as a right-of-use asset and a lease liability. Further, a lessee will report depreciation expense on the right-of-use asset and interest expense on the lease liability, rather than the current reporting of an operating lease as a lease expense.

The lease liability will be measured using the present value of the lease payments discounting by the interest rate implicit in the lease or, if this rate cannot be readily determined, the lessee's incremental borrowing rate shall be used.

The right-of-use asset will be measured by the lessee at:

- the amount of the lease liability;
- plus any lease payments made at or before the commencement date, less any lease incentive renewal;
- plus any initial direct costs of the tenant; and
- plus an estimate of costs for dismantling or removal of an underlying asset or site restoration costs to the condition required by the lease.

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***What's not included?***

The standard provides an exemption from recognizing a lease under the above requirements where it is a short-term lease and leases for an underlying asset of low value. In this situation, the accounting treatment is similar to that of an operating lease as currently required in IAS 17 where the lease payments are recognized on a straight-line basis over the term of the lease.

***Action steps***

To prepare for the adoption of IFRS 16, an entity should undertake the following steps:

- identify all leases
- determine the non-lease components which are accounted for separately
- measure the lease liability and right-of-use asset assess the financial impact of adoption of IFRS 16
  - determine impact to the statement of financial position
    - assets will generally increase
    - liabilities will generally increase
    - in most cases, there will be a negative impact on debt ratios
  - determine impact to the income statement
    - for leases that were previously treated as operating leases:
      - earnings will change in the individual years of lease, but will be the same over the lease term under both IFRS 16 and IAS 17 (the impact may be significant for companies with numerous leases)
      - you will need to separate the service component of lease contracts, which may involve estimates and judgements
      - changes may effect earnings for purposes of calculation of compensation
  - determine impact on EBITDA
    - EBITA will generally increase because previous lease costs recognized on a straight-line basis as lease costs will now be replaced with interest expense and depreciation, both of which are added back in the determination of EBITDA
  - determine impact on debt covenants and financial ratios
    - an entity should commence assessing the impact on its financial ratios and debt covenants
    - discussions with lenders may be necessary, as debt covenants may require renegotiations (commencing discussions as soon as possible will help facilitate the transition process)

***In summary***

The accounting for leases as a lessee will have a significant impact upon the financial statements of some entities compared to current practices. These entities will need to have a clear understanding of how these standards will impact them and the repercussions of those changes with respect to matters such as debt and loan covenants, the valuation of the entity and compensation and performance evaluation that is dependent upon results. Implementation of this standard can take time to fully assess its impact and implement the changes in existing contracts and agreements to account for the impact. The year 2019 may sound like it is a long time away, but time has a habit of passing quickly. Your Collins Barrow advisor would be pleased to discuss this standard with you.

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