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IFRS Practical Matters

Leases make their way onto the balance sheet

Navigating the journey for a smooth landing

What you need to know

- The IASB issued a new standard for leases that requires lessees to recognise most leases on their balance sheets.
- The new standard will significantly change the accounting for lessees' leases and may have far-reaching implications for a company's finances and operations.
- The new standard will be effective for annual periods beginning on or after 1 January 2019.

Overview

The International Accounting Standards Board (IASB) issued a new standard for leases, which will require lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. The IASB issued its standard as part of a joint project with the Financial Accounting Standards Board (FASB). The FASB has not yet issued its new leases standard, but it is also expected to require lessees to recognise most leases on their balance sheets. However, the standards are not expected to be fully converged due to different decisions reached with respect to lease classification and the recognition, measurement and presentation of leases for lessees and lessors. These differences could result in similar transactions being accounted for differently under International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (US GAAP). This publication focuses on the IASB's new leases standard, IFRS 16 *Leases* (the new standard). However, companies with both IFRS and US GAAP reporting requirements may also wish to consider implications of the differences between IFRS 16 and the FASB's new standard.

The IASB has set an effective date to apply the new standard for annual periods beginning on or after 1 January 2019. Early application will be permitted, provided the new revenue standard has been applied, or is applied at the same date as the new leases standard.

Building a better working world

What is the impact for lessees?

For many companies, leases play a critical role in their business operations. However, because most lease transactions (e.g., operating leases) are off-balance sheet today, accounting for leases under current lease standards often does not require a significant effort. The new standard will require a company to do more than simply convert its existing operating lease commitments footnote disclosure to reflect lease assets and liabilities. Its implementation could result in changes to the policies, processes, controls and IT systems that support lease accounting and possibly lease procurement, lease administration and tax. Companies may also wish to consider the implications for financial statements and metrics as they negotiate contracts that are, or may contain, leases. These activities will require involvement from a variety of departments across the company.

Data collection and ongoing data management

In order to determine what changes are necessary to apply the new standard, much of the preliminary work will revolve around assessing the state of a company's current lease contract data management (i.e., its systems, policies, processes and controls), including the data required for financial reporting purposes.

Companies that already have well-organised lease administration and accounting functions may simply need to evaluate whether their existing systems, policies, processes and controls require adjustments to accommodate the changes in the new standard. However, while existing systems (e.g., spreadsheets and software) may include some lease information, they may not have all of the information required to make the calculations, judgements (including on-going assessments) and information for disclosures necessary to comply with the new standard. As such, significant effort could be required to manually gather missing lease information.

Other companies (e.g., those with lease procurement, lease administration and lease accounting functions that are decentralised depending on the business unit, geographic location, or type of leased asset) could have a challenging journey ahead. For such companies, determining the completeness of the lease portfolio, as well as the accuracy and completeness of the lease data, may require considerable effort.

One example of how the new standard will drive the need for changes in a company's lease data management is the treatment of lease and non-lease components within a contract. For contracts with multiple components, a company is required to identify and separate non-lease components (e.g., operations, maintenance services) from the lease component. Today, many companies may not focus on identifying the distinct components because their accounting treatment (i.e., the accounting for an operating lease and a service contract) is often the same. The new standard does permit, as an accounting policy election, lessees to recognise the lease and non-lease components as a single lease component on the balance sheet, but that would have the effect of increasing the lease obligation on the balance sheet. We expect lessees may find that policy attractive when the non-lease components are not a significant aspect of the arrangement. Therefore, lessees that do not elect to combine lease and non-lease components may need to put robust processes in place to identify and account for the separate components if they wish to minimise the impact of the new standard on their balance sheets.

IT systems, processes and controls

Today's lease-related IT systems are often designed primarily to assist with lease administration, and many are focused on real estate leasing or a lessor's investment in leased assets. However, lessees commonly use spreadsheets to supplement requirements for current lease accounting and reporting because today's lease-related IT systems often lack the capabilities to perform the calculations required for accounting.

To satisfy the new financial statement presentation and disclosure requirements, companies will need to evaluate whether to update their existing systems or to implement a new system. Selecting or updating a lease IT system will probably require input, not only from accounting, but also from the lease administration and IT functions, depending on the company's enterprise resource planning (ERP) environment. When implementing any IT system, it is important to define system requirements and the expectations of relevant stakeholders prior to selecting a vendor.

If a company chooses to apply the new standard on a full retrospective basis, upon initial application, it will be required to restate comparative reporting periods. Furthermore, companies may need to keep separate books for external reporting, local statutory requirements and tax purposes. This will increase the IT system requirements, and may also further complicate processes and controls. Identifying, developing and implementing changes to IT systems are not easy exercises, and the amount of time necessary would depend on the legacy systems in place.

Companies that are presently designing or upgrading IT financial reporting systems would be well advised to consider the new standard as part of their current IT development efforts. This could reduce the risk of costly re-work and re-design at a later date. Companies also should be mindful that although IT programs can help accumulate data and perform calculations required by the new standard, they are not a complete solution; no program can make the critical estimates or judgements required by the new standard.

Accounting policies and manuals

The new standard requires the application of judgement and estimates. For example, evaluating whether an arrangement meets the definition of a lease could require judgement for certain arrangements such as those with a significant service component. The revised definition of a lease could result in some arrangements receiving different accounting treatment compared to current standards. Other key decisions requiring judgement include lease payments and lease term, including the ongoing evaluations of lease term and the accounting for lease modifications. While the IASB expects many of the conclusions to be the same under the new standard, many of the judgements and estimates may receive increased scrutiny because lease assets and liabilities will be reported on the balance sheet for most leases.

Also, there are a number of accounting policy elections that may be made, both at transition and for the accounting post-transition, including whether to apply the recognition exemptions for short-term leases and leases of low-value assets. In addition, the new standard allows for certain transition reliefs that, if elected, can help minimise the implementation burden. Companies will need to understand the impact of these options to help them make informed choices as to which elections to make.

Companies will also need to update their policies and manuals, as well as provide education and guidance on the new standard across the organisation, in order to ensure accurate and consistent policies and processes around areas of judgement and estimates.

Lease procurement and negotiation

Under the new standard, lessees will recognise the present value of lease payments over the lease term as a lease liability on the balance sheet. Similar to current accounting, the definition of lease payments excludes certain variable payments, and the lease term includes only those lease term options that are reasonably certain of being exercised. As such, lessees may reassess their needs when negotiating their lease terms and payments. A higher proportion of variable payments compared to fixed payments or shorter initial lease terms may result in smaller lease liabilities.

Some lessees may reassess whether buying an asset would be more advantageous than leasing it. At a minimum, companies entering into new leases today should be aware of the potential impact of the new standard on their financial statements.

Although some of these approaches to minimising the lease liability appear advantageous from a financial statement presentation perspective, lessees should understand that there are certain economic and business risks associated with such approaches. Therefore, companies should consider any changes to their approach to lease contracts in the context of their underlying commercial requirements. For example, a company may consider balancing a lower lease liability from a shorter lease term for a property against the security of longer-term access to the premises. Further, lessors may be hesitant to take on the additional risk associated with variable payments and shorter initial lease terms. While companies should not make economic decisions based on accounting results, they should be aware of the accounting consequences associated with their business decisions.

Financial statements and metrics

For most lessees, the new standard will result in a gross-up of the balance sheet. This could cause a deterioration of debt ratios and return on assets compared with current accounting. Certain regulatory ratios also may be impacted.

A company should assess the potential impact on its financial statements and metrics and evaluate how this may affect the way stakeholders view its financial position and performance. Companies will likely need to educate internal and external stakeholders on the financial statement implications of the new standard. Some companies anticipate the need to better manage the communication of key performance indicators to stakeholders under both current lease accounting and the new standard during the transition period.

In addition, companies should identify whether compensation (e.g., employee bonuses) and debt arrangements should change in light of the new standard. However, renegotiating these arrangements may not be straightforward. For instance, companies may need to evaluate their existing debt arrangements and, if necessary, negotiate with their creditors either to allow for more headroom in covenants or to allow for the continued use of current lease accounting in the covenant calculations. While the continued use of current lease accounting may seem like a good idea, it would require the ongoing burden of maintaining a separate set of books for covenant calculation purposes. Similar considerations should be evaluated if key metrics underlying compensation arrangements are impacted.

Tax considerations

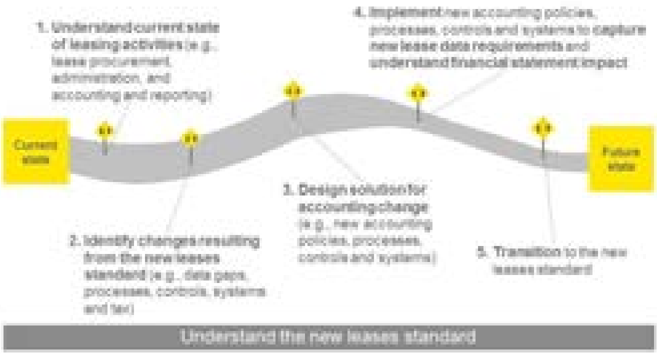
Adoption of the new standard will result in additional tax-related considerations. These include understanding the impact of the lease accounting changes on existing tax positions, initial adjustments to deferred taxes and tracking book/tax differences. Companies will need to determine necessary changes to tax-related processes and controls required to identify and track tax adjustments. The impact on taxes will, of course, depend upon the requirements of the specific tax jurisdiction and whether and how they are changed to reflect the requirements of the new standard.

Are there changes for lessors?

Although the accounting by lessors is substantially unchanged from current accounting, lessors will have new disclosure requirements.

However, lessors should understand how the new standard could affect their lessee-customers' behaviour. This would help lessors negotiate lease arrangements that meet the needs of their customers. For example, certain lessees may desire shorter lease terms or a larger portion of variable payments in an effort to minimise their financial statement impact. However, shorter leases and variable payments could result in unpredictable revenue for lessors and drive up costs to lessees. Lessees may request that lessors assist them by separately pricing non-lease components to help them provide data to support the allocation of consideration between the lease and non-lease components to minimise the financial statement impact. However, lessors may be reluctant to disclose this information for proprietary reasons. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes.

How should companies prepare?



Education

An initial step in preparing for implementation of any new accounting standard is developing an understanding of what's changing. Companies should review the new standard and understand the implications of the changes, including the areas within the company that will experience the greatest impact. It is also important to stay updated for potential changes in interpretation of the new standard that may emerge.

Global companies that report under both IFRS and US GAAP will also need to understand the changes in US GAAP. While a long-standing objective of the project was a single converged leases standard, the IASB and the FASB reached different decisions in some key areas. One of the main expected differences between IFRS and the expected US GAAP standard is lease classification and subsequent measurement. As it relates to lessees, the IASB decided that lessees will treat most leases similar to today's finance leases, resulting in the recognition of depreciation expense and interest expense for those leases. In contrast, the FASB decided to require lessees to classify most leases into two types: finance leases and operating leases. While both types of leases will be recognised on lessees' balance sheets, the expense recognition will be similar to today's finance and operating leases based on the lease classification. Another key difference is that the IASB's new standard includes a recognition exemption for lessees' leases of low-value assets (e.g., personal computers, tablets, telephones but not vehicles).

As such, companies that are required to apply both IFRS and US GAAP may be subject to additional costs and complexities arising from maintaining multiple processes and systems to comply with the requirements under each respective standard and to identify the differences when comparing one set of financial statements to the other.

Project team and planning

After obtaining an understanding of the new standard, companies should identify a cross-functional team and develop a project plan with effective project management to tackle its implementation. This is unlikely to be a 'one size fits all' approach as the nature of leasing activities (i.e., the underlying assets, value and volume of leases), existing policies and processes, financial reporting requirements, and strategic business decisions vary across companies.

Another critical element of planning is ensuring appropriate governance, including seeking input from relevant stakeholders and obtaining an understanding of whether a company wants simply to comply with the new standard or to use this as an opportunity to drive organisational improvements and savings in its leasing activities.

Diagnostic: understand current state and identify changes

Not all aspects of current lease accounting are changing under the new standard. Therefore, companies should assess what lease arrangements exist and the lease procurement, lease administration and lease accounting functions that support these arrangements in comparison with the requirements of the new standard. This will allow companies to determine the extent of the changes that will be required and appropriately design and plan the transition.

As part of the review, companies should consider the policies and systems in place within other departments, including treasury, legal, IT and tax, and understand how processes involving leasing may vary depending on geographies or other differences within the company.

Design, implementation and transition

Implementing the new standard will require companies to determine when to transition. Companies may decide to early adopt the leases standard to align with the transition to the new revenue recognition standard. Once the transition decisions are made and there is a clear understanding of what changes will be necessary based on current state diagnostics, companies can then design the implementation and transition plan.

Preparing for an accounting change of this magnitude presents a considerable challenge. Understanding how the new standard will affect your company is critical. All companies with significant leasing activities should review the new standard and begin thinking about the implications now, as we believe that starting early is the best way to reduce the overall cost of implementation and to avoid unwanted surprises and costly mistakes.

For more information about the new leases standard, refer to the following publication available at www.ey.com/ifrs

- *IFRS Developments, Issue 117*: IASB issues new leases standard (January 2016, EYG No. AU3676)

How can EY help?

EY has a multidisciplinary team of accounting, tax, corporate real estate, systems and IT professionals to assist in assessing what the new leases standard will mean to you. The table below outlines considerations your company should assess with respect to the new standard and how EY may be able to help you from initial diagnostic all the way through to eventual adoption.

Issues and steps	**How EY may be able to help**
Gain a general understanding of the new standard	▶ Design and help deliver a training session for company personnel ▶ Share insights of the IASB, FASB, regulator views
Perform an assessment of the impact of the new standard on your company	▶ Advise and provide input into: ▶ Identifying all arrangements that are in the scope of the new standard ▶ Gathering information required under the new standard especially considering the additional disclosures ▶ Summarising the terms of arrangements and interpreting the standard and its application to current practices ▶ Developing a consistent methodology around judgements and estimates that may be necessary to evaluate whether an arrangement contains a lease, separate lease and non-lease components, estimate lease term and lease payments, and identify events that require reassessments ▶ Assessing lessors' lease classification, including estimates of the economic life and fair value of the leased asset at lease inception and the residual value at the end of the lease term ▶ Calculating the financial statement impact and effect on key financial metrics
Assess impact of the new standard on strategic business decisions	▶ Advise and provide input into: ▶ The impact of changes to financial performance and related metrics on financial covenants or compensation arrangements ▶ Lessees' analysis of whether to continue to lease versus to buy ▶ Lessors' decisions to modify terms of their lease arrangements to meet the demands of customer-lessees in light of the changes to lessee accounting
Benchmark your company against peers and others in the industry	▶ Provide observations on how others are approaching the new standard, problems they encountered and solutions developed ▶ Assist in the evaluation of peers, competitors and industry disclosures, and expected impact on their financial reporting
Assess tax positions relating to the new standard	▶ Advise on analysing tax positions arising from the new standard, reducing tax exposure and determining tax effects of lease modifications
Plan for ultimate adoption of the new standard	▶ Advise on project management and planning, including timeline, tasks and resource allocation
Update accounting manuals and policies	▶ Read and provide input into accounting manuals and policies selected by management ▶ Help draft policies reflecting the requirements in the new standard
Communicate effect of adoption to stakeholders: analysts, regulators and shareholders	▶ Advise on developing a communication plan ▶ Advise on drafting communications

For more information, please contact:

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