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Technical Accounting Alert

IASB releases new standard on leases

Introduction

The IASB has published IFRS 16 Leases, completing its long-running project on lease accounting.

The new Standard requires lessees to account for leases 'on-balance sheet' by recognising a 'right of use' asset and a lease liability. It will affect most companies that report under IFRSs and are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment. For many other businesses, however, exemptions for short-term leases and leases of low value assets will reduce the impact (see below).

The table below summarises the main changes at a glance.

Heading	Main changes
Who is affected?	• entities that lease assets as a lessee or a lessor
What's the impact on lessees?	• all leases will be accounted for 'on-balance sheet', other than short-term and low value asset leases • lease expense will typically be 'front-loaded' • lease liability will exclude: – option periods unless exercise is reasonably certain – contingent payments that are linked to sales/usage
What's the impact on lessors?	• only minor changes from the current Standard, IAS 17 *Leases*
Are there other changes?	• a new definition of a lease may result in some arrangements previously classified as leases ceasing to be so, and vice versa • new guidance on sale and leaseback accounting • new and different disclosures
When are the changes effective?	• annual reporting periods beginning on or after 1 January 2019 • various transition reliefs • early application is permitted if IFRS 15 *Revenue from Contracts with Customers* is applied

Definition of a lease

Because the new lease accounting model brings many more leases 'on-balance sheet', the evaluation of whether a contract is (or contains) a lease becomes even more important than it is today.

Under IFRS 16 a lease is defined 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'. A contract is, or contains, a lease if:

- fulfilment of the contract depends on the use of an identified asset; and
- the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration

In practice, IFRS 16's new definition (and the accompanying guidance) is unlikely to affect most businesses as the new definition is largely based on the existing requirements. Furthermore, the new definition will only apply to new lease contracts and there will be no need for businesses to re-assess their existing leases when transitioning to IFRS 16.

Lessee accounting

Subject to the optional accounting simplifications discussed below, a lessee will be required to recognise its leases on the balance sheet. This involves recognising:

- a 'right-of-use' asset; and
- a lease liability

The lease liability is initially measured as the present value of future lease payments. For this purpose, lease payments include fixed, non-cancellable payments for lease elements, amounts due under residual value guarantees, certain types of contingent payments and amounts due during optional periods to the extent that extension is 'reasonably certain'.

In subsequent periods, the right-of-use asset is accounted for similarly to a purchased asset and depreciated or amortised. The lease liability is accounted for similarly to a financial liability using the effective interest method.

Optional accounting simplifications

IFRS 16 provides important reliefs or exemptions for:

- short-term leases (a lease is short-term if it has a lease term of twelve (12) months or less at the commencement date. The use of this exemption is an accounting policy choice that must be made consistently for each class of underlying asset); and
- low-value asset leases (the assessment of value is based on the absolute value of the leased asset when new and therefore requires judgement. In the Basis for Conclusions which accompanies the Standard, however, the IASB notes that they had in mind leases of assets with a value when new of around US$5,000 or less. The use of this exemption is an accounting policy choice that can be made on a lease-by-lease basis).

If these exemptions are used, the accounting is similar to operating lease accounting under the current Standard IAS 17 Leases. Lease payments are recognised as an expense on a straight-line basis over the lease term or another systematic basis (if more representative of the pattern of the lessee's benefit).

Lessor accounting

IFRS 16's requirements for lessor accounting are similar to IAS 17's. In particular:

- the distinction between finance and operating leases is retained
- the definitions of each type of lease, and the supporting indicators of a finance lease, are substantially the same as IAS 17's
- the basic accounting mechanics are also similar, but with some different or more explicit guidance in a few areas. These include variable payments; sub-leases; lease modifications; the treatment of initial direct costs; and lessor disclosures.

Effective date and transition

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Early application is permitted for entities that apply IFRS 15 at or before the date of initial application of IFRS 16.

In terms of transition, IFRS 16 provides lessees with a choice between two broad methods:

- full retrospective application – with restatement of comparative information in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- partial retrospective application – without restating comparatives. Under this approach the cumulative effect of initially applying IFRS 16 is recognised as an adjustment to equity at the date of initial application. If a lessee chooses this method, a number of more specific transition requirements and optional reliefs also apply.

Australian context

The Australian Accounting Standards Board (AASB) is expected to issue the equivalent Australian Standard, AASB 16 Leases, shortly.

Further information

For further information on any of the information included in this Technical Accounting Alert, please get in touch with your local Grant Thornton Australia contact or a member of the National Audit Support Team at nationalaudit.support@au.gt.com.