

## Leases one year on—putting IFRS 16 into practice

When the International Accounting Standards Board (the Board) issued IFRS 16 *Leases* in January 2016, it set an effective date of 1 January 2019<sup>1</sup>, giving companies three years to implement the new Standard. We are now a third of the way into that implementation period—how are companies getting on?

In this article, four IASB Members discuss messages they have heard from stakeholders about IFRS 16 implementation over the last year and give advice to companies implementing the new Standard.

**“If companies have not yet started their implementation activities, they need to do so soon.”** Gary Kabureck, IASB member

### Sue Lloyd, IASB Vice-Chair

On transition options and benefits



It is crucial that companies think about their transition choices as early as possible. There are potentially very significant cost savings available depending on which options are chosen.

The transition requirements in IFRS 16 provide a number of different options for companies applying IFRS 16 for the first time. What we have heard from companies is that once the options, and the reasons the Board decided to include those options, are fully understood, companies are benefitting from the control that they have in balancing the costs of transition and the quality of financial reporting.

There are potentially very significant cost savings available depending on which options are chosen. For example, a company can choose not to restate comparative information in the year that it first applies IFRS 16 and not to apply IFRS 16 to leases with a term ending within 12 months of the date of initial application.

There are also practical expedients available relating to the measurement of lease liabilities and right-of-use assets that companies will report on their balance sheets for the first time when IFRS 16 is applied.

However, taking the least costly options will lead to approximations in a company's financial statements. These approximations will affect reported amounts in the year of transition and possibly for several years thereafter.

For example, one of the practical expedients in IFRS 16 enables a lessee to measure right-of-use assets on the date of initial application without using any historical data. However, if this practical expedient is used, companies will measure right-of-use assets at a higher amount than they would using historical data.

Consequently, depreciation charges in the income statement will be higher for the remainder of the lease term. For long-term leases of large assets such as property, companies may prefer to incur extra costs gathering historical data on transition to avoid a higher depreciation charge in the income statement. Conversely, for leases that are less significant to the financial statements, a company may prefer to take some shortcuts on transition. For this reason, many of the transition options in IFRS 16 are available on a lease-by-lease basis.

<sup>1</sup>A company can choose to apply IFRS 16 before 1 January 2019 if it also applies the new revenue Standard, IFRS 15 *Revenue from Contracts with Customers*.

It is therefore crucial that companies think about their transition choices as early as possible. This will enable them to make the best use of the cost savings available, and find the right balance between cost and reporting outcomes based on their own particular lease portfolio.

### **Gary Kabureck, IASB Member**

#### On early planning and practical steps



Companies must allow themselves sufficient time for the practical steps involved in implementing IFRS 16. There are some time-consuming steps to be taken in the early stages.

Another important reason to make transition decisions as early as possible is to allow sufficient time to implement those decisions. In addition to understanding the technical requirements in the new Standard, companies must allow themselves sufficient time for the practical steps involved in implementing IFRS 16.

One reason the Board provided a three-year implementation period is because many companies told us they would need that time to implement the requirements. We are now a third of the way into the implementation period and if companies have not yet started their implementation activities, they need to do so soon. Those companies that have already started are finding that there are some time-consuming steps to be taken in the early stages.

For example, some companies with large volumes of leases are finding that the initial step of identifying and locating all of their lease contracts may in itself be a substantial task. This is particularly true for companies that do not maintain lease records centrally.

Companies next need to establish a process for entering those contracts into their accounting system and ensuring that the data entered is accurate. This is another step that is likely to be time consuming for companies with high volumes of operating leases today.

Accounting teams are also likely to need to spend time talking to other parts of the business. This is not only to identify contracts, but also to understand the reasons for contract provisions such as extension options and variable payments. Such contract provisions will need to be understood to account for leases appropriately applying IFRS 16. Companies will also benefit from engaging with their auditors in the early stages of implementation, particularly in relation to any accounting judgements applied during the implementation process.

A final point to note about timing and transition options: if a company applies IFRS 16 retrospectively, restating comparative information, IFRS 16 will have to be applied to the 2018 financial information. In other words, these companies will need to start capturing IFRS 16 information just one year from now.

### **Darrel Scott, IASB Member**

#### On judgements and discount rates



Companies could benefit significantly from an early consideration of their approach to determining discount rates.

Most accounting judgements required to apply IFRS 16 are already required applying IAS 17. That is because IFRS 16, in essence, increases the population of contracts to which finance lease accounting judgements need to be applied. Most companies that will apply IFRS 16 will have had experience applying the judgements required by the new Standard, albeit to a smaller population of contracts.

Although the judgements involved in applying IFRS 16 and IAS 17 are similar, some new information is needed to apply the requirements in IFRS 16. Most notably, companies need to establish the discount rate for each lease, including those that were formerly operating leases. Determining an appropriate discount rate for what were formerly operating leases is a new process, and is likely to be one of the most challenging areas to implement.

IFRS 16 includes two ways to determine discount rates. The first is to use the rate implicit in the lease. If a lessee already has the information, it is straightforward to establish this rate. However, it is likely that in many cases lessees will not currently have sufficient information about how the lessor priced the contract to determine this discount rate. For example, the lessee would need to know any initial direct costs of the lessor and any residual value the lessor has assigned to the asset that it expects to get back at the end of the lease term.

If it is not practicable to determine the rate implicit in the lease, then the lessee instead uses its incremental borrowing rate for that lease. In an audience survey taken at a recent IFRS Foundation conference, 74 per cent of the audience expected to use incremental borrowing rates when applying IFRS 16.

To arrive at an appropriate incremental borrowing rate for the lease, lessees need to think about the factors a lender would typically consider, such as the lease term, the value of the right-of-use asset, the nature of the asset and the economic environment. Lessees may also want to think about whether they have any groups of leases with similar characteristics. If so, they may be able to determine a discount rate for a portfolio of similar contracts.

Based on the feedback we have heard, the biggest challenge relating to discount rates is determining an appropriate incremental borrowing rate for long-term leases such as long-term leases of property. Lessees cannot always identify a rate for a similar borrowing to use as a starting point. In these cases, lessees may benefit from thinking about how they assessed the price of the lease at contract inception.

For example, at inception, what rate the lessee used to assess whether the long-term lease pricing was reasonable? Alternatively, lessees could think about starting with other observable rates such as relevant property yields, and then consider how those observable rates might need to be adjusted to reflect the lessee's own risk profile.

Companies need to establish what kind of information they already have, or might be able to access. If companies have contracts for which establishing the discount rate may require judgement or additional

information, they could benefit significantly from an early consideration of their approach to determining discount rates.

### **Stephen Cooper, IASB Member**

On investor expectations and lease disclosures between now and 2019



Ensuring that lease disclosures are complete and robust before 2019 will avoid unnecessary complications on transition.

A recurring theme we have heard over the last few months is the importance of companies ensuring that they are happy with their IAS 17 operating lease commitment note *before* the transition to IFRS 16. We have heard this from both preparers and users of financial statements. Some users have indicated that, assuming there are no surprises on transition, applying IFRS 16 is not expected to give rise to changes in credit ratings or the cost of finance. Credit-rating agencies and lenders already estimate the effects of off balance sheet leases on financial leverage and, economically, nothing changes when IFRS 16 is applied.

A user of financial statements might reasonably expect that the amount of lease liabilities appearing on the balance sheet when IFRS 16 is first applied will be broadly similar to previously reported operating lease commitments, adjusted for the effect of discounting. If the amount of lease commitments on the balance sheet in 2019 is likely to differ from investor expectations, communicating early is the best approach. We know some companies are thinking about this already.

Differences could arise because judgements about whether to include particular amounts in lease liabilities become more critical when IFRS 16 is applied. Today, the inclusion of an amount as a lease payment often affects only the operating lease commitment note; when IFRS 16 is applied, it will affect the face of the primary financial statements. Therefore, some companies are expecting to



apply a greater degree of rigour to judgements such as whether to include extension and termination options in the lease term and the definition of a lease. This new rigour could lead to the recognition of a different amount of lease liabilities than today's operating lease commitment note might suggest.

For example, at a recent IFRS Foundation conference, only 45 per cent of companies surveyed said they will have the same population of leases when they apply IFRS 16 as they have today. This is despite the fact that, for the vast majority of contracts, applying IFRS 16 will not change the conclusions reached about whether the contract contains a lease.

If companies have concerns about their existing operating lease commitment note, they should resolve these concerns now. Ensuring that lease disclosures are complete and robust before 2019 will avoid unnecessary complications on transition or surprises for users of financial statements.

It is also a good idea for companies to communicate with investors and other stakeholders about the effects of IFRS 16 sooner rather than later. This will enable them to manage expectations about exactly what will be coming on to the balance sheet in 2019.

## IFRS 16 Implementation Support

The Board's activities to support the implementation of IFRS 16 are summarised at <http://go.ifrs.org/IFRS16-implementation>. Here you can find educational webcasts and other supporting materials, Board Member articles and information about future IFRS Foundation events. You can also find out how the Board deals with technical enquiries and implementation issues relating to IFRS 16.

### Get in touch

If you would like to discuss this topic, please contact [leases@ifrs.org](mailto:leases@ifrs.org), or alternatively:

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