IFRS 16

Changes in recognizing leases in the financial statements

Polish Leasing Association

The new standard in a nutshell:

To whom the new standard applies / Binding terms and conditions

In January 2016, the International Accounting Standards Board (IASB) published the new International Financial Reporting Standard No. 16 (IFRS 16) concerning leases, which was adopted by the European Union on 9 November 2017. IFRS 16 will become binding for the companies which report and prepare financial statements according to IAS/IFRS for the reporting periods beginning on or after **1 January 2019.** The standard will have an impact on most companies that use assets based on lease, rental and similar contracts for the provision of services, if the customer has the right to control the use of an identified asset over the term of the lease (in such case the contract may contain a lease component). Companies will be allowed to apply IFRS 16 early only if they implement it together with the new IFRS 15 (Revenue from contracts with customers).

Change in calculation and presentation policies

The new requirements eliminate the term 'operating lease', and therefor also the off-balance sheet recognition of assets used on this basis. **The standard introduces** a single lessee accounting model. All the assets used and respective commitments to pay rent will have to be disclosed in the balance sheet. This will have an impact on the basis for calculating universally used financial ratios, such as gearing or EBITDA. The application of the standard may also have an impact on the credit contract covenants, credit ratings, finance costs and perception of the companies by stakeholders.

Business data and processes

Changes in recognizing leases will have an **immense impact on business processes, IT systems and the internal control environment of the lessees**. A lessee will need decidedly more data on its lease contracts due to the requirement of recognizing all such contracts in the balance sheet. Companies will be forced to adopt a comprehensive approach to the issue of implementing the new standard, not limited to only accounting issues.

Possible exemptions

IFRS 16 allows companies to not disclose leased assets and lease liabilities in the balance sheet only in respect of lease **contracts which last no longer than 12 months**. In such an instance the lessee recognizes lease payments in the income statement on a straight-line basis over the term of the lease. **Low-value assets** such as: tablets, computers, telephones or office furniture with low initial value are treated similarly. The maximum value of an asset qualifying for this type of exemption, as suggested by IASB, is approx. $ 5,000.

This leaflet has been prepared exclusively from the lessee's perspective. IFRS 16 and respective disclosures by and impact on the lessor have not been taken into consideration.

IFRS 16 – The new lease standard

In January 2016 IASB published the new IFRS 16 on leases which becomes binding as of 1 January 2019. The new standard requires that the lessee recognize almost all contracts containing a lease in the balance sheet. The purpose of this is to reflect the right of the lessee to use the asset in the given period and to recognize the respective liability to pay the lease rent/instalments.

Leases are an important and popular source of finance. They enable companies access to real estate, machines and equipment, and their use without the need to incur high initial expense. Additionally, it ensures flexibility and allows the lessee to eliminate problems related to the limited period of economic usefulness of an asset and the risk related to its residual value. In practice sometimes leases are also the sole solution enabling using the assets which cannot be purchased.

According to the currently binding standards (IAS 17) lease contracts are classified as finance leases or operating leases. This classification is often based on a complicated list of principles and terms which lead to a different accounting approach depending on whether they are met or not, despite the lease transactions often being very similar from an economic point of view.

The impact of the new standard on financial reporting, the manner of financing assets, operating systems and processes and internal controls may be significant. Many companies use leases as a source of obtaining valuable assets, such as cars, offices, plants, shops or aircraft fleets. Therefore, lessees will be seriously affected by the new standard and should prepare for its implementation.

Impact of IFRS 16 on lessees

- The new standard will impact almost all universally used financial ratios and measures of effectiveness, such as: the gearing ratio, current liquidity, asset turnover ratio, interest coverage, EBITDA, EBIT, operating profit, net profit, earnings per share (EPS), return on capital engaged, return on equity (ROCE, ROE) and cash flows from operating activities. These changes may also have an impact on the covenants included in credit contracts, on credit ratings and borrowing costs, and may also be reflected in changes in behaviours on the financial market. These changes will force many companies to re-analyse their decisions as to whether to lease or purchase an asset.
- The balance sheet totals will increase and the equity ratios will drop. A change will also be noted in the classification of costs (lease rent will be replaced with depreciation and interest expense) and in the date of their recognition (lease expenses in the new model will be recognized relatively earlier compared to the current model of recognition of operating lease expenses).
- The changed standard will strongly affect those entities that lease assets of significant value – including real estate, manufacturing plant, airplanes, trains, ships and technological equipment. The impact on entities with many lease contracts of less valuable assets such as computers, small office equipment or telephones may be lower. In respect of lower value assets (unit value of a leased asset no higher than $5000 upon purchase) IASB offers an exemption from the obligation to recognize the lease in the balance sheet (more below).
- The cost of implementing and further reporting in accordance with the requirements of the new standard may be significant for most lessees, in particular if currently they have no information systems which could provide the required data on the lease contracts the entity has concluded.

Definition of a lease under IFRS 16

The scope of IFRS 16 is very similar to IAS 17, and covers all types of leases, including assets in respect of the right of use concerning sub-leases. Rights to intellectual property granted by the lessor, rights received by the lessee based on licence agreements, leases of biological assets, service concession agreements and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources do not lie within the scope of IFRS 16. Companies may also refrain from using IFRS 16 for other intangible assets.

However, the definition of a lease in IFRS 16 differs from the current definition in IFRIC 4, which may lead to different recognition and classification of some contracts. IFRS 16 includes detailed guidelines to enable companies to assess whether a given contract is, or contains a lease, a service, or both features. In accordance with the currently binding regulations and accounting practice, there is not much pressure to differentiate between service and operating lease components due to the same accounting treatment of both.

Under IFRS 16 contracts have to be analysed in terms of determining whether the contract meets the definition of a lease. A contract is a lease contract when it gives the customer a right to control the use of an identified asset over a period of time for a consideration.

A contract contains a lease when all of the conditions specified below are met:

- the asset is identified (please note: an asset is not identified when the supplier has significant rights to replace the asset);
- the customer has rights to practically all the economic benefits;
- the customer determines in what way and for what purposes the asset is being used, or the same is determined in a top-down manner, but the customer uses the asset or has designed it.

Example 1

A lease contract was concluded based on which the entity obtained the right of exclusive use of four vehicles for a period of five years. The contract relates to concrete cars (the type, brand and registration numbers were specified).

The company determines when, where and which goods are to be transported using the vehicles (with the exception of specified types of cargo (e.g. explosives), which the company is not entitled to transport).

Only if the vehicle requires repair or maintenance will the provider be obliged to replace it with the same type of vehicle.

Conclusion:

The contract contains a lease as the assets are identified (if an asset is replaced due to failure or technical corrections, the right to replace it is immaterial). The company obtains practically all the economic benefits and has the right-of-use.

Example 2

A lease contract was concluded based on which the entity obtained the right of use of four vehicles to transport goods within the territory of Poland for a period of five years. Additionally, the supplier provides drivers who will perform the transport services. The company determines the general parameters of the vehicles used in transport, such as their capacity, with the supplier, but it is the supplier that decides which vehicle is to be selected for a given shipment of goods (e.g. depending on the route), and the company is not entitled to decide which concrete vehicle is to be used for the given shipment. The supplier also provides the same vehicles to service other customers.

Conclusion:

The contract does not contain a lease as the asset is not identified – there is a significant right to replace it.

Recognition in the lessee's books of account

The new standard abolishes the difference between operating and financial leases. Now leased assets (representing the rights to use a given asset over a specific period) and lease liabilities (representing the liability to pay rent) will be recognized for all leases (with the exemption option in respect of short-term leases and leases of low-value assets – more below).

Lessees should initially **recognize a lease liability determined at the amount of discounted future payments over the term of the lease, and then the respective right to use the asset.** The term of the lease is the period compliant with the new definition of the term of a lease provided in IFRS 16. Initial direct costs related to the lease contract and the costs of restoration to the initial condition incurred after the end of the lease term will also require disclosing.

Key elements of the new standard and their impact on the financial statements:

- Replacement of the 'risk and rewards' model with the 'right-of-use' model. Lessees will be obliged to recognize assets and liabilities in respect of every lease contract.
- All lease liabilities should be measured on the basis of the estimated lease term, i.e. including the optional periods when the entity is certain it will exercise an option to extend the lease, (or not to exercise an option to terminate the lease).
- Contingent rentals or variable lease payments will need to be included in the measurement of lease assets and liabilities when these depend on an index or a rate or where in substance they are fixed payments. A lessee will be obliged to reassess variable lease payments that depend on an index or an interest rate only when remeasurement of the lease liability is required for other reasons (for example, because of a reassessment of the lease term) and when there is a change in the cash flows resulting from a change in the actual reference index or interest rate (that is, when an adjustment to the lease payments takes effect).
- Lessees should reassess the lease term only upon the occurrence of a significant event or a significant change in circumstances that are within the control of the lessee.

Right-of-use of an asset	Lease liability	Lease costs in the statement of comprehensive income
Lease liability	**Lease payments** **Discount rate**	Depreciation Interest expense
Lease payments before the commencement of the lease		
Costs of restoration to the initial condition	**Provision for the costs of restoration to the initial condition**	
Initial direct costs		

—— Mandatory elements

- - - - Elements that may potentially appear

Recognition in the lessee's books of account – IAS 17 vs IFRS 16

Balance sheet

IAS 17		IFRS 16
Finance leases	***Operating leases***	***All leases***
Asset	-	Right-of-use asset
Lease liability	-	Lease liability

Income statement

IAS 17		IFRS 16
Finance leases	***Operating leases***	***All leases***
Depreciation	Lease costs	Depreciation
Interest expense		Interest expense

Change compared with the current off-balance-sheet accounting

Balance sheet

Assets	↑
Liabilities	↑

Income statement

Rental costs	↓
Depreciation	↑
Interest expense	↑
EBIT	↑
EBITDA	↑
Net profit, EPS	↑↓

Cash flow

Cash flows from operating activities	↑
Cash flows from financing activities	↓

Practical consequences of implementing IFRS 16

Lease payments

Pursuant to IFRS 16, when the financial liability in respect of the lease is determined, the lease payments have to be discounted using the interest rate implicit in the lease or, if such a rate is non-existent, all lease payments should be discounted using the incremental borrowing rate as at the inception of the lease. Lease payments which should be taken into account include in particular:

- fixed payments (including payments which are in substance fixed, that is those which although of a variable nature, are nevertheless unavoidable, such as payments when the asset is in working order) net of the incentives offered by the lessor;
- variable payments dependent on the rate or index;
- guarantees of residual value (expected payments which the lessee is obliged to make);
- purchase price (if there is reasonable certainty that the purchase option will be exercised);
- payments of penalty for terminating a contract (if the lease period reflects early termination of the contract).

Lease period

IFRS 16 defines the lease term as the total non-cancellable period for which a lessee has the right to use the underlying asset. The start date of a lease term is the date on which the lessee makes available the underlying asset for use by the lessee. The lease term also includes the optional periods when the entity is certain it will exercise an option to extend the lease (or not to exercise an option to terminate the lease). When deciding whether reasonable certainty exists, such factors as, among others, contractual terms, penalties for terminating the contract, legal regulations, market rates, economic benefits and incentives, or the importance of the asset for the lessee.

The extension option should be recognized in the lease term if there is reasonable certainty that it will be exercised by the lessee. The lessee is obliged to reassess the extension option upon the occurrence of material events when significant events or changes in circumstances occur that are within the control of the lessee.

In respect of contracts with an indefinite term the lease term has to be determined by verifying the termination option. In respect of an option which may be exercised by the lessee, it should be determined whether exercising the option is sufficiently certain, and if both parties are entitled to the termination option (without the consent of the other party and without a material penalty) the earliest termination notice period should be taken into account.

Example 3a

In respect of the contract from Example 1 (lease of four vehicles for a period of five years) the lessee may purchase the vehicles after the lease term at a price equal to 10% of the initial value of the vehicle. The lessee assesses that the probability of purchasing the vehicle after the end of the lease term is high.

Conclusion:

If the probability of exercising the purchase option is high, the purchase price should be included in the lease payments.

Example 3b

The contract described in Example 1 (lease of four vehicles for a period of five years) obliges the lessee to make fixed lease payments and additionally to make variable payments in amounts depending on the mileage (payments for exceeding specified thresholds).

Conclusion:

Lease payments taken into account in calculating the lease liability account exclusively for the fixed lease payments as the variable payments following from the contract are not based on an index or rate.

Example 4

In respect of the contract from Example 1 (lease of four vehicles for a period of five years) the lessee may terminate the contract with a one-month notice period. If it does that after 36 months have passed since its conclusion, no penalty is charged. However, if the contract is terminated within 36 months of its conclusion, it must pay a penalty in an amount equivalent to 12-months' instalments.

Conclusion:

If the lessee assesses the probability of using the termination option after the period in which the penalty is material as high, the lease period will be 37 months (equal to 36 months in which the penalty is imposed and the one month notice period).

Discount rate

The discount rate on the lease agreement must be determined by the lessee. The lessee should determine a rate on the application of which the present value of the lease payments including the present value of the unguaranteed residual value would be equal to the fair value of the asset including the direct costs of the lessor. If the interest rate on the lease cannot be determined, the rate should be equal to the incremental borrowing rate valid upon the commencement date of the lease, taking account of the lessee's credit rating.

Lease components

Moreover, IFRS 16 places requirements related to separating the components of a contract which should be accounted for separately if the lessee has the right to use a lease component separately or with other directly available resources and the components are neither highly dependent on, nor highly interrelated with one another.

Lease modifications

If a modification to a lease contract increases the scope of the lease and the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in the scope, the modification should be accounted for as a separate lease. If the increase in the scope of the lease is accompanied by a price increase other than that described above, the underlying asset should be adjusted and the lease liability remeasured. If on the other hand the renegotiation of the contract results in reducing the scope of the lease, the lease liability must be remeasured, the value of the right-of-use asset must be reduced and the profit or loss recognized to reflect the partial termination of the lease (as illustrated in example 5).

Exemptions

Short-term leases

In accordance with IFRS 16, a lessee may elect not to apply lease assets and liabilities for leases with a duration up to 12 months. In such case, the lessee recognizes lease payments in profit or loss on a straight line basis over the lease term. The exemption must be applied on the level of a class of assets.

Leases of low-value assets

IFRS 16 does not place an obligation on the lessees to recognize lease assets and liabilities for low-value assets, such as: tablet and personal computers, telephones and small office furniture. The maximum unit cost of an asset qualifying for exemption suggested by the IASB is $ 5000 (the initial unit cost at the moment of purchase).

Example 5

The lease contract has been concluded for a term of 10 years. The subject of the lease is office space with an area of 5,000 m^2. The annual value of the lease payments was PLN 50,000 and the discount rate adopted on the calculation of the financial liability in respect of the lease was equal to the incremental borrowing rate of 6%. At the start of the 6th year, the parties to the contract decided to reduce the scope of the lease to 2,500 m^2, thus reducing the annual lease payments to PLN 30,000. The incremental borrowing rate at the beginning of the 6th year was 5%.

Conclusion:

In such case, the lessee is obliged to reassess the financial liability in respect of the lease taking account of the remaining lease term (5 years) and payments until the end of the lease term – using the new discount rate. Given the annual payments of PLN 30,000, the remaining 5-year lease term and the 5% discount rate, the liability in respect of the lease is PLN 129,884. It is also necessary to proportionately reduce the right of use of the asset, i.e. by 50% (2,500 m^2 / 5,000 m^2 = 50%) – the value before the modification was PLN 184,002 which means a reduction to PLN 92,001. A similar step should be taken in the case of the liability in respect of the lease: the value as at the end of year 5 was PLN 210,618, therefore, the liability should be reduced to PLN 105,309.

The difference between the reduction in the liability (PLN 105,309) and the reduction in the asset (PLN 92,001) of PLN 13,308 should be recognized as a gain in profit or loss.

The difference between the remaining liability in respect of the lease (PLN 105,309) and the newly assessed liability (PLN 129,884) of PLN 24,575 should be recognized as a modification of the right of use of the asset, thus reflecting the modification of the amount of the lease payments and the discount rate.

Transitional provisions – how to apply IFRS 16 for the first time

The date of initial recognition of IFRS 16 is the start of the first period in which the entity applies the new standard, i.e. **1 January 2019.** Early application is possible but only in the case of applying IFRS 15.

As far as the definition of a lease is concerned it is not necessary to reassess the binding contracts – the new provisions in this scope apply to the contracts concluded after 1 January 2019.

The lessees applying IFRS 16 for the first time may adopt a retrospective approach in accordance with IAS 8 or a simplified approach under which the comparatives are not restated and the effect of the changes is recognized as an adjustment to retained earnings on the date of initial application.

On applying the simplified approach the entities should, in particular:

a) in the case of the former operating lease agreements:

- recognize lease liabilities equal to the present value of the outstanding lease payments, discounted using the incremental interest rate established as at the date of the standard becoming effective;
- recognize lease assets by measuring the asset as though IFRS 16 had been adopted from the date of concluding the contract, using the incremental interest rate of the lessee established as at the date of the standard becoming effective **or** measuring the asset in an amount equal to the amount of the recognized lease liability adjusted for any down payments or overpayments of lease instalments recognized directly before or after the date of implementing the new standard;
- take into account the possibility of applying various simplifications, including among other things exemptions for short-term leases (a lease term not exceeding 12 months from the date of initial application) or low-value assets;
- disclose additional required information: among other things, a reconciliation of the future lease payments disclosed in accordance with IAS 17 with the liabilities recognized in accordance with IFRS 16.

b) in the case of the former finance lease agreements:

- establish the value of the lease asset and liability without the need to recalculate the values which had been established based on the guidance contained in IAS 17 – these values will constitute the initial cost as at the date of implementing the new standard;
- continue the settlement of the above-mentioned assets and liabilities in accordance with the new principles contained in IFRS 16.

On applying the retrospective approach the entities should, in particular:

- apply the requirements of the new standard to each comparative period, i.e. restate the comparatives for each period required in accordance with IAS 8;
- adjust the opening balance of each equity item to which the modification relates for the earliest period presented and disclose other comparatives for each period as though IFRS 16 had always been applied.

The effect of IFRS 16 on the individual sectors

In nearly every sector, companies obtain assets based on lease contracts. However, the type and number of the leased assets, and the terms and structure of the lease agreements differ considerably depending on the sector.

For example, a professional service firm uses cars and offices under lease agreements; a municipal company leases power plants; a retail chain leases sales outlets (shops); a telecommunications company leases fibre optic cables and telecommunication towers; an airline uses aircraft fleet under lease contracts - all these leases have different characteristics, lease terms, regulatory framework, pricelist, risks and benefits. Therefore, the consequences of introducing the new standard will be different for each sector.

Retail trade

As a rule, retail chains use rent retail space, shops or sales outlets under lease contracts. Therefore, the implementation of the new standard will have a very significant effect upon them, especially in the following areas:

- Option to extend a lease – leasing of real estate is the basis for conducting business by entities from the retail trade sector, therefore, assessing whether there are economically justified reasons for exercising the option to extend the lease of the leased space may require significant judgement.
- Variable lease payments that depend on an index or a rate – sellers should implement an appropriate system/process for estimating variable lease payments based on the current indices for each reporting period (e.g. the consumer price index).
- Separating lease and non-lease components – sellers will need to separate payments for various types of services (e.g. administrative, municipal, marketing) from non-lease components for the majority of contracts with property managers – either in the case of leasing individual shops or when leasing the whole retail chains.

Telecommunications

Telecommunications companies lease high-value assets, such as network infrastructure, telecommunications towers, satellite receivers or fibre optic cables:

- Identification of a lease – in the case of telecommunications companies it may be complicated to establish whether a contract is a lease and it may require judgement. The new standard provides an example of differentiating between a network service and a lease of fibre optic cables. Telecommunications companies will have to specify whether their contracts ensure control over an asset or whether they ensure access to it.
- Separating lease and non-lease components – telecommunications companies will have to separate multi-component contracts with clients.

Transport and logistics

Companies from the sector of transport and logistics frequently lease high-value assets, such as: aircraft fleet, trains, ships, real estate, trucks and other vehicles:

- Option to extend a lease – companies very frequently apply leases for the purposes of their core operating activities, i.e. for generating revenue. A question arises when such a company has economic reasons that justify extending a lease (e.g. airlines, courier companies). Such assessment may require significant judgement.
- Identification of a lease –it may be complicated to establish whether a contract is a lease and it may require judgement. For example, does a transport company have control over an asset during hourly charter or charter of aircraft without the crew. In accordance with the currently binding guidance, considerable pressure is not exerted to separate a service from an operating lease, as it does not significantly affect the accounting treatment.
- Differentiating between lease and non-lease components – companies in the transport and logistics sector frequently link leasing of assets with other services (such as maintenance, insurance, etc.). The lessors frequently offer products in packages; in such cases the lessees will be obliged to separate the lease components from the service components.

The results of introducing the new standard will be felt by all sectors but they may differ significantly depending on the characteristics of the sector. A change in the accounting policies of the lessees is only the tip of the iceberg. Companies will need to conduct a thorough review of the proposed amendments and evaluate their effect on the financial ratios and effectiveness measures (including covenants in loan agreements), operating activities and internal controls, in order to understand the implementation related problems and costs relating to fulfilling the requirements of the new standard.

The leaflet has been prepared in cooperation with PwC – the official accounting advisor of Polish Leasing Association

To find out more visit the website www.pwc.pl/pl/mssf/mssf-16.html