Alert | January 2016

IFRS 16 | New lease financial reporting standard

The IASB has confirmed the new lease financial reporting standard IFRS 16 comes into effect

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The new standard will be effective for year-ends beginning on or after 1 January 2019. In essence for all lessees' leases IFRS 16 requires a lessee to:

a) Recognise lease assets and liabilities on the Statement of Financial Position (SOFP), initially measured at the present value of unavoidable lease payments.
b) Recognise amortisation of lease assets and interest on lease liabilities over the lease term.
c) Separate the total amount of cash paid into a principal portion (presented within financing activities) and interest (presented within either operating or financing activities).

Exemptions

IFRS 16 does not require a lessee to recognise assets and liabilities for (a) leases of 12 months or less (short-term leases), and (b) leases of small assets (such as laptops and office furniture).

Measurement of lease liabilities

A lessee can obtain flexibility in a lease. For example, leases often include extension options or break clauses, and can include payments that vary based on sales or the use of an asset. IFRS 16 will require a lessee to measure their lease liabilities at the present value of future lease payments. However, to reflect the flexibility obtained by a lessee and to reduce complexity, lease liabilities include only economically unavoidable payments and there is a simplified approach to deal with variability in payments. Lease liabilities include fixed payments (including inflation-linked payments), and only those optional payments that the lessee is reasonably certain to make. Lease liabilities exclude variable lease payments linked to use or sales.

Measurement of lease assets

A lessee would measure lease assets, initially at the same amount as lease liabilities, and also include costs directly related to entering into the lease. Lease assets would then be amortised in a similar way to other assets such as property, plant and equipment. This which would often be expected to result in straight-line amortisation over the lease term.

Effects on the SOFP

For lessees that currently have material operating leases, the most significant effect of the IFRS 16 will be an increase in lease assets and financial liabilities. Accordingly, there will be a change to key financial ratios derived from a lessee's assets and liabilities (for example, leverage and performance ratios). The carrying amount of lease assets will typically reduce more quickly than the carrying amount of lease liabilities. This will result in a reduction in reported equity compared to today for lessees with material off SOFP leases. This is similar to the effect on reported equity that arises today from financing the purchase of an asset, either through an on SOFP lease or a loan.

The actual effect on a lessee's reported equity will depend on the lessee's leverage, the terms of its leases and the ratio of lease liabilities to equity (which in turn depends on how the lessee finances its operations).

Effects on the income statement

For lessees that currently have material off-SOFP leases, the application of IFRS 16 will result in higher profit before interest (e.g. operating profit) compared to the amounts reported currently. This is because a lessee will present the implicit interest in former off-SOFP lease payments as part of finance costs whereas, today, the entire off-SOFP lease expense is included as part of operating costs. The increase in operating profit and finance costs will depend on the significance of leasing to the lessee, the length of its leases and the discount rates applied.

Effect on specific amounts

- Net debt and gearing – this amount will increase. The lease liability will be included in net debt calculations but the Right of Use (ROU) asset will be excluded. This could affect debt/equity ratios and debt covenants.
- Net assets – this amount will decrease. The lease liability and ROU asset will both be recognised but the ROU asset will be amortised straight-lined, whereas the lease liability will unwind more slowly in the early years.
- The ROU asset recognised on implementation will be less than the lease liability, reducing net assets.
- EBITDA – this amount will increase. The rental operating expense will be removed and replaced by interest, depreciation and amortisation.
- EBIT – this amount will increase. Part of the lease cost will become interest expense, which is excluded from EBIT.
- PBT – the impact on this amount will change with time. On implementation, existing leases will be re-calculated and so the annual expense could be higher or lower depending on how far through each lease one is.

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