

# The End of the Operating Lease

White paper

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The new lease standard, IFRS 16, will radically change the accounting treatment of most leases.

New rules issued could result in significant changes for any business that leases its premises or other significant assets.

The International Accounting Standards Board (IASB) has just issued IFRS 16 *Leases* that effectively abolish the concept of the operating lease and treat all leases as finance leases. The end result is that almost all leases will be recognised as liabilities on the balance sheet rather than the current distinction between operating and capital leases.

## Executive summary

- The IASB has issued IFRS 16 *Leases*. This will replace the current standard IAS 17 *Leases*.
- IFRS 16 abolishes the concept of the operating lease for lessees and effectively treats all leases as finance leases. The result is that all leases will be recognised as liabilities on the balance sheet, rather than as commitments in the notes to the financial statements.
- The only exemption to this requirement is for short term leases of durations of 12 months or less, and for leases of low-value assets, such as office furniture or computers.
- IFRS 16 largely retains the existing accounting requirements for lessors whereby leases are classified as operating leases or finance leases.
- The effective date for the new standard is for periods beginning on or after 1 January 2019. Early adoption is available provided the new IFRS 15 *Revenue from Contracts with Customers* is applied at the same time.
- These standards will be issued in Australia and New Zealand in the near future, following approval by the respective local standard setters.

## Background

The release of IFRS 16 in January 2016 marks the culmination of a project that has been running for over ten years. It reflects a long-standing view among global standard setters that the previous model, under IAS 17 *Leases*, was no longer fit for purpose. The previous distinction between finance leases, which were recognised on balance sheet, and operating leases, which were not, was often arbitrary, and resulted in substantial lease obligations being visible to investors only in the notes to the financial statements.

The Chairman of the IASB, Hans Hoogervorst, commented on the new standard:

*“The new Standard will provide much-needed transparency on companies’ lease assets and liabilities, meaning that off balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability between companies that lease and those that borrow to buy.”*

The new standard has been developed in conjunction with the United States’ standard setter, the FASB. However, IFRS has not been fully converged with US GAAP, as the latter continues to make a distinction between operating and finance leases in the income statement.

## Requirements

The key requirements of IFRS 16 are:

- The classification of leases as either finance leases or operating leases is eliminated for lessees. All leases will be recognised on balance sheet by capitalising the present value of lease payments and showing them as an asset (‘right-of-use’ asset), while future lease payments will be recognised as a financial liability. This is similar to the current treatment for finance leases under IAS 17.
- The nature of the expense recognised in the income statement will change. Rather than being shown as rent, or as leasing costs, it will be recognised as depreciation on the leased asset, and an interest charge on the lease liability. The interest charge will be calculated using the effective interest method, which will result in a gradual reduction of interest cost over the life of the lease.
- There is an exemption of IFRS 16 for low value items. For these assets, the expense may be recognised on a straight line basis over the life of the lease in a manner consistent with the current treatment for operating leases. This is expected to apply to commonly leased small items including mobile phones, electronic equipment, and furniture.
- Leases of 12 months or less are considered short-term leases and are also exempt from the new requirements. This exemption also applies to any longer term leases which end within 12 months of the date of initial application of IFRS 16.
- First time adoption of IFRS 16 may be done by way of a cumulative adjustment in the year of adoption, without the need to restate comparative amounts or to prepare a ‘third balance sheet’. Depending on the method of transition, the valuation for longer term leases at the date of initial application is determined either as if the standard had always been applied or based on the value of the lease liability as at transition.
- Disclosure requirements have been updated to require disclosure of a breakdown of the expense related to leases in the notes, a breakdown of leased assets between asset classes, and the total

amount of lease cash outflows. For leases that contain other clauses whose effect could be considered material, such as variable payments or guarantees of residual value, narrative disclosure is required in the notes to the financial statements.

- Accounting for lessors is not significantly affected by the new standard – it remains broadly consistent with IAS 17.

## Impact

The almost universal nature of the operating lease means that most financial statement preparers will be affected by the new standard to some degree. The impact will be particularly strong on industries which make extensive use of lease financing, or who have a large portfolio of rented premises.

Beyond the requirement to adjust the financial statements, the following impacts should be considered:

- The new recognition and disclosure requirements may require some entities to adjust their accounting systems in order to capture the data required for implementation.
- The recognition of previous operating leases on balance sheet may result in a large lease liability. This may impact gearing or capital ratios which may affect compliance with borrowing covenants. Affected entities should seek to renegotiate any such terms well in advance of the adoption of the new standard.
- Conversely, many loan covenants, business acquisition arrangements, and other contracts make use of EBITDA-based metrics. Payments which were previously classified as “rent” may now be treated as a mix of “depreciation” and “interest.” This may particularly impact earn-out arrangements based on EBITDA multiples.
- The replacement of today’s straight-line expense approach of operating leases with the front-loaded recognition of the interest expense may affect the timing of earnings associated with major projects or asset groups.

## Further information

For further information, please contact your local Crowe Horwath advisor on **1300 856 065**, or the Audit Technical team.

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