LeaseAccelerator EZLease

# IFRS 16 lease accounting handbook

## A guide for lessees

Achieve and maintain compliance
with the lease accounting standard

## Introduction

# The lease accounting standards

**In 2019, the IASB lease accounting standard, IFRS 16, began to go into effect for companies worldwide. However, there are still some companies that have yet to adopt the standard, as well as those who may be struggling with how to handle leasing processes post-adoption in order to maintain compliance with IFRS 16. This handbook will provide an overview of the technical accounting of IFRS 16 as well as how companies can successfully achieve and maintain compliance with the standard.**

## Why the standard was introduced

The change to lease accounting rules comes with many other accounting standard updates, all created with the purpose of closing loopholes in accounting guidance that could potentially allow companies to mislead financial statement users as to the true nature of the company's financial state.

IFRS 16 closes the lease accounting off-balance sheet loophole which allowed corporations to report their operating leases in the footnotes of financial statements. Under the new standard, companies are required to recognize most leases and report them as right-of-use (ROU) assets and lease liabilities. As a result of the shift, lease portfolios face increased auditor scrutiny, pushing companies to focus on ensuring accuracy and completeness of what they report as well as leading to greater comparability of financial statements.

## The major changes for lessees

The most notable change is the elimination of the operating lease classification. Under IFRS 16, all leases, excluding those that meet the practical expedient for low-value and short-term leases, if elected, are treated as finance leases. The lease assets and liabilities are recognized on the statement of financial position, which may result in a significant increase in the amount of assets and liabilities many companies report.

Finance leases are also reported differently on the profit and loss (P&L) statement than operating leases under the previous standard. Operating leases were reported as a straight-lined rent expense. However, under IFRS 16, all leases are reported as a separate (usually straight-lined) depreciation expense of the asset and front-loaded interest expense on the liability. Therefore, as a result of the new standard, all leases expense on the liability, potentially impacting financial metrics, like EBITDA, that are dependent on the P&L statement

The IASB also considers leases to be debt, so debt to equity ratios may see a dramatic increase. This could impact debt covenants not covered by frozen GAAP contractual provisions as well as credit ratings, if the lease liability recognition resulting from the adoption of IFRS 16 is significantly different from analysts' expectations.

Lastly, when measuring the lease liability, variable rents, such as those based on an index or rate, will be included. IFRS 16 requires that the lease liability be reassessed and remeasured anytime the index or rate adjusts.

**EXHIBIT 1 | Summary of the lease accounting standard**

### Timeline

- The final standard was issued in 2016.
- Companies that did not early adopt the standard began transitioning to the standard January 1, 2019 and have continued to do so depending on their fiscal year start date.

### Lessee accounting standard summary

- All leases are recognized (except where the entity has elected to use the short-term and low value exemptions) at the present value (PV) on the statement of financial position.
- All leases have a P&L pattern that is frontloaded (where rent expense is replaced by a usually straight-lined depreciation of the asset and front-loaded interest on the liability)
- Variable rents based on a rate (e.g. LIBOR) or an index (e.g. CPI) are recognized based on spot rates. The value of the lease liability, with a corresponding adjustment to the lease asset, must be remeasured when the rate or index adjusts
- Short-term (less than or equal to 12 months) and low-value leases (less than or equal to US $5,000 even if material in the aggregate) can continue to be accounted for off-balance sheet if so elected.



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Section 1

# Key provisions & changes in direction

## Key changes for the standard

For lessees, adoption of the rules will result in a significant change from IAS 17 reporting where operating leases were off-balance sheet.

**Leases capitalized:** The operating lease classification will no longer exist under IFRS 16. The new rules will require a lessee to capitalize all leases that do not meet the short-term and low-value practical expedient lease exemptions.

**Estimates of lease term and lease payments:** For purchase, extension, and termination options, a lessee should reassess whether the exercise of an option is "reasonably certain" (and thus must be recognized) only upon the occurrence of a significant event or a significant change in circumstances that is within the lessee's control.

**Transition:** IFRS 16 provides two transition methods.

**1**. The full retrospective approach: This approach requires companies to restate comparative figures for the year prior to adoption by recognizing a cumulative effect adjustment to the equity at the beginning of the prior year. A company's financial statements are presented as though the company has always been on the standard.

**2.** The modified retrospective approach: Under this approach, the cumulative effect of applying IFRS 16 is recognized as an adjustment on the effective date and comparative figures are not restated. The ROU asset may be recognized as equal to the lease liability or may be stated at a value reflecting amortization since commencement of the lease with the offset to equity. Under either method for the ROU asset presentation at adoption, the lease liability is the same in both elections.

**Present value calculation:** The lessee calculates the PV of the estimated lease payments using the implicit rate in the lease, if it is readily determinable, or the company's incremental borrowing rate ("the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment"). However, the IASB, in the Basis for Conclusions, stated that it is likely to be difficult for a lessee to determine the interest rate implicit in the lease and as a result it is expected that the company's incremental borrowing rate will be used in most cases.

The implicit rate is defined as follows in the new IASB standard: "The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor."

The PV is considered to be both (1) the value of the right to use the leased asset , and (2) the "principal" balance of the obligation to pay rent. This amount will be recorded as both an asset and a liability.

**The profit & loss statement:** All leases where the lessee has not elected the short-term or low-value exemptions are accounted for as finance leases. The asset is amortized as a depreciation or amortization expense in the P&L over the estimated lease term on a usually straight-line basis (SL). Interest expense on the lease liability is front-loaded. The sum of the interest and amortization creates a front-loaded expense pattern.

## EXHIBIT 2 | Lease accounting: a real-world example

Below is an example of lessee accounting under the IFRS 16 standard and contrast to the previous IAS 17 standard.

A company leases several general-use PCs for three years. The PCs have a useful life of 5 years. There is no purchase option.

The rent is $1,700 a month for 36 months ($61,200 in total). Under IAS 17, this is considered an operating lease, as the PV of the payments is less than substantially all of the fair value of the assets and the lease period is for less than the majority of the asset's useful life. Under the new IASB standard, the lease must be treated as a finance lease. That is, it is recognized as an asset and liability on the balance sheet with interest expense and amortization expense reported on the P&L statement.

At a 5.5% incremental borrowing rate, the present value of the rental payments is $56,557. This is the amount that is recognized on the balance sheet. The lessee's initial balance sheet entries are:

- Debit Right-of-Use Lease Asset = $56,557
- Credit Lease Obligation = $56,557

On the P&L, the first year's interest expense is $2,572 and the amortization expense is $18,852. Together, these two items total $21,425 for the first year's lease expense.

Under the previous lease standard, the rent expense would total $20,400 on a straight-line basis. Thus, capitalizing the lease has increased the company's lease expense by $1,025 in the first year.

The cross-over point occurs in the second year of the lease, when the total lease expense under the new standard would be less than the expense under IAS 17.

**Table 1.**
**Illustrated example of the IFRS 16 lease accounting**

| Assumptions | |
|---|---|
| **Rent in advance** | $1,700 |
| **Term in months** | 36 |
| **Incremental borrowing rate** | $5.50% |
| **Fair value of leased assets** | $65,000 |
| **Calculations** | |
| **PV of payments-inception** | $56,557 |
| **Total lease payments** | $61,200 |

**Table 2.**
**Annual journal entry summary**

| Entry to recognize the lease at inception | | |
|---|---|---|
| **ROU asset** | $56,557 | |
| **Lease liability** | | $56,557 |
| **Entry to record first year's liability activity** | | |
| **Imputed interest expense** | $2,572 | |
| **Liability** | $17,828 | |
| **Cash** | | $20,400 |
| **Entry to record first year's asset activity** | | |
| **Amortization expense** | $18,852 | |
| **Accumulated amortization** | | $18,852 |

**EXHIBIT 2 | Lease accounting: a real-world example**

**Table 3.**
**Income statement impact of front-ended lease expense**

| Comparative reported operating lease expense | | | | | |
|---|---|---|---|---|---|
| Year | IFRS Depreciations | IFRS Expense | IFRS Tool | IAS 17 | Variance |
| 1 | $18,852.36 | $2,572.18 | $21,424.54 | $20,400 | $1,024.54 |
| 2 | $18,852.36 | $1,566.55 | $20,418.91 | $20,400 | $18.91 |
| 3 | $18,852.36 | $504.20 | $19,356.56 | $20,400 | $(1,043.44) |
| **Total** | $56,557.07 | $4,642.93 | $61,200 | $61,200 | $0 |

## Evolution of key issues regarding lease payments

**Lease term:** The IASB decided that the lease term is defined at commencement as the noncancellable term plus extension or termination options, where the lessee is "reasonably certain" to exercise the option. Under the standard, for purchase, extension, and termination options, a lessee should reassess whether the exercise of an option has now reached the level of "reasonably certain" (and thus must be recognized) only upon the occurrence of a significant event or a significant change in circumstances that is within the lessee's control. The IASB has stated that the term "reasonably certain" is a high hurdle.

**Variable lease payments:** Only certain variable lease payments will be included in the lessee's lease capitalization, including:

- Variable lease payments that depend on an index or a rate, using the spot rate at lease inception for floating leases.
- In-substance fixed payments that are "disguised" minimum lease payments based on usage of the underlying asset or on lessee performance — in other words, payments that are unavoidable, in which case the expected payments must be included in the lease payments to be recognized.

## Impact of the standard

Companies are seeing significant changes because the majority of leases are now reported as finance leases. Potential impacts include higher debt amounts, permanent lost capital, new permanent deferred tax assets, and temporary reduced earnings after taxes in the first years following adoption of the standard.

Ratings agencies have typically included estimates of operating lease obligations in their analyses, so unless there is a large discrepancy between their estimate and what the company reports, there is not expected to be a large impact to credit ratings.

However, because the IASB considers lease liabilities to be "debt," the new standard may result in debt covenant breaches that will require negotiation and adjustment.

Financial metrics like return on assets, liabilities to net worth, leverage ratio, EBITDA, etc. can change, so a lessee should make pro forma calculations to determine if debt covenants, other contracts, or internal performance and incentive plans using those metrics are affected.

**Tax impact — minimal:** The changes to lease accounting for IASB companies may increase the administrative burden with regards to tracking deferred income taxes. This results from differences between the book value (based on IFRS 16) and tax calculations (based on unchanging tax laws).

**Operational impact — substantial increase in administrative burden:** The lease accounting standard increases a lessee's administrative burden due to the changes in process controls; data collection, analysis, and maintenance; monitoring; internal reporting systems; and, most importantly, audit scrutiny. Here are some of the key factors contributing to the added burden:

- Data to calculate payments comes from several sources in the organization, including Accounting, Procurement, Accounts Payable, and the asset users.
- Calculation of lease payments is complex.
- Non-lease components in gross or bundled billed payments must be separated (unless the practical expedient not to separate is selected by asset class).
- Calculation of some payments involves judgments and estimates.
- Financial disclosure requirements are expanded.

For most companies, the scale of the administrative requirements will mean additional systems and tactical support.

## To meet the timetable for implementation, lessees must prepare now

For those lessees that have not already adopted, it is critical to not underestimate the timetable for implementation. This is especially true if a company' lease portfolio includes many lease schedules with multiple assets, non-homogeneous assets, lessors, countries, or languages.

It is likely to take months for some companies to fully overhaul the lease accounting processes, systems, and controls that will be required to comply with the new standard. Companies must: (1) understand the new rules to determine compliance requirements, (2) start and complete a transition process, and (3) develop an ongoing process for complying with the new standard beginning on the effective date.

The lease accounting rules are complex, so lessees must read them in detail to understand how to comply.

## Setting objectives and defining compliance and ROI success

To address the lease accounting changes, companies have to change how they manage their leasing activities. Accounting for operating leases was relatively simple, since those leases were treated as operating expenses. Accounting for IFRS 16 leases, however, requires a much more rigorous approach, given the increase in risk and complexity. Such risks include the impact of estimation errors as well as the increased auditor scrutiny.

As with any change-management project, you should start by defining the objective, scope, and strategy of the project or process. Here is an example of an objective that you might establish for your company's transition to the standard. It is deliberately stated in past tense as if it has already been accomplished. The objective is not exclusively focused on compliance. Instead, it is designed to yield financial returns from the investment in compliance by improving the financial performance of your leasing process and portfolio.

**Example of an objective:**
By the implementation deadline for the lease accounting changes, we will have developed, deployed, documented, and iteratively refined a leasing process that is compliant with the lease accounting standard. This process will be well-controlled, auditable, automated, and scalable.

**Metrics example**

**We know we have been successful in meeting our objective because:**

- We can generate reports with the push of a button, quickly and easily, for:
  - The lease accounting changes that reflect the final lease accounting standard.
  - Preparation of our financial reporting disclosures, with full auditability.
  - Internal management of all lease terms that require timely decision making.
- All stakeholders who use the data, trust the data.
- All stakeholders in the leasing process receive timely, accurate, and complete reporting and notifications, especially notifications about the end of term.

SECTION 2

# Achieving & maintaining compliance

How to continuously meet the requirements and drive savings

## Transitioning to the standard

To transition to the standard, look for best practices and processes that will help you get compliant quickly and easily. Complying with the standard will require the collaboration of many individuals and departments within your company.

Most organizations start out their lease accounting projects using spreadsheets to track and manage leases and journal entries. They quickly realize that it's not a sustainable option with the potential for manual errors and the lack of audit transparency. Consider using a lease accounting solution that helps you get compliant quickly and that allows you to upload and change leases easily

## If you haven't already, start now

Getting ready for the implementation of the lease accounting standard takes resources, dedication, smart planning, and cooperation across all groups in the organizations that are involved with leasing activity.

Using lease accounting software can make this process much easier.

**First steps:**

- Budget the time and resources required to perform the work.
- Determine the proportions of internal resources vs. outsourcing to deploy to the process.
- Determine the right software solution for your project.
- In planning, build out the timeline for your project, allowing time for finding your leases.

## Maintaining compliance

Compliance with the lease accounting standards doesn't end once you adopt. IFRS 16 is an ongoing compliance project. To save time and effort post-adoption, incorporate establishing sustainable processes, policies, and controls to manage your lease portfolio into your project. Many companies made the mistake of focusing only on achieving compliance by the deadline and not planning for how they would maintain compliance beyond the deadline, so they fell behind again. It will save your company from a major headache if you plan for post-adoption ahead of time and secure software that you know is capable of supporting you over the long-term.

LeaseAccelerator

LeaseAccelerator provides enterprise lease lifecycle automation software that ensures long-term compliance, improves operational efficiency, and frees up cash. Thousands of users rely on our secure Software-as-a-Service (SaaS) platform to manage and automate 800,000 real estate and equipment leases valued at $200 billion across 5 million assets in 172 countries that generated 8 billion journal entries.

Contact us at leaseaccelerator.com

EZLease

EZLease provides fast, simple lease accounting software for ASC 842, GASB 87 ,GASB 96, and IFRS 16 that ensures long-term compliance across equipment and real estate assets for lessees and lessors. With over 15 years of implementations across private, government and public organizations of all sizes, EZLease manages and automates lease data management and lease accounting and reporting processes, leveraging customer-first support and deep accounting expertise.

Contact us at ezlease.com