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IFRS 16
LEASES

Potential impact on key sectors

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Introduction

Modern business environment is becoming increasingly complex. To succeed in these circumstances, the firms aim at growth with stability. Internal and external sources of finance are insufficient to cater the needs of expansion, diversification and modernisation. Leasing is an important and widely used financing solution. It enables entities to access and use property and equipment without incurring large cash flows at the inception. It enables lessees to address the issue of obsolescence and residual value risk.

Existing accounting standard for leases 'IAS 17 - Leases' provides principles resulting in all or nothing being recognised in balance sheet for economically similar lease transactions. The absence of information about leases on the balance sheet meant that investors and analysts did not have a complete picture of the financial position of an entity. It was difficult to appropriately compare entities that borrow funds to buy assets with those that lease assets. Off-balance sheet lease financing numbers were substantial.

The IASB issued 'IFRS 16 - Leases' in January 2016. IFRS 16 will significantly improve the transparency of information about those off-balance sheet leases. Recognition model for leases has undertaken a drastic shift as compared to the previous standard.

IFRS 16 - What do we need to know?

IFRS 16 requires lessees to recognise most leases on their balance sheets. The new standard is a significant change in approach from current standard and will affect many entities across various industries.

- Lessees will have a single accounting model for all leases, with two exemptions (low value assets and short-term leases).
- Lessor accounting is substantially unchanged.
- There will be additional disclosure requirements.

Impact on financial statements of lessees is illustrated as below:

Change is balance sheet position

	IAS 17		IFRS 16
	Finance leases	**Operating leases**	**All leases**
Assets		------------	
Liabilities	$$$$	------------	$$$$
Off-balance sheet rights/ obligations	------------	 $$$$	------------

Change in income statement

	IAS 17		IFRS 16
	Finance leases	**Operating leases**	**All leases**
Revenue	$$$$	$$$$	$$$$
Operating costs (excluding depreciation and amorisation)	------------	Single lease expense	------------
EBITDA		------------	▲▲
Depreciation and amortisation	Depreciation	------------	Depreciation
Operating profit			▲
Finance costs	Interest		Interest
Profit before tax			↔

IFRS 16 - Key impacts

The effects of IFRS 16 will need to be assessed on the facts and circumstances relevant to each entity. This will further be impacted by the different capital structures that entities have adopted, for example an entity that typically rents office premises, which is being accounted for as an operating lease, will be more significantly impacted than an entity that has purchased office premises. The financial statements of an entity shall be impacted in the following manner on an overall basis:

Effects on income statement		Effects on balance sheet		Effects on cash flow statement	
↑	EBITDA	↑	Leased assets	↑	Cash from operating activities
↑	Depreciation & finance cost	↑	Financial liabilities	↓	Cash from financing activities
↔	Profit before tax (over the lease term)	↔	Equity (over the lease term)	↔	Total cash flow

Along with impact on financial statements of the lessee, various other areas are likely to be impacted such as renegotiation of lease contracts, ascertainment of debt covenants, performance-based remuneration terms, dividend policy of the entity etc.

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IFRS 16 - Industry-wise impact

Oil and gas industry

Upstream oil and gas companies may have significant impact of the new standard because various aspects such as transportation contracts, drilling rigs, compressors, tanks and other equipment, as well as rentals of vehicles, office space and office furniture, depending on the terms of the agreement and the nature of the assets.

Such entities enter into various contracts in respect of land, building, heavy equipment that qualify as arrangement containing a lease (previous IFRIC 4). In order to comply with the requirements of the new standard, careful consideration is required in case of such contracts.

Real estate / equipment leasing industry

The real estate and equipment lessor industry may not be significantly affected in their accounting as lessors. However, they may be impacted in their business model due to change in lessees' behaviour. An entity may require its departments to evaluate the current portfolio of leases and prospective targets to identify tenants that may seek to alter their leasing strategies as a result of IFRS 16.

Lessees changing behaviours may result in requests for shorter lease terms and more variable lease payments which increases the risk for lessors. This puts a pressure on pricing of leasing transactions. Real estate and equipment lessor companies may find it challenging to ask for higher lease rates in the current regulatory changing environment. This could increase the cash flow volatility and risk. In turn this could impact lessors' own ability to obtain favourable financing for their own investments.

Airline industry

Financing aircraft through off balance sheet lease models has been a well-established practice in the airlines industry for decades. In addition, airlines normally rent the essential airport facilities from respective airport owners. Entities in this industry use leases of aircrafts in their revenue generating activities. Additionally, entities often lease assets combined with other services (e.g., maintenance, insurance, etc.). Lessors provide bundled products and lessees will need unbundled lease information to account for leases separate from service elements.

Retail industry

The retail industry is likely to be one of the most affected by the new standard, given the significant use of rented premises for their stores. Most of such leases are in the form of medium-term leases (generally 3-5/9 years), whether in premium locations (flagship stores), shopping centres or ordinary outlets. Such leases typically offer renewal options, and often involve variable rentals. This variability is commonly due to inflation adjustments and contingent rentals in some locations where the property owner has a vested interest in the performance of the business (e.g. airports, and shop-in-shop arrangements). Historically such leases have been considered as operating leases, and therefore didn't have any impact on the balance sheet.

There might be arrangements where the right of use of the asset is not so well defined and the entity might not have the full economic benefit of the asset. Careful analysis of the terms of these arrangements should be made, especially in situations where the space allocated to the entity is not clearly defined, and/or the store owner has the right to substitute the available space having a significant impact on the customer's economic returns. Such arrangements might not meet the definition of a lease, and instead be considered as a service.

Telecommunication industry

Telecommunications entities are expected to be significantly impacted by the new lease requirements. Careful consideration would need to be given to the new definition of a lease to identify arrangements that contain a lease (previously IFRIC 4). Telecommunications will need to consider leases of network equipment, tower arrangements, signal transmission devices as well as data and fixed line agreements and fibre optic cables. Some of these entities have extensive retail outlets, which will require further consideration. The prime consideration lies in determining whether their leases provide control over a physically distinct portion of an asset or provided capacity.

In addition, telecommunication entities will need to analyse contracts where equipment is provided to their customers. In such instances, consideration would need to be given to whether the contract contains a lease and if so, how the lease payments should be allocated to products and services provided.

Banking, insurance and other financial services industry

Banking and other financial services entities that have extensive branch networks as well as large administration and call centres will need to consider any lease arrangements carefully. In addition, contracts over ATMs and the related space occupied by such machines will need to be assessed under the new lease standard's requirements. Financial services entities may also make use of data storage facilities and these arrangements with providers could potentially fall within the scope of IFRS 16. Financial service entities will need to monitor how right-of-use assets will be treated for regulatory capital requirements.

Reach us

LeazeOn Private Limited
Fifth floor, 'Shree Niketan',
Sheelavihar Colony,
Off Karve Road, Pune 411038,
Maharashtra, India

www.leazeon.com

info@leazeon.com

CA Akshay Oke	Mobile:	+91 7030197888
	Email:	akshay.oke@leazeon.com
Ravindra Damle	Mobile:	+91 9822089629
	Email:	ravindra.damle@leazeon.com
Arun Kadekodi	Mobile:	+91 9890658101
	Email:	arun.kadekodi@leazeon.com