



# IFRS 16: Leases- A Step towards a more Transparent Balance sheet

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**“One of my great ambitions before I die is to fly in an aircraft that is on an airline’s balance sheet...”**

Sir David Tweedie  
(Former IASB Chairman)  
April 2008

**“IFRS 16 requires all off-balance sheet commitments arising from operating leases to be recognised on the balance sheet of lessees”**

Agnes Lutukai  
(Head, KPMG DPP West Africa)  
October 2016

## Have you considered...

- Key changes to the requirements of IAS 17?
- Key industries impacted?
- Potential impacts on financial ratios?
- Key provisions of IFRS 16?
- Effective date?
- Transition requirements?
- Practical expedients?
- How KPMG can help?

## Introduction

On 13 January 2016, the International Accounting Standards Board (IASB) issued a new standard - IFRS 16 *Leases* (the “new Standard”), thereby realizing its long-standing goal of ensuring that entities that engage in lease transactions present more transparent balance sheets by providing relevant information in a manner that faithfully represents the transactions. IFRS 16 *Leases* sets out the principles for the recognition, measurement, presentation and disclosure of leases and replaces the following standards and interpretations:

- IAS 17 *Leases*
- IFRIC 4 *Determining whether an Arrangement contains a Lease*
- SIC-15 *Operating Leases - Incentives*
- SIC-27 *Evaluating the Substance of Transactions involving the Legal Form of a Lease*

The new Standard is the by-product of a joint project of the IASB with the Financial Accounting Standards Board (FASB) of the United States of America, in response to concerns about the lack of transparency of information about lease obligations - notably those arising from operating leases. Consequently, companies engaged in leasing assets are required under the new Standard to recognise assets and liabilities arising from both operating and finance leases. Investors and analysts would therefore, be able to make direct comparison between companies that borrow to buy assets and companies that use assets under operating lease arrangements.

The Standard applies to leases of all assets, except for: leases of non-regenerative resources, leases of biological assets, service concession arrangements, licences of intellectual property granted by lessor, and rights held by a lessee under certain licensing agreements.

The new Standard will be effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers* has been applied, or is applied at the same date as IFRS 16.



## Key changes to the requirements of IAS 17

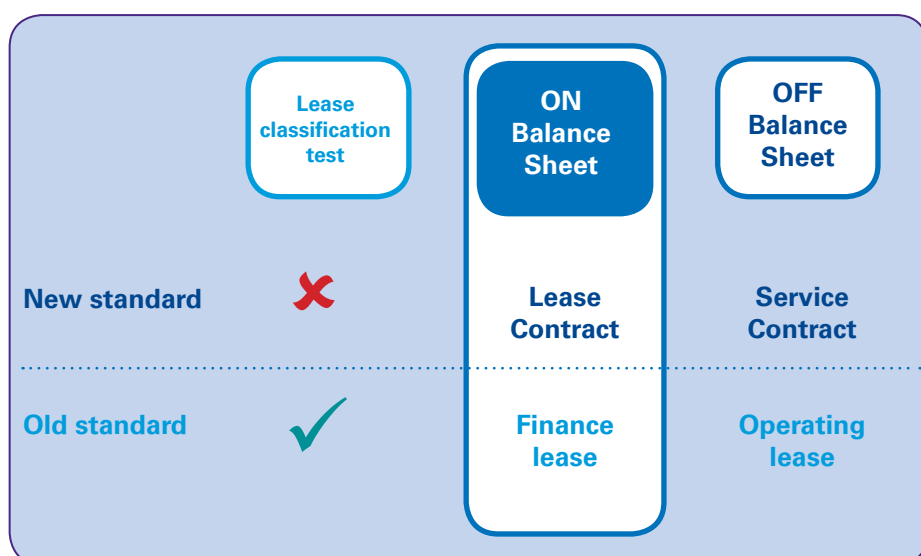
The new Standard has the most impact on lessees, as it requires lessees to recognise assets and liabilities for most leases; while for lessors, there is no significant change to the existing requirements of IAS 17.

Lessees are required to apply a single lease accounting model after careful consideration and determination of whether the contract is or contains a lease. Once the determination has been made that the contract contains or is in fact a lease, the entity is required to recognise the right-of-use (ROU) asset and lease obligation in its financial statements. This requirement eliminates the classification of leases (in the books of the lessee) into finance and operating leases previously required under IAS 17.

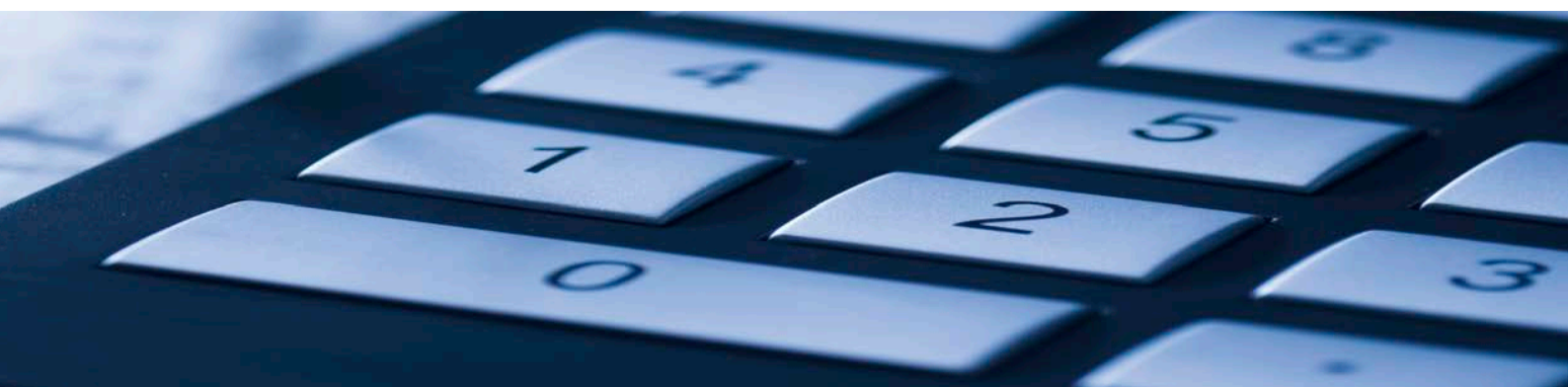
Lessors on the other hand will continue to apply the dual lease accounting model after applying the lease classification test based on IAS 17 classification criteria.

### The new on/off-balance sheet test for lessees - a key judgement area

The single lease accounting model for lessees is captured in the diagram below:

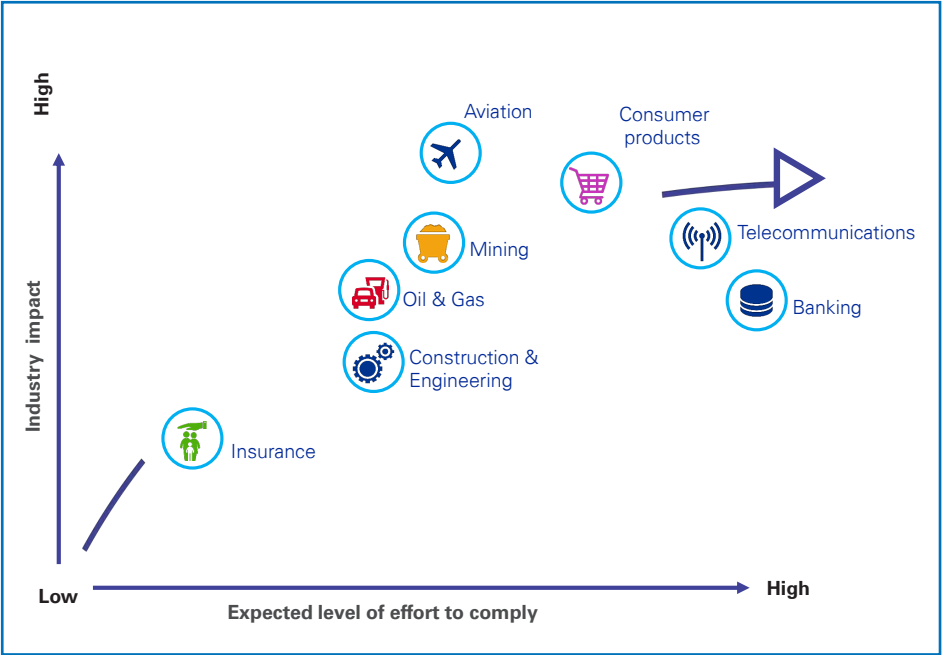


✗ - Not required  
✓ - Required



## Key industries impacted

Companies with large volumes of assets on operating leases would face high implementation costs as they identify their leases, extract key data and apply the accounting models. Likely impacts on specific industries is shown in the diagram below:



## Potential impacts on key financial ratios

For most lessees, key financial metrics will be affected as a result of the recognition of new assets and liabilities, and differences in the timing and classification of lease income/expense. A summary of potential impacts on key financial ratios is shown below:

	Profit/loss	Balance sheet	Ratios
↑	EBITDA	Total assets	Gearing
↓	EPS (in early years)	Net assets	Interest cover Asset turnover

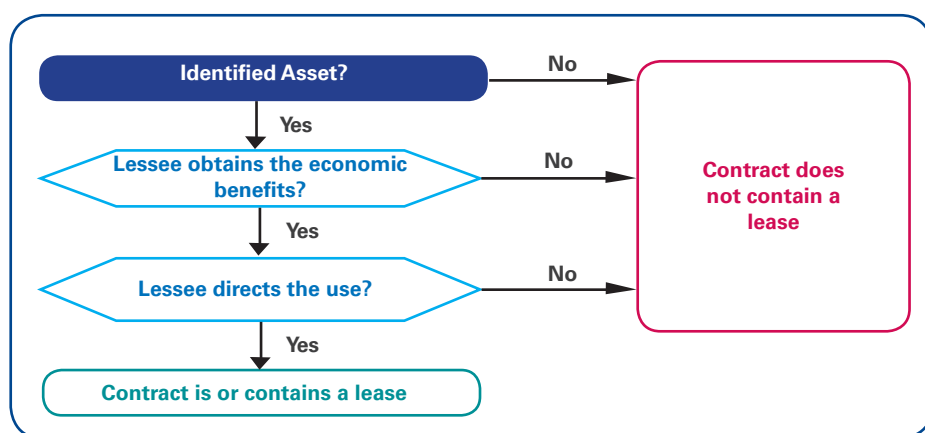


## Key Provisions of IFRS 16

### Lease identification

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. [IFRS 16:9]  
Significant judgment is required in the determination of who controls the use of the identified asset ( i.e the lessor or the lessee)

The diagram below summarises the thought process in the determination of whether a contract is, or contains a lease:



### Lessee accounting model

#### Balance sheet

##### Asset

= 'Right-of-use' of underlying asset

##### Liability

= Obligation to make lease payments

#### Profit or loss

##### Lease expense

Depreciation

+

Interest

=

Front-loaded total lease expense

### Initial recognition/measurement

The lease liability is measured at the present value of the lease payments to be made over the lease term. The right-of-use (ROU) asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g. commissions) and an estimate of restoration, removal and dismantling costs.

### Subsequent measurement

Generally, a lessee shall measure the ROU asset applying a cost model in accordance with IAS 16 Property, Plant and Equipment (i.e. cost less accumulated depreciation and any accumulated impairment losses). However, a lessee can alternatively apply either the fair value model to ROU assets that meet the definition of investment property in IAS 40 Investment Property; or the revaluation model to ROU assets which belong to a class of property, plant and equipment to which it applies the revaluation model in line with IAS 16.

### Presentation

The financial statements of lessees are required (for leases previously treated as operating leases) to be presented as follows:

Statement of financial position	Statement of profit or loss and other comprehensive income	Statement of cash flows
<b>Right-of-use asset</b> <ul style="list-style-type: none"> <li>Separate presentation in the statement of financial position or disclosure in the notes to the financial statements.</li> </ul>	<b>Lease expenses</b> <ul style="list-style-type: none"> <li>Separate presentation of interest expense on the lease liability from depreciation of the right-of-use asset.</li> </ul>	<b>Operating activities</b> <ul style="list-style-type: none"> <li>Variable lease payments not included in the lease liability</li> <li>Payments for short-term and low-value leases* (subject to use of recognition exemption).</li> </ul>
<b>Lease liability</b> <ul style="list-style-type: none"> <li>Separate presentation in the statement of financial position or disclosure in the notes.</li> </ul>	<ul style="list-style-type: none"> <li>Presentation of interest expense as a component of finance costs.</li> </ul>	<b>Financing Activities</b> <ul style="list-style-type: none"> <li>Cash payments for principal portion of lease liability.</li> </ul> <b>Depending on 'general' allocation</b> <ul style="list-style-type: none"> <li>Cash payments for the interest portion are classified in accordance with other interest paid.</li> </ul>

\* i.e. leases ≤ 12 months and ≤ \$5000 respectively

### Lessor accounting model

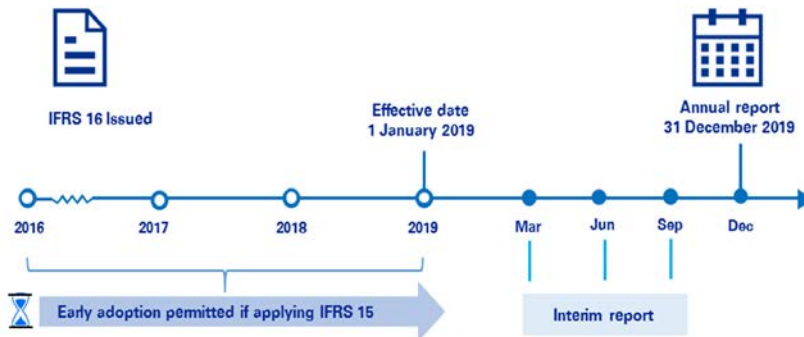
The accounting by lessors under the new Standard is substantially unchanged from the accounting under IAS 17. Consequently, lessors will continue to classify all leases into operating and finance leases.

### Sale and leaseback

Sale and leaseback transactions are generally on-balance sheet for the seller/lessee. The new Standard requires an entity to apply IFRS 15 to determine if the transfer of an asset is to be accounted for as a sale of that asset, and if it is a sale, account for the lease-back transaction in the books of the seller-lessee using the single accounting model and in the books of the buyer-lessor, using the dual lease accounting model. Otherwise, the transaction will be accounted for as a financing by both the seller-lessee and the buyer-lessor.



## Effective date



An entity is required to disclose the fact, if it applies the standard earlier than the effective date.

## Transition requirements

A lessee shall apply the new Standard to its operating leases using either the:

- Full retrospective approach - retrospectively to each prior reporting period presented by applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
- Modified retrospective approach (with practical expedients) - retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application.

A lessee is required to apply the election consistently to all of its leases.

## Practical expedients

The new Standard offers a number of practical expedients, which are aimed at easing the pressure on application of the lease definition and reducing compliance costs for preparers. Some of the practical expedients are as follows:

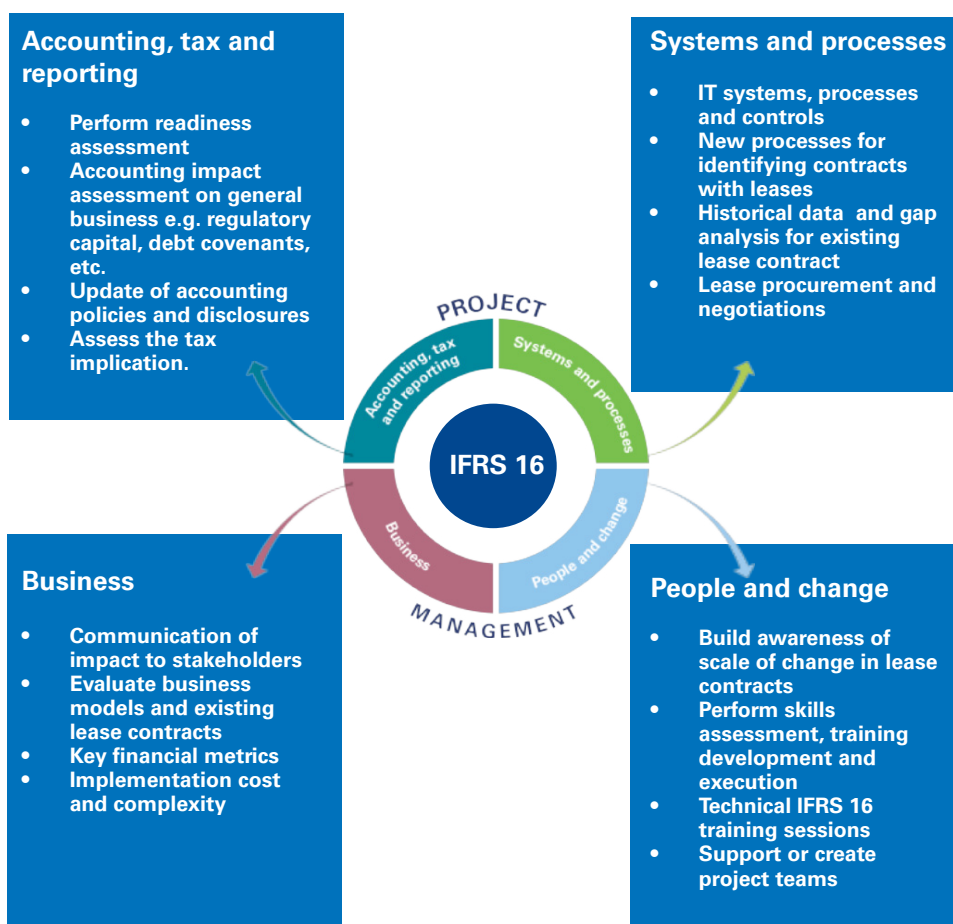
- an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Consequently, the entity is permitted to apply IFRS 16 to contracts previously identified as leases under IAS 17 and IFRIC 4.
- an entity may elect not to apply the lessee accounting model to short-term leases ( $\leq 12$  months) and leases of low-value items (for example  $\leq \$5,000$  [IFRS 16.BC100]);
- portfolio-level accounting is permitted if the entity expects that the financial statements impact does not differ materially from applying the requirements to the individual leases;

# How KPMG can help you?

The implementation of IFRS 16 will be challenging and the impact will cut across companies operating in various industries.

At KPMG, we can work with you to consider the impact on your business from an accounting, tax and regulatory perspective, as well as the impact on your systems and processes, business strategy and people.

Our IFRS 16 implementation solution covers the following key areas;





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