KPMG

Alert

Insurance Sound Bytes

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Many insurers lease significant property and equipment for their own use, lease investment property to others, or both. Are you ready for the new rules?

The new standard at a glance

IFRS 16 requires organizations to bring most leases on-balance sheet, recognizing new assets and liabilities.

The impacts are not limited to the balance sheet. There are also changes in accounting over the life of the lease. In particular, organizations will now recognize a front-loaded pattern of expense for most leases, even when they pay constant annual rentals. And the new requirements introduce a stark dividing line between leases and service contracts – the former will be brought on-balance sheet, while service contracts will remain off-balance sheet.

The accounting changes do not affect cash flows directly. However, given the scale of the accounting change, KPMG expects that organizations will want to understand the size of the lease liabilities arising from transactions they enter into between now and 2019 when the new standard comes into effect.

> "All companies that lease major assets for use in their business will see an increase in reported assets and liabilities…"

Lessor accounting (e.g. where you lease your investment properties to others) remains similar to current practice – i.e. lessors continue to classify leases as either finance or operating leases.

IFRS 16 applies for annual reporting periods beginning on or after January 1, 2019.

Lessees face major changes

At the simplest level, the accounting treatment of leases by lessees will change fundamentally.

IFRS 16 eliminates the current dual accounting model for lessees, which distinguishes between on-balance sheet finance leases and off-balance sheet operating leases. Instead, there is a single, on-balance sheet accounting model that is similar to current finance lease accounting.

Bringing operating leases on-balance sheet also changes the profit and loss account of lessees. Currently, operating lease expenses are charged to the P&L on a straight-line basis over the life of a lease.

From 2019, leases will be accounted for as if the organization had borrowed funds to purchase an interest in the leased asset. This typically results in higher interest expense in the early years than in the later years, similar to any amortizing debt. In turn, this means that total lease expense in the P&L will be higher in the early years of a lease – even if a lease has fixed regular cash rental payments.

For major renters of property and organizations that lease other assets such as vehicles, this raises some significant issues.

New definition, new accounting

Assessing whether an arrangement is, or contains, a lease will be one of the biggest practical issues when applying the new standard. In effect, lease definition becomes the test that will determine whether an arrangement is on- or off-balance sheet for a lessee.

Further, applying the new definition is likely to be one of the biggest practical issues under IFRS 16. However, significant

practical expedients could ease the pressure on application of the lease definition and reduce the compliance costs for IFRS preparers – notably in respect of:
- leases of low value items; and
- short-term leases

Leases of low-value items
This exemption is intended to capture leases that are high in volume but low in value – e.g. leases of small IT equipment (laptops, mobile phones, basic printers) or office furniture. The new standard defines low-value items as those assets with a value of USD 5,000 or less when they are new, even if they are material in aggregate.

Short-term leases
This exemption applies to leases with a term of 12 months or less.

Things to think about now

In order to be ready for 2019, it would be worth asking yourself a few simple questions, to get a feel for the scale of the challenge ahead.

Which contracts are, or contain, leases?
This is a very important question as the definition of a lease has changed and lease definition is the new on/off-balance sheet test for lessees. Consideration will also need to be given to compiling a complete inventory of contracts, both current financing, operating, and other contracts.

Which transition options to choose?
IFRS 16 offers a range of transition options, featuring many practical expedients. The transition options organizations choose will have an influence on the cost and effort that will be necessary to implement IFRS 16.

Impact on financial ratios?
Key financial ratios may be affected by the recognition of new assets and liabilities, as profits will be recognized on a different basis from when plans were set.

Impact on capital requirements?
For many, the new rules will bring significant additional assets and liabilities onto the balance sheet for the first time. Consideration will also need to be given to the impact of higher upfront expenses which drives down retained earnings/surplus.

Insurance companies won't have the full picture until the regulator has responded. A key question for consideration is how the regulator will treat the new assets and liabilities for regulatory capital purposes.

> "Lease definition is the new on/off-balance sheet test for lessees – and a key area of judgement in applying the standard."

If you want a sounding board to discuss the new leasing standard, please don't hesitate to reach out.

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