IFRS Alert: Release of IFRS 16 *Leases*

June 2016

Background

The Accounting Standards Board (AcSB) participated in the International Accounting Standards Board's (IASB) and the Financial Accounting Standards Board's (FASB) joint project to develop a single source of principle-based guidance to improve the accounting for leases.

The existing accounting model for leases under International Financial Reporting Standards (IFRS) and United States Generally Accepted Accounting Principles (US GAAP) requires lessees and lessors to classify their leases as either finance leases or operating leases and account for those leases differently. For example, it does not require lessees to recognize assets and liabilities arising from operating leases but does so for finance leases. The IASB and FASB initiated this project to improve the financial reporting of leasing activities under IFRS and US GAAP in light of criticisms that the existing accounting model for leases fails to meet the needs of users of financial statements. In particular:

- Many users, including the US Securities and Exchange Commission (SEC), have recommended that changes be made to the existing lease accounting requirements to ensure greater transparency in financial reporting and to better address the needs of users of financial statements. Many users often adjust the financial statements to capitalize a lessee's operating leases. However, the information available in the notes to the financial statements is often insufficient for users to make reliable adjustments to a lessee's financial statements. The adjustments made can vary significantly depending on the assumptions made by different users.
- The existence of two very different accounting models for leases in which assets and liabilities associated with leases are recognized for some, but not all, leases means that transactions that are economically similar can be accounted for very differently. That reduces comparability for users and provides opportunities to structure transactions to achieve a particular accounting outcome.
- Some users have also criticized the existing requirements for lessors because they do not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from its retained interest in the underlying asset), particularly for leases of assets other than property that are currently classified as operating leases.

These criticisms have been addressed by the IASB and FASB by developing a new approach to lease accounting. The new approach requires a lessee to recognize assets and liabilities for the rights and obligations created by all leases with a maximum possible term (including any options to extend) of more than 12 months. This approach should result in a more faithful representation of a lessee's financial position and, together with enhanced disclosures, greater transparency of a lessee's financial leverage. The new approach also provides enhanced disclosures about a lessor's risk exposure, particularly exposure to residual-value risk.

Key Details Relating to IFRS 16

On January 13, 2016, the IASB issued new IFRS 16 *Leases* and the standard was incorporated into Part I of the CPA Canada Handbook – Accounting by the AcSB in June 2016. The new standard supersedes IAS 17 *Leases*, IFRIC 4 *Determining Whether an Arrangement Contains a* Lease, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a* Lease. IFRS 16 is effective for annual periods beginning on or after January 1, 2019. Earlier application is permitted for entities that also apply IFRS 15 *Revenue from Contracts with Customers*.

A **lease** is defined as a contract, or part of a contract, that conveys to the customer the right to use an asset for a period of time in exchange for consideration. Leases are different from services because, at the start of a lease, the customer obtains control of a resource (the right to use an asset). In contrast, in a service contract, the supplier retains control of the use of any resources needed to deliver the service.

A lease exists when the customer controls the use of the identified asset throughout the period of use. This is when the customer has both the right to:

- Obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use.
- Direct the use of the identified asset throughout that period.

A lessee may elect not to apply the recognition, measurement and presentation requirements in IFRS 16 to:

- Short-term leases (i.e., leases of 12 months or less). A lease that contains a purchase option is not a short-term lease.
- Leases for which the underlying asset is of low value (e.g. personal computers, small items of office furniture and telephones, etc.).

An entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted to:

- Apply IFRS 16 to contracts that were previously identified as leases in accordance with IAS 17 and IFRIC 4.
- Not apply IFRS 16 to contracts that were not previously identified as containing a lease in accordance with IAS 17 and IFRIC 4.

Resources

Click on this link for documents issued by the IASB.

Click on this link for a CPA Canada reporting alert on IFRS 16.

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