What you need to know about the new leases standard

In May, the Institute issued HKFRS 16 *Leases*, the equivalent of IFRS 16 *Leases* issued by the International Accounting Standards Board. This new standard is effective for annual periods beginning on or after 1 January 2019. Early application is permitted for entities that also apply HKFRS 15 *Revenue from Contracts with Customers*.

Many companies lease assets, for example, property and equipment for their own use. HKFRS 16 is therefore expected to have material impact to most, if not all, entities. This article provides an overview of the new standard.

Why we need a new lessee accounting model?

The current HKAS 17 *Leases* classifies leases into two categories: finance leases and operating leases. Finance leases are recorded on the balance sheet but operating leases are not recorded on the balance sheet. The classification is based largely on whether significant risks and rewards of the leased asset are incidental to ownership of the underlying asset. The IASB noted that, currently, listed companies around the world have around US$3 trillion worth of leases – over 85 percent of these leases are classified as operating leases, and are therefore off-balance sheet.

The absence of information about off-balance sheet leases meant that investors or users of financial reports do not have a complete picture of the financial position of a company. Users are also unable to properly compare companies that borrow to buy assets with those that lease assets, without making adjustments. In his article *Shining the Light on Leases*, IASB Chairman Hans Hoogervorst explains that financial statements of an airline that leases most of its airplane fleet looks very different from its competitor that borrows to buy most of its fleet, even when in reality their financing obligations may be very similar.

The new leases standard changes this.

At a glance: lessee accounting model

HKFRS 16 defines a lease as "a contract, or part of a contract that conveys to the customer the right to use an asset (the underlying asset) for a period of time in exchange for consideration." HKFRS 16 eliminates the dual lease classification – operating and finance – and, instead, introduces a single lessee accounting model. Under the new model, a lessee recognizes a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing the obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The right-of-use asset is measured similarly to other non-financial assets and the lease liability is measured similarly to other financial liabilities. (See Table 1 on page 49)

Are there any exemptions?

Some respondents had commented to the IASB that the new recognition and measurement requirements can be cumbersome and costly to apply for short-term leases and low-value assets, and provide little benefit to users of financial reports. These respondents explain that the effect of the new requirements on profit or loss is about the same as the current treatment for operating leases.

Consequently, for lessee accounting, leases that are (a) short-term (i.e. leases of 12 months or less) and (b) low-value assets (for example, a personal computer) are exempted from applying the requirements of HKFRS 16. A lessee may recognize lease payments of exempted leases in profit or loss on a straight-line basis (or another systematic basis) over the lease term.

What are the implications for a company's income statement?

There will no longer be a typical straight-line operating lease expense when reporting under HKFRS 16. A depreciation charge over the life of the right-of-use asset is required to be recognized most likely within operating costs. The lease liability is required to be amortized as interest expense most likely within finance costs in accordance with the effective interest method under HKFRS 9 *Financial Instruments*.

The depreciation charge is expected to be evenly distributed. Interest expense is expected to reduce over the life of the lease as lease payments are made. This results in a reducing total expense as an individual lease matures. (See Table 2 on page 49)

What are the implications for cash flows?

HKFRS 16 will not have any effect on the total amount of cash flows reported but it is expected to have an effect on the presentation of cash flows.

HKFRS 16 is expected to reduce operating cash outflows, with a corresponding increase in financing cash outflows, compared to reporting under HKAS 17. This is because, when applying HKAS 17, entities presented cash outflows on former off-balance-sheet leases as operating activities. When applying HKFRS 16, principal repayments on all lease liabilities are included within financing activities. Interest payments can be included either within operating or financing activities in accordance with HKAS 7 *Statement of Cash Flows*.

Table 1

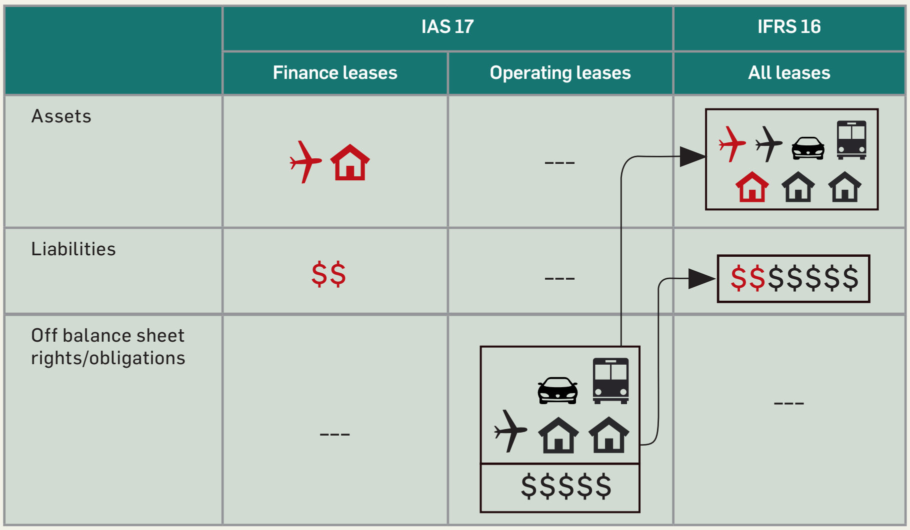

Table 2

	IAS 17		IFRS 16
	Finance leases	Operating leases	All leases
Revenue	X	X	X
Operating costs *(excluding depreciation and amortization)*	---	*Single expense*	---
EBITDA			⇧ ⇧
Depreciation *and* amortization	*Depreciation*	---	*Depreciation*
Operating profit			⇧
Finance costs	*Interest*	---	*Interest*
Profit before tax			⇔

(Source: IASB's project summary of IFRS 16 issued in January 2016)

What about lessor accounting?

The accounting requirements for lessors are substantially the same as the lessor accounting requirements in HKAS 17. A lessor, therefore, continues to classify its leases as operating leases or finance leases, and continues to account for those two types of leases differently.

Benefits outweigh costs?

When IFRS 16 was issued, Hoogervorst highlighted that costs are expected in updating systems to implement IFRS 16. However, the IASB expects the benefits of IFRS 16 to greatly outweigh its costs. The new visibility of all leases will lead to better informed investment decisions by investors and will better reflect the lease-versus-buy decisions by management. The improved capital allocation will benefit the economic growth.

Get in touch with the Institute's Standard Setting Department *(outreachhk@hkicpa.org.hk)* if you have any questions or issues with implementing the new leases standard. Also, look out for more Institute seminars on implementing HKFRS 16.

This article is contributed by the Institute's Standard Setting Department.