EXTERNAL REPORTING BOARD
Te Kāwai Ārahi Pūrongo Mōwaho

Achieving greater transparency: Important changes to lessee accounting

Now that the new lease accounting standard, NZ IFRS 16 *Leases,* is effective for companies reporting in accordance with NZ IFRS, the impacts of the new lease accounting requirements are being reflected in companies' market announcements, interim financial statements and annual financial statements.[1] The new requirements see lessees bringing almost all of their leases on to the balance sheet, and will affect reported performance measures, such as EBITDA and EBIT or Operating Profit.

Bringing leases on to the balance sheet increases visibility over companies' lease obligations, resulting in financial statements which better reflect companies' solvency – an important measure for many investors. Such transparency is critical to maintaining confidence in our capital markets, especially given the global economic impact of the COVID-19 pandemic.

Nevertheless, the rationale behind the new requirements is questioned by some, and as a result is receiving growing attention around the boardroom table.

Jane Taylor, a Professional Director, and Gali Slyuzberg, a staff member of the External Reporting Board, shed some light on the new lease accounting requirements. They explain why the requirements were introduced and how they aim to improve financial reporting. They also discuss a new practical expedient for lessees in response to the COVID-19 pandemic.

NZ IFRS 16 *Leases*: Quick facts

- Introduces requirements for lessees reporting in accordance with NZ IFRS to bring virtually all leases on to the balance sheet
- Lessor accounting remains substantially unchanged
- Became effective for entities with 31 December 2019 year ends and onwards
- There are transition options and practical expedients to help with the initial application of the standard

[1] NZ IFRS is based on IFRS as issued by the International Accounting Standards Board (IASB). NZ IFRS 16 is converged with IFRS 16 *Leases*.

Overview of the new requirements

The accounting standard NZ IFRS 16 *Leases* introduces significant and important changes to lessee accounting.

The previous standard on leases (NZ IAS 17 *Leases*) required lessees to distinguish between two types of leases:

(i) a lease that was economically similar to purchasing the leased asset was classified as a *finance lease* and was recognised on the lessee's balance sheet as a liability and an asset; and

(ii) all other leases were classified as *operating leases* and were not recognised on the balance sheet. Rather, they were recognised as an annual operating expense through profit and loss over the lease term, usually on a straight-line basis – with the total amount of future lease payments disclosed in the notes only. For this reason, operating leases were often referred to as 'off-balance sheet' leases.

In contrast, NZ IFRS 16 requires lessees to recognise all leases on the balance sheet (except for leases with a lease term shorter than 12 months and those defined as 'low value' leases). This means that lessees need to bring on to their balance sheet those leases that were previously classified as 'operating' leases.

Key new requirements of IFRS 16 – all leases (except short-term and low value leases)	Impact on financial statements of lessees with 'operating' leases
Initial recognition of lease on the balance sheet: • a lease liability for the future lease payments, discounted to present value; and • a right-of-use (ROU) asset, for the right to use the leased item over the lease term, in exchange for the lease payments.	**Balance sheet** Liabilities ↑ Assets ↑
Accounting after initial recognition: • The lease liability decreases as the lessee makes payments. • Interest accrues on the lease liability (i.e. the discount unwinds); The interest is recognised as an expense through profit or loss, and is included in finance costs. • Generally, the ROU asset is depreciated through profit or loss, usually on a straight-line basis.	**Income statement** Operating expenses (excluding depreciation and amortisation) ↓ Depreciation and amortisation ↑ Operating profit ↑ Finance costs ↑ Plus: **Change in the pattern of expense recognition** – this may impact the lessee's net profit.

NZ IFRS 16 also changes the pattern of the lease expense recognition. The ROU asset is usually depreciated on a straight-line basis. However, the interest expense on the lease is higher at the start of the lease term and lower at the end of it, because the 'principal' of the lease liability decreases as the lessee makes payments (similar to a table mortgage). In contrast, under the previous requirements the operating lease expense was generally recognised evenly throughout the lease term.

A note on adoption: Impact on reported net profit

The adoption of NZ IFRS 16 may impact a lessee's reported net profit, depending on factors such as how far the leases are into their respective lease terms, and what method the lessee uses to transition to NZ IFRS 16.

For example, if most of the entity's leases are still at the early stages of their lease terms, the adoption of IFRS 16 is likely to decrease net profit in the first year of adoption.

The adoption of NZ IFRS 16 could affect a lessee's solvency and performance measures, as summarised in the table below. Banking covenants may also be impacted, particularly those relating to solvency, and may require renegotiation with financiers.

Metric	What it measures	Calculation	Expected effect on metric
Leverage	Solvency	Liabilities / Equity, or Liabilities to Total Assets	**Increase** in leverage
Asset turnover	Efficiency	Sales / Total Assets	**Decrease** in asset turnover
EBITDA	Profitability	Earnings before interest, tax, depreciation and amortisation	**Increase** in EBITDA
EBIT, operating profit	Profitability	Earnings before interest and tax; various methods	**Increase** in EBIT and operating profit
Interest Cover	Solvency	EBIT / Net Interest	In general, **decrease** in Interest Cover

Why the change?

IFRS 16 *Leases* was introduced to address inconsistencies and concerns arising from the previous lease accounting requirements. These included concerns regarding transparency (given the exclusion of operating lease obligations from the balance sheet) and comparability (due to the very different treatment of operating leases as compared to finance leases).

> Distinct accounting requirements for finance leases compared to operating leases meant that economically similar transactions were accounted for very differently. NZ IFRS 16 addresses this concern by requiring the recognition of virtually all leases on the balance sheet. – Gali Slyuzberg

At the start of the lease the lessee incurs a liability to pay for the use of the leased item. The lessee also obtains an asset – the right to use the item over the lease term. Nevertheless, under the previous lessee accounting requirements, many leases were accounted for off-balance sheet because they were classified as operating leases.

To mitigate the omission of information from the balance sheet, investors and analysts often attempted to estimate the liabilities and assets arising from operating leases using the information that lessees disclosed in the notes. However, the information in these disclosures was limited in content and detail, which made it difficult to make accurate estimates about liabilities and assets arising from leases – particularly for less-sophisticated investors.

The lack of information on operating leases was particularly concerning when such off-balance sheet leases were significant. By way of example, the value of the off-balance sheet leases far exceeded the on-balance sheet debt for the retailers listed in the table below. These retailers ultimately went into some form of liquidation or re-organisation.

Retailer	Off balance sheet leases		On balance sheet debt[1]	Off balance sheet leases (discounted) as multiple of on balance sheet debt
	(undiscounted)[1]	(discounted)[2]		
Borders (US)	USD 2,796m	USD 2,152m	USD 379m	5.68
Circuit City (US)	USD 4,537m	USD 3,293m	USD 50m	65.86
Clinton Cards (UK)	GBP 652m	GBP 525m	GBP 58m	9.05
HMV (UK)	GBP 1,016m	GBP 809m	GBP 115m	7.03
Praktiker (Germany)	EUR 2,268m	EUR 1,776m	EUR 481m	3.69

Woolworths (UK)	EUR 2,432m	GBP 1,602m	GBP 147m	10.90

[1] Based on averaged published financial statements data available in the five years before the company entered Chapter 11 (US), liquidation (UK) or bankruptcy (Germany).

[2] Estimated using: (a) a discount rate of 5 per cent and (b) estimated average lease terms based on information disclosed in the financial statements.

Source: IFRS 16 Effects Analysis, IASB, 2016

Bringing leases on to the balance sheet will give greater transparency over companies' lease obligations, resulting in better quality financial reporting for investors and directors. – Jane Taylor

How will the new lease requirements improve financial reporting?

- **Provide greater transparency about financial leverage and capital employed**: Under the previous requirements, investors' estimates of off-balance sheet lease liabilities could vary widely. NZ IFRS 16 will provide investors and analysts with more accurate information about companies' leases, reducing the need for investors and analysts to make estimated non-GAAP adjustments. Arguably, the increased transparency around companies' lease obligations – and ultimately companies' solvency – is particularly important to investors in times of economic turbulence, such as the current COVID-19 crisis. This greater transparency also means that companies will benefit from a more level playing field, as investors are less likely to over- or under-estimate companies' liabilities and leverage.

- **Facilitate improved decision-making for companies**: As the adage goes, *you manage what you measure*. It is expected that the requirement to recognise virtually all leases on the balance sheet will result in boards and management monitoring lease arrangements more closely and giving greater consideration to the efficiency of these arrangements. For the same reason, NZ IFRS 16 is also expected to improve companies' ability to assess lease vs buy decisions.

- **Assist comparability between lessees and borrowers**: By requiring lessees to recognise assets and liabilities arising from leases, NZ IFRS 16 improves comparability between companies that lease assets and companies that borrow funds to purchase assets. At the same time, NZ IFRS 16 still reflects the economic differences between the two types of transactions (for example, the lessee recognises the right to use the leased asset, rather than the underlying asset itself).

The new requirements will assist boards and management to improve their capital allocation and lease vs buy decisions – Jane Taylor

Of course, as with any accounting change, there are costs to implement the new requirements. Some companies may need to make changes to their IT systems to enable compliance with NZ IFRS 16. Specific requirements of NZ IFRS 16 may also pose challenges for some companies – such as determining the discount rate for the purpose of calculating the lease liability and arriving at the appropriate lease term when a lease has renewal options or is cancellable.

To reduce the costs of applying the new requirements, NZ IFRS 16 contains several practical expedients. As mentioned above, leases of 'low-value' items and leases whose term is shorter than 12 months are exempt from recognition on the balance sheet. NZ IFRS 16 also contains transition options to assist with the initial application of the standard. For example, there is an option not to restate comparative information on initial adoption of the standard.

New practical expedient for lessees: accounting for rent concessions granted due to COVID-19

In response to the COVID-19 pandemic, the IASB has recently decided to provide a new practical expedient for lessees. This practical expedient makes it easier for lessees to account for rent concessions granted as a result of COVID-19, such as rent holidays and temporary rent reductions – while still enabling lessees to provide useful information about their leases to investors.

It is also worth remembering that, as with all accounting standards, the requirements of NZ IFRS 16 are subject to materiality considerations. This means that the requirements in NZ IFRS 16 need only be applied if their effect is material to the company's financial statements – which in some cases, may mean that some of the more detailed aspects of the standard may not be applicable.

Ultimately, the benefits of the new requirements for both companies and the users of their financial statements – in particular the benefits arising from greater transparency around companies' lease obligations – are expected to far exceed the costs of implementation.

Jane Taylor

Jane is a Barrister, FCA and Professional Director. Jane's director appointments currently include Orion New Zealand, Silver Fern Farms, Port Otago, Manaaki Whenua Landcare Research and OTTP NZ Forest Investments.

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