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IFRS 16 Leases

The International Accounting Standards Board (IASB) issued IFRS 16 – *Leases* in January 2016. IFRS 16 is applicable to annual accounting periods beginning on or after 1 January 2019 and changes fundamentally the accounting of leases for all lessees: IFRS 16 eliminates in most cases the differentiation between on-balance sheet finance leases and off-balance sheet operating leases. Accordingly, for lessees only a single, on-balance sheet accounting model similar to the current finance lease accounting is allowed. Lessees have to the assess the impact of IFRS 16 as it does not only increases assets and liabilities in the lessees' balance sheet. The lessee's statement of income will change and additional disclosure requirements will become applicable.

Scope of IFRS 16

IFRS 16's objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information should give a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the entity.

The previous accounting model was criticized as it did not require lessees to recognize assets and liabilities arising from operating leases and therefore for failing to meet the needs of users of financial statements. IFRS 16 introduces a single lessee accounting model and required a lessee to recognize assets and liabilities for all leases with a term of more than 12 months unless the underlying asset is of low value.

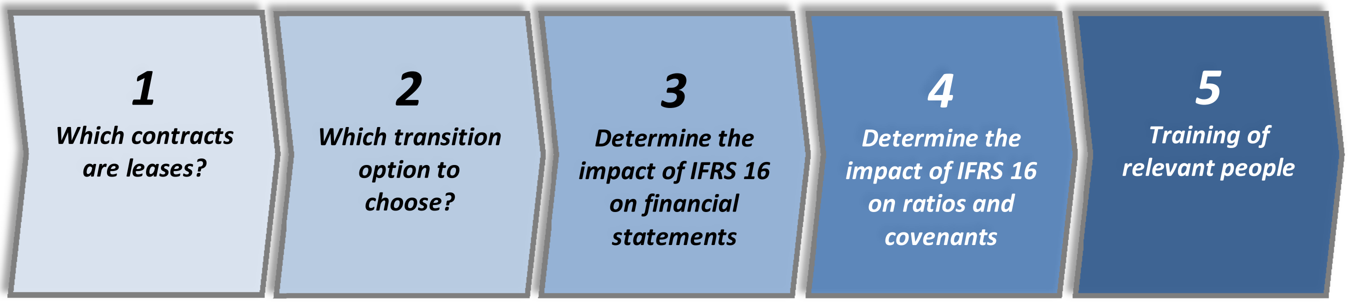
IFRS 16 supersedes IAS 17 (Leases), IFRIC 4 (Determining whether an Arrangement contains a Lease), SIC-15 (Operating Lease-Incentives) and SIC-27 (Evaluation the Substance of Transactions Involving the Legal Form of a Lease).

Impact on financial ratios

Lessees will show more assets in their balance sheet but also more debt, i.e. the net equity decreases. Even for lease contracts with constant payments over the lease term the expense will be more "front-loaded" as depreciation and interest expenses will likely exceed the lessee's payments at the beginning of the lease term. On the other hand as rent expense will be replaced by depreciation and interest expense, EBITDA will likely increase. The major impacts can be summarized as follows:

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

BHP can support you in implementing IFRS 16



Aside from understanding the standard, the first step should include gathering data, which contracts are (finance) leases. For companies with a substantial lease portfolio adoption of IFRS 16 is a data-heavy task. Development of a comprehensive lease database is strongly recommended. Companies should not underestimate that challenge as information has to be generated from various sources and may be outdated or not readily available.

As a second step the transitional options have to analyzed. The transitional options of IFRS 16 are complex and include cost/benefit implications of adopting the modified retrospective of the full retrospective approach. The applicability of the available recognition exemptions for short-term and low-value leases will also need to be addressed.

Step 3 and 4 include the assessment of IFRS 16's impact on the financial statements as well as on the company's key performance indicators (KPI). It is necessary to assess the impact on communcations with investors, other stakeholders (including banks) as well as employees: as KPI change, debt contracts might have to be renegotiated as covenants might be have to be changed, remuneration schemes might be subject to changes if bonus payments depend on EBITDA instead of EBT ratios (and vice versa).

Although 2019 may seem some way off, the implementation of IFRS 16 *Leases* is not something to be taken lightly. Instead, entities with a substantial lease portfolio will need significant time to prepare for the impact of the new standard.

In some cases, the standard will require significant system changes or will significantly affect other aspects of operations (e.g. internal controls and processes, Key Performance Indicators, debt covenants, etc.), and, therefore, it is imperative that entities identify any such impacts early on.

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About Prof. Dr. Binder, Dr. Dr. Hillebrecht & Partner GmbH in Germany

Since 1948 BHP has been successful in helping individuals and companies to achieve their goals in both their commercial and private endeavours. Clients now range from individuals and entrepreneurs to multi-national and listed companies with operations across Germany, Europe and abroad.

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