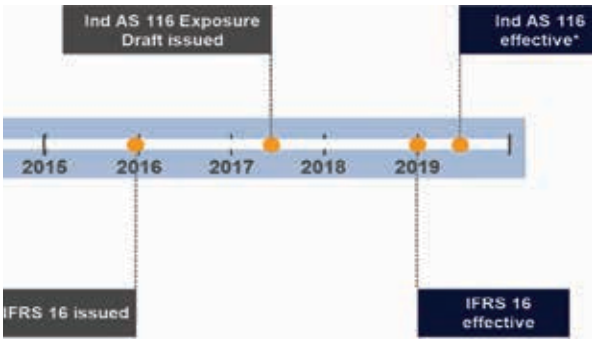
The New Lease Accounting Standard – Overview of Implicit Implications

A form of contract with centuries of history is set to take center stage with the introduction of a new lease accounting standard that to an observer represents an accounting change. However, this article provides an overarching view of the broader set of implications of the new lease accounting standard and the potential opportunities it presents. Read on…

The Evolution and Significance of Lease Accounting

Over a decade ago the former IASB chairman Sir David Tweedie had expressed his ambition to fly at least once in his lifetime on an aircraft that was actually on the airline's balance sheet. Soon his ambition will be realized once the new lease accounting standard, IFRS 16, becomes effective across most countries from 1st January 2019. In the Indian context too, the local accounting standard (Ind AS 116) which is largely converged with IFRS 16[1], is expected to be effective from annual periods beginning on or after 1st April 2019, replacing the in-force Ind AS 17.



Timeline of the new lease accounting standards[2]

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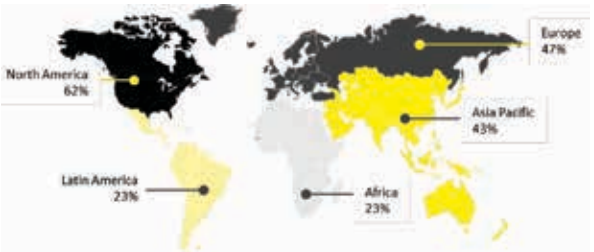
[1] Collectively referred as the new lease accounting standard, [2] Ind AS 116 effective date is expected to be for periods on or after 1st April 2019 and is pending notification

At a global scale, the new lease accounting standard is conservatively estimated to have an impact on USD 2.86 trillion of off-balance sheet leases[1]. As per the study on the effects conducted by IASB, each country and industry has different exposures to off-balance sheet leases.



Percentage of listed companies who disclose off balance sheet leases

Further, the impact on each industry is *inter-alia* based primarily upon the complexities, the volumes, and the value of lease agreements. The below heat-map illustrates the increasing impact on certain key industries on a relative scale based on the aforesaid parameters:

Increasing impact of the new lease accounting standard across key industries

Under the erstwhile accounting standard for leases, many lease-type arrangements were not recognized on the balance sheet. Further, the disclosures in relation to the 'off-balance sheet' leases have not been considered sufficient enough to meet user requirements and this has resulted in a lack of comparability between leasing and non-leasing entities. Often users resort to workarounds in analyzing the financial statements to gauge the impact of leases entered into by an entity. However, these workarounds have their own set of assumptions and challenges. In order to overcome the shortcomings of the current accounting standard on leases, the new lease accounting standard was conceptualised and will soon be effective.

Under the new lease accounting standard, a lease is a contract, or part of a contract, which provides for a right of use ('ROU') for an asset for a specified period of time and in exchange for a consideration. This recognition in turn affects the composition of the Profit & Loss statements and the Cash Flow Statements. Further, the recognition of a lease agreement, in accordance with the requirements of the new standard, provides for three main steps of - initial detection, subsequent measurement and impact on income statement. The new standard also introduces a significant increase in the disclosure requirements.

Considering that the new lease accounting standard represents a significant shift compared to the current standard and its high-value impact, entities would have to thoroughly envisage the implications on account of the new lease accounting standard. While it clearly provides for the accounting and disclosure requirements, there are other key implicit implications outlined in the ensuing paragraphs that entities would have to consider. Furthermore, given that there is only limited time remaining before the new lease accounting standard takes effect, all its implications would have to be considered and addressed with swift execution.

The Broader Implications

The wide-ranging implications of the new lease accounting standard can broadly be categorised into five segments. While each segment would have to be analysed in-depth based on each entity's respective facts and circumstances, the key aspects in relation to each segment has been outlined.

➢ **Accounting and Finance:**

To better understand the accounting aspects of the new lease accounting standard it would be beneficial to examine the prescribed treatment for a lessor and a lessee. For all lessees, a single balance sheet accounting model applies that leads to an

[3] Source: IASB study of over a sample of 14,000 listed companies

asset and liability gross-up, with select exemptions based on value and term of the lease contract. As a consequence, the lease expenses are presented in the income statement as depreciation costs and interest costs. Further, in terms of disclosures, there are both quantitative and qualitative requirements. While the standard cites the quantitative disclosures across the financial statements, it provides only guiding principles for the qualitative disclosures.

For lessors, the accounting is substantially unchanged and would continue to require an assessment of contracts into operating and financial leases. The changes primarily relate to new and additional disclosure requirements in comparison to the erstwhile standard.

In addition to the aforesaid change in accounting and disclosure requirements, certain key financial metrics would be impacted as a consequence that can be summarised below which may have a domino effect on financial arrangements such as debt-related covenants:

Impact on key financial metrics

➢ Technology and Data

The new lease accounting standard provides the opportunity to revisit the existing system architecture as well as system of records and determine sufficiency to manage the increase in requirements and areas of improvement. Efficiencies across functions such as finance, procurement and operations can be enhanced with the use of enabling technology and tools. For instance, cross-functional integrated technologies boosted by analytical capabilities in a retail environment can analyse space utilisation at its warehouses and provide insights to better manage lease procurement and inventory.

The increase in disclosure and reporting requirement also triggers a substantial increase in data capture, such as parameters that previously may not have been considered from an end to end perspective, as well as in data processing. This challenge can be aggravated based on the quality and source of the existing data and the transition method adopted. Based on an entities scenario, the rationalizing their chart of accounts may also be considered in the process. This new set of data requirements would also need to be integrated with the entity's existing data standards and governance protocols.

➢ Procurement, Legal, and Tax

In light of the impact on the financial metrics and new insights that can be generated from the data, lease contracts are likely to be impacted and may take the form of a change in payment terms, structure of the contracts, duration of contracts, pricing mechanisms, additional information or even request for negotiations. Further, entities would have to revisit the parameters considered in arriving at a lease or buy decision that may impact existing lease arrangements.

Additionally, while lessors are not as significantly impacted by the new lease accounting standard, it would be advantageous to take cognizance of the impact on their customers to reach better a consensus during lease negotiations.

Recognising the impact of the new accounting standards, tax authorities in countries such as UK, Singapore and India have issued guidance/ invited suggestions on the treatment of leases and the change in the manner of calculating amounts (e.g. deferred tax assets/ liabilities) to arrive at the tax figures for the period. Entities would have to consider this aspect to ensure they are tax compliant and at the same time optimize their lease arrangements.

➢ Process and Change Management

Given the high degree of change brought about by the new lease accounting standard, there would be a redesign/ development of processes associated with lease arrangements that span across functional areas. As a consequence of this redesign/ development, the relevant control mechanisms from a process and technology standpoint are required to be integrated by the entities. For instance, creation of approval hierarchies and ownership structures based on the present value of their contracts or the reconciliations to be performed between interfacing systems.

Further, entities would also have to manage the change to its processes, functions, policies, technology, and data. As an initial step, identification and education of the anticipated changes and its causes to employees, capital markets and other stakeholders would help build the right foundation to drive the required changes in due course. Thereafter, appropriate change management champions and teams can be created and trained for the implementation of the changes across the entity. Additionally, entities would also need to consider any implications on/from in-flight projects and determine the degree of acceptable overlap, as applicable.

➢ **Incentives and Management Information**

Entities that have rewards and incentives linked to financial metrics would have to revisit the policies and computational mechanisms in light of the impact of the new lease accounting standard to ensure equitable compensation to its employees and key personnel. This change also offers the opportunity to entities to evaluate the relevant drivers for personnel roles for determining suitable rewards and incentive structures. Similarly, management information would also require a recalibration to set appropriate baselines and refreshed key performance indicators given the foreseeable impact of the new lease accounting standard on the financial statement.

The Transformative Journey Ahead

The new lease accounting standard has a much wider transformative potential than the apparent change in accounting of lease contracts. As outlined, there are a five key segments to consider, each having its own level of detail based on an entity's scenario, to truly determine the holistic implications of the new lease accounting standard. Further, given the pervading nature of this change, it is imperative to consider the aspects coherently to capitalise on the opportunities presented to improve efficiency and scalability whilst not limiting the agenda to fulfilling a compliance requirement.

In the above context, setting the objectives of the lease transformation program is critical. While undertaking the transformation journey, there are likely to be potential challenges in the form of change resistance, technological landscape, and contract data volumes and complexity exacerbated by a fast approaching effective date. However, with a well-designed and comprehensive lease transformation program, entities can overcome the challenges and achieve the objectives. ■

The best way to find yourself is to lose yourself in the service of others. - Mahatma Gandhi