HOUSE OF CONTROL

Guide:

An overview of IFRS 16

This is what you need to know

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Introduction

IFRS 16 is the accounting standard that, from 2019, made the accounting of leases far more complicated than simply recording the invoices as expenses in the income statement. In this guide we will provide you with a practical overview of what IFRS 16 means for the finance department.

Let's start with a basic insight: The main value that leasing equipment and renting premises brings to the business world is that companies don't have to tie up as much equity in investments. The prevailing sentiment is to use scarce capital for core business activities instead.

The logic underlying IFRS 16 goes roughly as follows: While it's true that leases don't tie up capital, they grant companies both rights and obligations for an extended period. These include the exclusive rights to use the premises and equipment, coupled with the contractual obligation to pay agreed amounts for a specified period. In practice, this is akin to investing in the assets, owning them, making depreciation, and paying interest and installments to the bank. Leases should therefore be reflected in the company's assets and liabilities – in the balance sheet.

Simply put, IFRS 16 is the standard that transforms leases into investments in the company's accounts. This guide provides an overview of what the standard means for the company and for employees in the finance department who must deal with the requirements of IFRS 16.

Background: What, why and how

We introduced some of the background of the IFRS 16 standard above. IFRS 16 is a set of rules about how companies should deal with leases. A lease is when a company rents something like a building or equipment. These rules say that when a company leases something, they have to show it on their balance sheet, like they do with traditional investments. As familiar to all accountants, a balance sheet tells you what a company owns and what it owes.

Before IFRS 16, leases were split into two types: operating leases and finance leases. The first kind did not have to be shown on the balance sheet, while the second kind did. But IFRS 16 changed this, based on the logic that a lease basically gives a company the same rights-of-use and commitments as for an investment financed with a bank loan. Now, almost all leases have to be on the balance sheet. The exceptions are short term leases, and leases where the value of the underlying asset is considered too low to be relevant. Typical examples of low value assets would be coffee machines and printers.

This change makes financial statements more clear and helps different stakeholders compare companies. It shows what a company owes in the future due to leases. This can make a company look better or worse to investors. An EY survey of big companies found that after IFRS 16, assets went up by 14%, but liabilities went up by over 20% in some industries like aircraft and retail. This means that – according to the IFRS 16 standard – companies have more assets but also more liabilities due to leases.

"IFRS 16 is a set of rules about how companies should deal with leases."

The basics of IFRS 16: When is it a lease?

The first question that is relevant to answer is: When is the contract in question a lease? The IFRS 16 standard states that a “contract is, or contains, a lease if it conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration.”

In practical terms, you need to be able to answer yes to the following questions:

- Do you obtain substantially all the economic benefits from using the asset? Meaning, does your company get the income generated from using the leased asset?

- Do you have the right to direct how and for what purpose the asset is being used? Is it up to your company to decide how to use the leased asset?

If the answer to the questions above is no or unclear, it will still be a lease if you can answer yes to one of the following questions:

- Do you have the right to operate the asset without the supplier/lessor having the right to change that?

- Did you design the asset in a way that predetermines how and for what purpose the asset will be used?

These questions are designed to cut to the core: Are you in reality owning the asset while using leasing simply as a way of financing it? For real estate, the ownership question is less important than for assets such as machinery, cars, ships, and aircrafts.

FRS 16 calculation:

Introduction to right-of-use and lease liability estimates

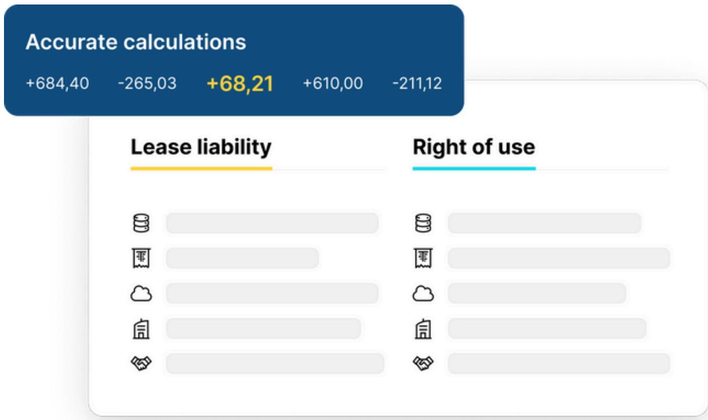
Let’s assume your company has leases according to IFRS 16, and you have gathered an overview of the ones you have. How do you get started estimating the values of each lease to do the accounting and reporting?

The IFRS 16 right-of-use value for each lease is a key component of the lease accounting. Start by determining these three figures

1. The lease payments:
The lease payments are the total lease or rent element to be made by the lessee over the term of the lease, including any variable lease payments that depend on an index or a rate, but excludes any payments for options to purchase the underlying asset and payments that are not lease or rent such as service expenses.

2. The lease term:
The lease term is the period over which the lessee has the right to use the underlying asset, and can include any options to extend or terminate the lease.

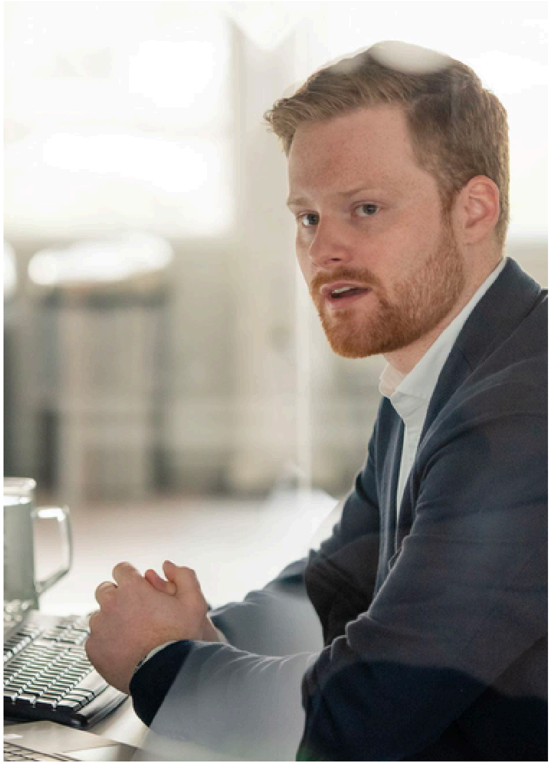
3. The discount rate:
The discount rate is the rate at which the lease payments should be discounted to present value. This is typically the lessee's incremental borrowing rate, which is the rate that the lessee would have to pay to borrow the funds necessary to purchase the underlying asset.



Now, you can use the above figures to estimate the right-of-use and liability values:

1. Calculate the present value of the lease payments:

The present value is calculated by discounting the cash flows obligated in the contact.



2. Recognize the liability and the asset:

The lease liability is the present value of lease payments. The right-of-use asset is the difference between the lease liability and any lease payments made in advance. The right-of-use assets should be amortised on a straight-line basis over the lease term.

Easier said than done? We agree. In 2021, House of Control converted from Norwegian GAAP to IFRS. We saved the roadmap to IFRS 16 compliance that we used, and we share it with you in the next section.

Converting to IFRS?
The journey to first-time IFRS 16 compliance

The journey to first-time IFRS 16 compliance starts by getting a thorough understanding – and consulting with auditors for clarity. This process will lead you to recognize that IFRS 16 can vary in its application across industries. Thus, you need to tailor your approach to fit your company's unique leasing contracts.

For the next steps, we asked our own finance department for advice.

At House of Control, we started by identifying leases, carefully assessing each contract's characteristics, significance and duration. It was a meticulous task, requiring our colleagues to dive into each contract to define key parameters like lease payments, duration, terms, and incentives.

There are several methods to choose from when transitioning to IFRS 16. Our finance team opted for the modified retrospective method. This choice allowed them to decide on how to recognize right-of-use assets, taking into account their financial preferences.

Lease terms and payments were determined with precision, considering contractual stipulations and potential extensions. To calculate lease liability and right-of-use assets, they used discounted future cash flows, ensuring they matched on the application date.

Post-commencement, they continuously measured right-of-use assets and lease liabilities, adjusting for amortisation and interest. They used our own market-leading lease accounting software to facilitate easy recalculation of figures.

The accurate figures were then transferred to the ERP and financial statements, providing transparency through additional disclosures in the notes. The financial statements were thoroughly reviewed, including comparisons with prior years.

To ensure ongoing compliance, internal controls and follow-up procedures were established. Finally, the auditor confirmed their adherence to IFRS 16, certifying the accuracy and alignment of their financial practices with the standard.

Switching from GAAP to IFRS: Our best tips for a smooth overall transition

Let us take a step back. While managing the requirements of the IFRS 16 standard is itself a challenge, it is often a challenge within a considerably larger challenge: Switching from local GAAP to IFRS.

Is your company planning an IPO? It is a big move, offering capital, visibility, and credibility. When aiming for an IPO, switching from generally accepted accounting principles (GAAP) to international ones (IFRS) is vital. Why? IFRS aligns your financial reporting with global standards, aiding potential investors in evaluating your performance and comparing it worldwide. It shows transparency and commitment to high-quality reporting.

Using IFRS means your financial statements follow a universal set of rules, making it easier for investors, analysts, and regulators to understand your results. This helps when attracting international investors familiar with IFRS.

Also, it lets you address accounting differences early, avoiding surprises during the IPO. Plus, many exchanges and regulators demand IFRS compliance for listings. So, consider the switch early to ease your IPO journey and appeal to a broader investor base.

We asked our own finance team how they processed the transition from Norwegian GAAP to IFRS. Here are the 13 generic steps they advice your company follow.

OK, let's jump back into the "IFRS 16 bubble". How does your company's financial statements change due to IFRS 16? What about the balance sheet? The profit and loss statement? Is even cash flow impacted? That's what we will explore in the next section.

How IFRS 16 affects financial statements

Three experts examined the potential impact of IFRS 16 on the financial statements of 197 publicly listed companies on the Oslo Stock Exchange. This assessment aimed to simulate how IFRS 16 would influence financial statements of different scopes.
Their findings revealed significant changes in several financial indicators, including:

1. Balance sheet impact:
Across industries (excluding finance), balance sheet assets increased by approximately 6.8%, while liabilities rose by nearly 9.4%, with only a minor shift in equity. This shift also led to a substantial increase in EBITDA (earnings before interest, taxes, depreciation, and amortisation) by about 20%.

2. Industry variation:
The most substantial increases in balance sheet values were observed in the retail sector, with a remarkable 26.6% rise, followed by the transport industry at 19.3%. This disparity illustrated that certain sectors were more impacted by the change due to a higher dependence on operating leases.

3. Income statement changes:
The adoption of IFRS 16 also affected key income statement ratios, particularly EBITDA. Companies with significant operating lease costs experienced a rise in annual net profit.

4. Operating margin enhancement:
The overall operating margin increased from 7.5% to 10.2%, with the oil industry experiencing the most significant boost. Return on assets (ROA) also rose from 1.7% to 2.2% on average, while the equity ratio declined slightly from 38.8% to 37.3%, primarily due to changes in the retail sector.

Beyond the IFRS 16 compliance burden: Creating business value with better lease accounting

PwC, a global consulting firm, conducted a study involving CFOs from 400 companies across 50 countries regarding their experiences with IFRS 16. While many companies initially focused on meeting the basic requirements of IFRS 16, PwC suggests that it offers opportunities for enhanced contract management and cost reduction.

Three areas identified by PwC where finance departments can achieve more business value from IFRS 16 include:

1. **Integrating specialised software into existing ERP systems or adopting dedicated software if currently using spreadsheets.**
2. **Optimising and automating contract management processes.**
3. **Analysing lease data to identify cost-saving opportunities and efficient asset utilisation.**

Centralising lease data is key to improving control over leasing agreements. With centralized data and the right tools, companies can reduce risk and achieve cost savings before and during lease contracts.

Despite the potential benefits, many companies are still in the early stages of understanding and analysing their lease agreements and data. Over half of the surveyed companies used spreadsheets to some extent, and nearly 40% planned to adopt new IT solutions within two years.

A challenge lies in managing leases decentrally, despite central management of IFRS 16 implementation projects. Only 40% of respondents organized their rental processes centrally. Centralised control allows for better analysis and sharing of insights across departments, leading to cost savings and broader business benefits.

wC recommends using IFRS 16 software to integrate lease management into the company's IT and reporting environment, automating processes, and optimising costs. Our point of view is that using IFRS 16 software helps your finance team manage several other practical day-to-day challenges of lease accounting and contract management. Let’s have a look at some of them in the next section.

Why lease accounting software should coexist with the ERP system

Switching to specialised lease accounting software alongside your Enterprise Resource Planning (ERP) system can offer several advantages, including improved lease management and cost savings. Here are 10 reasons why this makes sense:

1.Lease estimates and calculations:
IFRS 16 software is designed to handle the complexities of lease calculations and contract management efficiently.

2.Changes in lease terms:
Easily manage changes in lease terms, such as extensions or modifications, which can be challenging within an ERP system.

3. Avoid using Excel:
Excel can introduce errors and inefficiencies in lease accounting. Specialised software provides more reliable calculations and prevents personal dependence.

4. Demands experience:
Frequent IFRS 16 calculations can be stressful for finance department members. Specialised software streamlines the process and minimises resource usage.

5. Register numbers once:
All lease-related data can be managed within the lease accounting software, reducing duplication and ensuring consistency.

6. Proximity to contracts:
Lease administrators outside the finance department can manage agreements effectively with dedicated software, ensuring accurate data updates.

7. Note requirements:
Specialised software can automatically generate notes required for IFRS 16 reporting in the annual report.

6. Smarter lease management:
IFRS 16 software can help optimise leases, leading to cost reductions and improved budgeting precision.

9. Saves auditor hours:
Using IFRS 16 software can simplify the auditing process, reducing back-and-forth interactions and saving time and costs.

10. ERP consultant knowledge:
ERP consultants may lack expertise in lease accounting, making specialised software a better choice for handling IFRS 16 requirements accurately.

By using IFRS 16 lease accounting software side-by-side your ERP system, you can enhance lease management, reduce risks, and ensure compliance with accounting standards. It's a strategic move that can lead to significant improvements in your financial processes.

Can Excel be this specialised IFRS 16 software? We think not, and we will explain why in the next chapter.

Why Excel is not ideal for solving IFRS 16 lease accounting

Spreadsheets, especially Excel, is the air that finance team professionals breathe. Excel can also be leveraged to solve for IFRS 16. We know dozens of CFOs and other finance professionals companies that used Excel – before they got too many leases. Even though Excel is great for many financial purposes, we believe that for managing IFRS 16 compliance, Excel is not ideal in the long run for several reasons:

1. CPI adjustments:
Most leases require price adjustments at regular intervals. Excel requires manual recalculations when these adjustments occur, while specialised IFRS 16 software can automate this process.

2. Changes in contract scope:
When a business's growth differs from expectations, lease terms may change. Specialised lease accounting software offers standard functionality for handling these changes.

3. Document management:
Excel is not designed for document storage, making it challenging to ensure you have the latest contract terms and payment plans. Lease accounting software streamlines document management.

4. Termination and expiration:
Spreadsheets lack calendar and notification features. Lease accounting software can provide advance notifications for key dates and contract renewals.

5. Multiple entries:
IFRS 16 agreements are often recorded in multiple locations, causing duplication. Lease accounting software centralises data entry for improved accuracy.

6. Dependency on key personnel:
Relying on one person to manage a spreadsheet poses risks, such as formula errors or the person leaving the company.

7. Collecting contracts:
Large organisations with multiple locations face challenges collecting and structuring lease contracts. Cloud-based lease accounting software allows local experts to assist the finance department.

8. Efficiency and time:
IFRS 16 compliance demands significant time and effort. Spreadsheets can only partially automate these complex processes.

9. Auditor costs:
Lease accounting software simplifies auditing with random sampling, reducing expensive audit hours. Auditing Excel-based calculations requires a more in-depth examination.

As mentioned, Excel is almost always a valuable tool to any finance department, but it has limitations for complex lease management and IFRS 16 reporting. Therefore, a better choice would be a specialised lease accounting software that offers features and automation that significantly improve accuracy, efficiency, and compliance.

In the section below we have identified the most important functionality an IFRS 16 software should have.

Functionality to look for in IFRS 16 software

When selecting an IFRS 16 lease accounting software we recommend considering several functionalities and vendor features:

1. Fast implementation:
The software should seamlessly integrate with your ERP system, requiring minimal IT assistance, and the setup should be quick.

2. Ease of use:
It should be user-friendly, eliminating the need for extensive training and simplifying compliance processes.

3. Rich functionality:
Look for software that offers automation, real-time calculations, and comprehensive reporting to meet lease accounting compliance requirements while supporting better lease-related business decisions.

4. Leasing subledger:
Ensure the software transparently records all relevant leasing transactions and generates accounting outputs for your ERP system.

3. Rich functionality:
Look for software that offers automation, real-time calculations, and comprehensive reporting to meet lease accounting compliance requirements while supporting better lease-related business decisions.

4. Leasing subledger:
Ensure the software transparently records all relevant leasing transactions and generates accounting outputs for your ERP system.

5. Simplified re-measurement:
The software should automatically calculate adjustments to the right-of-use asset and lease liability as contract changes occur, with corresponding general ledger postings.

6. Amortisation and depreciation schedules:
It should create right-of-use (ROU) assets and amortisation schedules at lease inception, updating them as contract terms change.

7. Accurate disclosures and audit trails:
The software should provide pre-built accounting and standard reports for IFRS 16 disclosures and forecasting, aiding portfolio run-off and audit reporting.

8. End-of-lease notifications:
Ideal IFRS 16 software also acts as a contract lifecycle management tool, sending notifications for approaching key dates, lease expirations, or required actions.

9. Centralised lease data:
Effective contract management is vital. The software should centralise and display your entire lease portfolio in real-time.

10. Automated compliance:
Replace inefficient spreadsheets with software that ensures compliance every year.

11. Accuracy:
Software provides fast, accurate disclosure and reporting.

12. Real IFRS 16 support:
Access to a support team with extensive experience can help address any questions or concerns efficiently.

In summary, the best IFRS 16 software combines user-friendliness, automation, comprehensive functionality, and robust support to streamline lease accounting compliance and enhance lease-related decision-making at your company.

Conclusion

IFRS 16 is a demanding standard. It will take time to understand the regulations and what it means for your business – regardless of where you're starting from. Furthermore, for most, it will require significant effort to get an overview of all the lease agreements. Are they covered by IFRS 16?

This work must be done before you can potentially benefit from digital tools. How challenging the subsequent steps in the process are, both the first time you report under IFRS 16 and in the future, will largely depend on the digital choices you make.

Specialised software for lease agreements helps you achieve easier, faster, and better compliance. Such software can also bring you other benefits, including reduced costs, minimised risk, and improved financial management.

We hope this guide has helped you getting a better overview of IFRS 16 and what it means for the finance department.

Do you want to know more about how House of Control’s advanced software can help you be in control of your leasing agreements?

Visit our website or book a live demo with one of our IFRS 16 experts.

HOUSE OF CONTROL

Thank you for your interest in **House of Control!**

Read more about our IFRS 16 solution:

IFRS 16 solution

Contact

House of Control AS
O.H. Bangs vei 70 1363 Høvik, Norway
+47 815 66 355

www.houseofcontrol.com
mops@houseofcontrol.com
Follow us: Linkedin