IFRS 16, the new leases standard which replaces IAS 17, will have significant implications for lessee banks’ balance sheets and consequently on their operations and regulatory capital requirements. Yusuf Hassan assesses what banks should be doing now.

International Financial Reporting Standards (IFRS) 16 Leases, applicable for periods beginning after 1 January 2019 (early adoption permitted), brings significant enhancements in accounting requirements for leases. Lessees, that is the entity that takes assets on lease, are most affected by these changes. Instead of recognising a periodic lease expense over the lease term for operating leases, as under International Accounting Standard (IAS) 17, lessees are required to recognise most of the leases on the balance sheet. Interestingly, IFRS 16 does not change the way lessors classify and account for their leases.

UAE banks have many leasing arrangements that will now be in the ambit of the new IFRS 16 standard: branches, automated telling machines (ATMs), IT infrastructure, outsourcing arrangements and many more. As such, IFRS 16 will have significant implications for the lessee-banks’ balance sheets and consequently on their operations and even regulatory capital requirements. Importantly, it will also change how they assess their obligors’ balance sheets.

**How will accounting for lessees change?**

Presently, IAS 17 requires lessees to recognise a periodic lease expense on a straight-line basis over the term for operating leases. IFRS 16, on the other hand, will require lessees to recognise most operating leases on their balance sheets as a right-of-use (ROU) asset and a corresponding lease liability. There is no significant change in the accounting for leases currently defined as finance leases. Lessees will subsequently recognise amortization expense on the ROU asset and interest expense on the lease liability. As the interest expense depends on the declining balance of the lease liability, total expenses arising from the lease contract will be higher during the initial years of the lease contract, similar to finance lease accounting under IAS 17.

**Impact on balance sheet**

Companies with operating leases will appear to be more asset-rich, but also more heavily indebted

**Impact on profit and loss**

Total lease expense will be front loaded even when cash rentals are constant
It is also important to note that IFRS 16 allows lessees to opt for a method similar to IAS 17 in accounting for their operating leases when the leases under consideration have a term of 12 months or less, and they do not contain a purchase option. In addition, for low-value assets, lessees may choose to retain accounting for leases similar to IAS 17. However, IFRS 16 does not provide a quantitative threshold for assets to qualify as ‘low-value’. UAE banks will have to exercise significant judgment in applying guidance under the new standard.

The client impact
Banks also need to anticipate how IFRS 16 will affect the way they do business with their customers. Since the impact of IFRS 16 will extend to the banks’ borrowers, who may have substantial operating lease commitments, significant training would be required for the business to review the change in presentation in the financial statements. The additional liabilities on the balance sheet translate to reduced ability to be able to meet their debt covenants. As a result, borrowers may seem to be stressed even though nothing in essence has changed. This could also have an impact on the expected credit loss calculations, and could increase the pressure on capital. Banks would either need to allow more headroom on the debt covenants to their clients, or to retain the use of the current lease accounting for the debt covenants.

In conclusion, IFRS 16 is likely to have significant implications for banks’ financial statements, operations and capital requirements. Banks should therefore consider conducting an impact assessment as soon as possible. This assessment will be more complex for geographically dispersed bank networks with more lease commitments, and may require more time to conduct. With IFRS 9 implementation projects safely out of the way, we recommend that banks should ensure they set up the processes, systems and controls necessary to comply with IFRS 16.

The impact on a bank’s capital and operations
UAE banks commonly enter into long-term operating leases for many assets. Under current principles, leased assets are not recognised on a bank’s balance sheets. However, under IFRS 16, such off-balance sheet leases are expected to become on-balance sheet, and result in an increase in the total assets and total liabilities of the bank.

Grossing up of the balance sheet will impact the capital adequacy ratio (CAR) computation for banks. Since operating leases are not currently recognised on the balance sheet, the regulatory requirement to hold capital against such lease liabilities does not arise. On the date of implementation of IFRS 16, the recognition of the ROU asset and the lease liability may result in banks being required to set aside further capital.

The Central Bank of the UAE (CBUAE) has not yet issued guidance in relation to IFRS 16 or its impact on prudential reporting and CAR reporting of banks in the UAE. It is essential, nevertheless, for banks to evaluate the potential impact of the new standard on their capital requirements.

In addition, some banks enter into sale-and-leaseback transactions to manage their capital or liquidity requirements. Since all long-term leases will now have to be recognised on the balance sheet, such sale-and-leaseback transactions may no longer provide the lessee banks with a source of off-balance sheet financing.

“Banks should consider conducting an impact assessment as soon as possible”

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Yusuf leads our Accounting Advisory Services function for KPMG Lower Gulf and is the Head of Department of Professional Practice (DPP) in the Middle East and South Asia region. He is responsible for assisting our clients with technical IFRS related issues, in particular advising on: the interpretation and application of IFRS to specific transactions and scenarios; the implementation of the latest IFRS developments; standard setting processes; and regional IFRS issues. Yusuf has provided IFRS assistance to a wide range of blue chip clients in various industries across the Middle East. He has conducted IFRS training in South Africa and across the Middle East and has presented at a number of regional IFRS seminars.