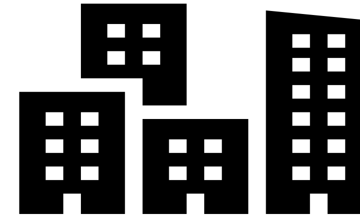
IFRS 16 – Leases



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Objective

This Standard sets out the principles for the recognition, measurement, presentation and disclosure of leases.

The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity.
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IFRS 16 is applicable for annual periods beginning from January 1, 2019.

IFRS 16 eliminates the classification of lease as operating or finance lease for a lessee. Instead all leases are capitalized in the books of lessee. Where lessor accounting remains unchanged.

Exclusion

Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

Biological assets- IAS 11;

Service concession arrangements- IFRIC 12;

Licenses of intellectual property granted by a lessor within the scope of IFRS 15 Revenue from Contracts with Customers; and

Rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

Exemptions

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- Companies may elect not to apply this standard for below cases:
  - Short term leases- Those that are mainly used in operations, (discussion paper comments that this relates to those leased asset with lease term less than a year),
  - Leases where the asset value is low- Which means lessee can benefit from use of underlying asset on its own or together with other resources that are readily available for use and the underlying asset is not highly dependent- Independent- Examples include: Tablet, computers, small items of office furniture and fixtures.

- ***If the entity decides not to apply IFRS 16 for the asset mentioned above, then the entity can accounted those leases in a straight line basis expense- IFRS 16.6***

Practical example on low value assessment

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Low Value Lease Assessment

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Scenario

A lessee in the pharmaceutical manufacturing and distribution industry has the following leases:

(a) Leases of real estate (both office buildings and warehouses);

(b) Leases of manufacturing equipment;

(c) Leases of company cars, both for sales personnel and senior management and of varying quality, specification and value;

(d) Leases of trucks and vans used for delivery purposes, of varying size and value;

(e) Leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones);

(f) Leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as the lessee has needed to increase the storage capacity of the servers;

(g) Leases of office equipment:

(i) Office furniture (such as chairs, desks and office partitions);

(ii) Water dispensers; and

(iii) High-capacity multifunction photocopier devices.

Low Value Lease Assessment

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Assessment

The lessee determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are (or were) individually of low value:

(e) Leases of IT equipment for use by individual employees; and

(g) Leases of office furniture and water dispensers. The lessee elects to account for these leases using the low value exemption. Although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low-value assets. This is because each module is highly interrelated with other parts of the servers. The lessee would not lease the modules without also leasing the servers

How to identify a lease??

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A contract is, or contains, a lease if the contract **conveys the right to control** the use of identified asset for a period of time, in exchange of consideration. **Right to control has the both**

- The right of the customer to obtain substantially all economic benefit,- Having the right to use the asset, by holding or sub leasing and cash flow benefit, - ***IFRS 16. B21-B23***
- Right to direct the asset- The customer can decide upon the purpose, the customer has right to operate the asset, the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period **Decision making power of the customer (*B25*)on output and when to use the asset**. ***IFRS 16.B24.***

There can also be the scenarios whereby the supplier has protective rights (Maximum amount of use of an asset or the follow practices that the customer needs to be followed), these protective rights does not mean there is no right to direct the use by the customer- ***IFRS 15.B30.***

Practical example on economic benefits

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Obtaining Economic Benefits

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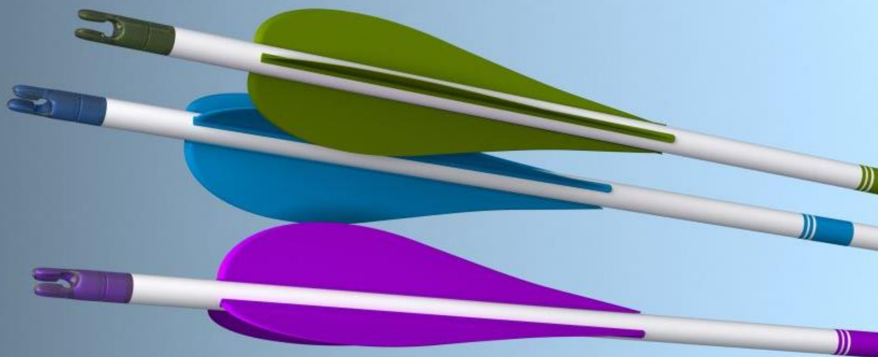
- A retailer enters into a contract for the lease of a store in a shopping Centre for 5 years. The rental terms include payments equal to 10% of the gross sales revenue generated from the store. The retailer has the right to determine which products that are to be sold, the interior design of the store, etc.
- **Assessment**
- It is the customer’s control and use of the property which generates all of the sales revenue. The fact that a portion of the cash flows generated from use of the property are passed to the lessor is not relevant. The lessee has a right to 100% of the sales revenue generated from the store (i.e. all of the economic benefits generated by the store), albeit that it has negotiated a contract which results in rent being determined by reference to that gross sales revenue.
- ***Example- Direct the use***
- A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. The customer designed the bio-mass facility before it was constructed by hiring experts in the field to assist in determining the location of the facility and the engineering of the equipment to be used. The supplier is responsible for building the facility to the customer’s specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.
- ***Assessment***
- In assessing the ‘right to direct use of asset’ criterion, the functionality of the facility is predetermined based on its design, and those predeterminations were made by the customer. Therefore, the customer has the right to direct its use.



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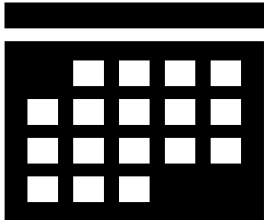
Identify a lease contract through questionnaire

- Is there any lease identified by being explicitly stated in a contract or by made available to customer?
- Does the customer have substantially the right to obtain the cash flow from use of the asset?
- Does the customer have the right to direct the use of the asset for its purpose?
- Does the customer have the right to operate the asset through the leased term?
- Then yes, the contract contains lease. If the customer has no right to direct or operate then the contract does not contain lease.

Lease term



Lease term commences when the asset is made available to the customer.

- Lease term can be non cancellable period of lease if the contract has both:
- If the lessee has an option to extend the lease and certain that the lessee will exercise that option,
- If the lessee has an option to terminate the lease and certain that the option will be exercisable.

Practical examples of lease term

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Lease term assessment

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- ***Scenario***
- A customer is considering entering into a lease for equipment to manufacture widgets. The lease has a 5-year term, with an option exercisable by the lessee only to extend the lease for an additional 2 years. This means that there is effectively a termination option for the lessee at the end of year 5, but not the lessor. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional 2-year period if the lessee exercises its extension option. The customer operates in a remote location where the cost of shipping and installation for pieces of equipment are significant.
- ***Assessment***
- Here the lessee can terminate the lease. The customer lacks a direct, contract-specific economic incentive to extend the lease given that lease payments are at a market rate throughout the period of the lease. However, all relevant facts and circumstances that create an economic incentive for the customer to exercise, or not exercise, options must be considered. This, therefore, includes entity-specific factors such as the costs the customer would incur to obtain a suitable replacement asset, the importance of the asset to the customer's operations, and the availability of suitable replacement assets. As the customer operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement, it concludes that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be 7 years.

Lease term assessment

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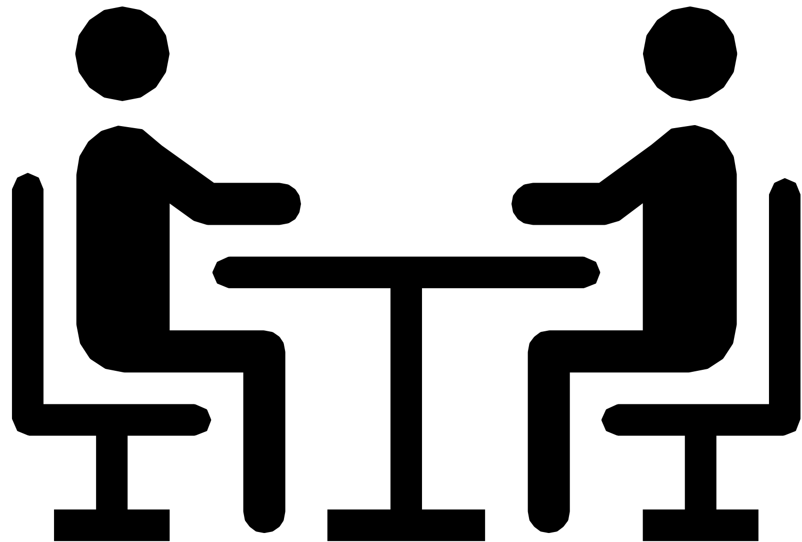
- ***Scenario***
- Assume similar facts to the prior example except both the lessee and the lessor have a termination option at the end of Year 5 with a zero-termination payment. A customer is considering entering into a lease for equipment to manufacture widgets. The lease has a 5 year term, with an option to extend the lease for an additional 2 years. Either party can terminate the lease at the end of the 5-year term with zero termination payment. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional 2-year period if the lessee exercises its extension option. The customer operates in a remote location where the cost of shipping and installation for pieces of equipment are significant.
- ***Assessment***
- Here both the lessee and lessor have a termination option. Therefore, we need to consider there is no more than an insignificant penalty. The contract specifies there is no monetary penalty however, this is only one kind of penalty that could arise. There needs to be no penalty of any type in order for the termination clause to have economic substance and the lease term to be capped at 5 years. There could be other kinds of economic penalties in addition to those explicitly in the contract. In this instance, due to the remote location and likely difficulty obtaining a new tenant along with the specialised nature of the leasehold improvements, the lessor would have an economic penalty. In addition, as noted in the prior example the lessee would also have economic penalties. Therefore, the penalty is determined to be more than insignificant, and the contract is enforceable.
- The term of the lease is then determined based on the lessee factors similar to the prior example with the conclusions that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be 7 years.



Recognition

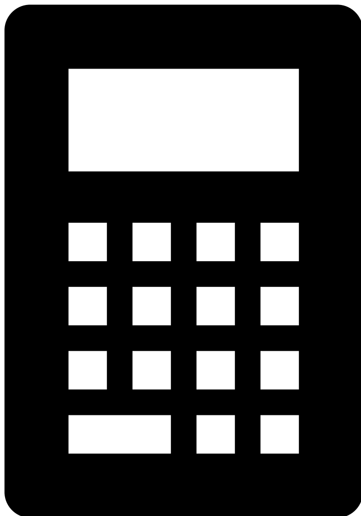
Lessor recognition

For lessor the accounting and recognition as per IAS 17- Leases remains the same whereby under both operating and finance lease the lessor will retain the assets in the books as part of fixed assets.

Lessee accounting- Initial recognition

- At the commencement of lease term the lessee shall recognize right of use asset and a lease liability.
- ***Right of use is measured at cost which includes***:
- Amount of initial measurement of lease liability,
- Any lease payments made prior to commencement of the lease,
- Any initial direct costs less any lease incentive received and
- Any estimated cost to be incurred in dismantling and removing the leased asset.
- ***Lease liability consist of:***
- Fixed future payments,
- Variable payments,
- Amount expected to be payable under residual value guarantee,
- Any termination penalties,
- And the cost shall be discounted using interest rate implicit in the contract in not the lessee can consider borrowing rate in case if they had purchased that asset (incremental borrowing rate).

Lessee accounting- Subsequent recognition



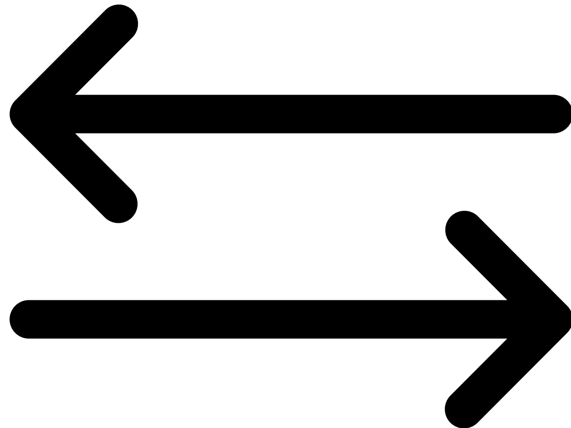
- Right of use asset:

Right of use asset will be measured using the cost model i.e., at cost less accumulated depreciation and adjusted for remeasurement of lease liability.

- Lease liability:

Leased liability is measured at amortized cost model where the carrying value is increased by interest on the lease less any payments made.

Transition rules



- Full retrospective approach
- Apply retrospectively hence starting from the year 2016
- Modified retrospective approach
- Does not require the restatement hence the cumulative effect of IFRS 16 is adjusted to equity at the start of current accounting period (2019).
- For lease liability the adjustment would be on the remaining payments using incremental borrowing rate,
- For right of use the adjustment is done for prepaid or accrued lease payments immediately before the date of initial application or as if IFRS 16 had always been applied by using the incremental borrowing rate at initial recognition.

Impact on financial reporting

- All leases will be treated under the same accounting treatment,
- Present value of the liability is to be considered,
- Right of use asset will be shown separately under non-current asset,
- Lease liability is to be apportioned as non and current liability,
- EBITDA will increase,
- Operating profit will increase,
- Cash flow from operational activities will improve,
- Cash flow from financing activities will decrease.

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