IFRS 16

LEASES

- IFRS 16 effective from **January 1, 2019**
- IAS 17 will no longer apply
- Early application only with IFRS 15

Objective:

IFRS 16 sets out the principles for the **recognition, measurement, presentation and disclosure of the leases**. The objective is to ensure that lessees and lessors provide relevant information in the manner that faithfully represents those transactions

- IFRS 16 **does not** apply to:

- Leases to explore for/use of minerals, oil, natural gas and similar
- Leases of biological assets (IAS 41)
- Service concession agreements (IFRIC 12)
- Intellectual property licenses
- Rights under licensing agreements

Lease:

A contract, or part of a contract, that conveys the right to use an asset, the underlying asset, **for a period of time** in **exchange for consideration**.

Underlying Asset:

An asset that is subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

An entity must identify whether a contract contains a **lease**, which is the case if the contract conveys the **right to control** the use of an identified asset for a period of time in exchange for consideration.

Right to control the use of an identified asset depends on the lessee having:

a) The right to obtain **substantially all of the economic benefits** from the use of identified asset,(exclusive right of use including the primary output and the by products) and
b) The right to **direct the use** of the identified asset.(decision about why and how the asset is used, protective rights do not limit the right to direct the use)

The right to direct the use of the asset will arise when either:

1) The customer has the right to direct **how and for what purpose** the asset is used during the whole term of usage.
2) Relevant decisions about the use of asset are **pre-determined** and the customer can operate the asset without the supplier having the right to change those operating instructions or the customer designed the asset in a way that pre determines how and for what purpose the asset will be used throughout the period of use. (identified asset)
3) Customer does not have the right to direct the use of an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.

Identified Asset:

Customer has following rights to the identified assets:

- Explicitly – Assets specified
- Implicitly – Capacity portion (physically distinct – Warehouse, Substantially all of the capacity –Eg: Pipeline)

Example1:

A has entered into a 5 year contract with B, under which B supplies A with ten vehicles for the purpose of community transport. B owns relevant vehicles, all ten of which are specified in the contract. A determines the route for the community transport and the charges and the eligibility for discounts. A can choose to use the vehicles for purpose other than community transport. When vehicles are not being used, they are kept at the A's office and cannot be retrieved by B unless A defaults on payment. If vehicle need to be serviced or repaired, B is obliged to provide a temporary replacement vehicle of the same type.

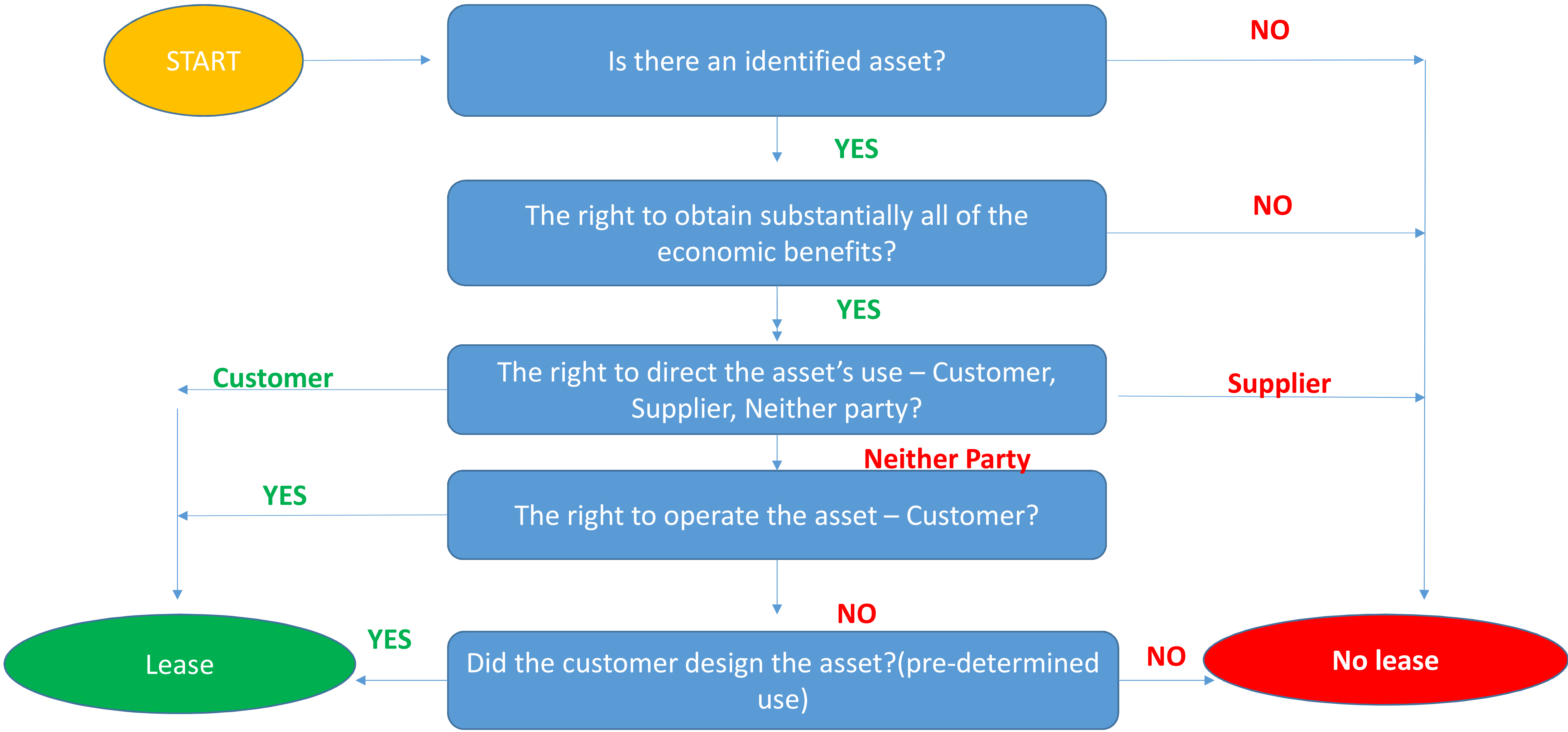
This is a lease.

There is identifiable asset- 10 vehicles in the contract. A has right to use the vehicle for the period of contract. B does not have the right to substitute any of the vehicles unless they are being serviced or repaired.

Example 2:

A has recently made substantial cuts to its community transport service. It will now provide such service only in the cases of great need, assessed on a case by case basis. It has entered into a two year contract with B for the use of one of its minibuses for this purpose. The minibus must seat ten people, but B can use any of its ten seater minibus when required. The minibus are held on B's premises and are only made available to A on request.

This is not a lease. There is no identifiable asset. B can exchange one minibus for another. Therefore A should account for rental payments as an expense in the profit or loss.


START
Is there an identified asset?
NO
YES
The right to obtain substantially all of the economic benefits?
NO
YES
The right to direct the asset's use – Customer, Supplier, Neither party?
Customer
Supplier
Neither Party
The right to operate the asset – Customer?
YES
NO
Lease
YES
Did the customer design the asset?(pre-determined use)
NO
No lease

Separating Components of a contract

An entity accounts for lease component separately from non lease component if :

❖Lessee can benefit from the use of asset

❖Asset is not highly dependent on or interrelated with other assets in the contract

Lessee:

Allocate consideration on the basis of relative stand alone prices of the lease component

If stand alone price not readily available, estimation is permitted.

Lessees need not separate if they elect not to.

Lessor:

Allocate consideration based on the requirements of IFRS 15.

Note: Any other components like Administration charges included as part of lease it should be excluded from the allocation.

KEY TERMS

Inception of the contract:

Earlier of : Date of lease agreement or date of commitment by the parties → Assessment of the contract is made

Commencement date:

When lessor makes an **underlying asset available for use** by the lessee → Accounting starts

Lease Term:

Non-cancellable period of lease together with both:

1) Extension option – reasonably certain to exercise
2) Termination option – reasonably not certain to exercise

Assess whether the option will be exercised:

Terms and condition of the option (market rates)
Cost of terminating the lease (whether possible to find a place similar)
Leasehold improvements
Importance of underlying assets

<u>Lease Payments:</u>

Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term** comprising the following:

- Fixed payments,(including in- substance fixed lease payments) less any incentives (Incentive- Payments made by the lessor to the lessee or reimbursement or assumption by the lessor of costs of the lessee)
- Variable payments that depends on the index and rate (other variable payments that are based on the performance are accounted for as period costs in profit or loss and hence excluded from the lease payments)
- Amounts expected to be payable under residual value guarantees
- Purchase option if reasonably certain to be exercised
- Penalties for terminating the lease

<u>Right of use asset:</u>

- Amount of initial measurement of the lease liability (PV of lease payments not paid at the commencement date discounted at interest rate implicit in the lease)
- Prepaid lease payments less Incentives received
- Initial direct costs(legal fees, commissions etc)
- Estimate of restoration, removal and dismantling costs

Accounting by Lessee:

No classification of leases!!!!!!!!!!

At the commencement of lease:

Recognise **Right of use of asset** and
lease liability

Recognition Exemption:

- Short term leases of 12 months or less
- Leases of low value of assets : to an underlying assets when new, on absolute basis, irrespective of materiality. Egs: Tablets, personal computers

Lease payments are recognised on a straight line basis.

Discount Rate:

Lessor: Interest rate implicit in the lease (IRR)
PV of lease payments + PV of unguaranteed residual value = FV of underlying assets + lessor's initial direct cost
Lessee: IRR (difficult to determine) / incremental borrowing rate (observable rates/ similar term & security)

Accounting by lessees

After the commencement:

Right of use asset : Debit PL Depreciation expense
Credit ROU Accumulated depreciation

Cost model (IAS 16)
FV model(IAS 40)
Revaluation Model (IAS 16)
Impairment tests (IAS 36)

Lease Liability –

Interest on Lease Liability

Debit: PL Interest   Credit: Lease Liability

Reduction of Lease Liability

Debit : Lease Liability   Credit: Cash/bank

Accounting by lessees:

Re-measurement:

After the commencement date, lessee re-measures the lease liability to reflect the changes in the lease payment. Re-measurement can be adjusted for right of use asset. But the carrying amount of right of use asset cannot go below zero. The difference in carrying amount and re-measured liability to be adjusted in PL.
Revised discount rate: Change in lease term, Change in option to purchase assessment
Unchanged discount rate: Change in amounts for residual value, change in future payments due to index/rate

Modifications:

Separate Lease

- Does the modification add the right to use one or more assets
- Does the consideration increase commensurate with the stand alone price

Not a Separate lease

- Lessee shall calculate modified lease liability:
- Allocate consideration
- Determine the lease term
- Re-measure the lease liability by discounting the lease payments using a revised discount rate.

How to account for modification of lease liability:

Modification decreases the scope of lease:

- Decrease the carrying amount of right of use asset to reflect partial or full termination
- Recognise any gain or loss in profit or loss

Modification does not decrease the scope of lease:

- Make corresponding adjustment to the carrying amount of right of use asset
- Adjust lease liability to reflect re-measurement.

Presentation:

- Present right of use asset separately from other assets
- Present lease liabilities separately from other liabilities
- Present interest on lease liability separately from depreciation of ROU asset
- Cash Flows:
  - Payments for principal = Financing activities
  - Payments of interest = Financing activities
  - Payments for Short term leases, low value asset leases and variable payments not within the lease liability = operating activity

Disclosures:

Disclosures of assets, liabilities, expenses and cash flows in tabular format:

- Depreciation of ROU assets by class
- Interest expense on lease liabilities
- Expense related to Short term lease
- Expenses related to low value leases
- Expenses related to variable lease payment not within lease liability
- Income from subleasing of ROU assets
- Cash outflow for leases
- Addition to ROU assets
- Gains/losses from sale and leaseback
- Carrying amount of ROU by class

Portfolio Application

Lessee groups its company cars, trucks and vans into portfolios on
The basis of similar characteristics if the entity reasonably expects that the
Effects on the financial statements of applying IFRS 16 to the portfolio would
Not differ materially from applying IFRS16 to the individual leases within that
portfolio.

Accounting by lessors: Classification of leases

Are the **risks and rewards** of ownership **transferred to lessee**?

Yes : Finance Lease
No : Operating Lease

Situations for Lease to be classified as finance lease:

- Ownership transferred by the end of lease term
- Option to purchase the asset at price < FV
- Lease term = major part of economic life of asset
- PV of lease payments >= FV
- Leased assets are of specialised nature

If answer is **no** to the above situations, classify them as **operating lease.**

Accounting by Lessors: Classification of Leases

Land & Building: Land – indefinite economic life
Operating Lease unless title passes at the end of lease term

Building : Operating or Finance lease

Allocation of lease payments are done based on proportion of fair value.

Accounting by Lessors: Operating Lease

Lease payments = Revenue on a straight line basis
Underlying Asset = Initial direct cost added to the asset plus depreciation

Accounting by Lessor: Finance Lease

At the commencement:

Debit: Lease receivable-net investment in lease
Credit: PPE
Credit: Gain (loss) on sale of PPE

Net Investment in lease includes:

- Fixed payments
- Variable payments(index)
- Residual value guarantee
- Exercise price of purchase option
- Penalties for terminating the lease
- Initial direct costs

After the commencement:

Debit : Cash (reduction of Lease receivable)
Credit: Lease receivable
Credit: Interest Income

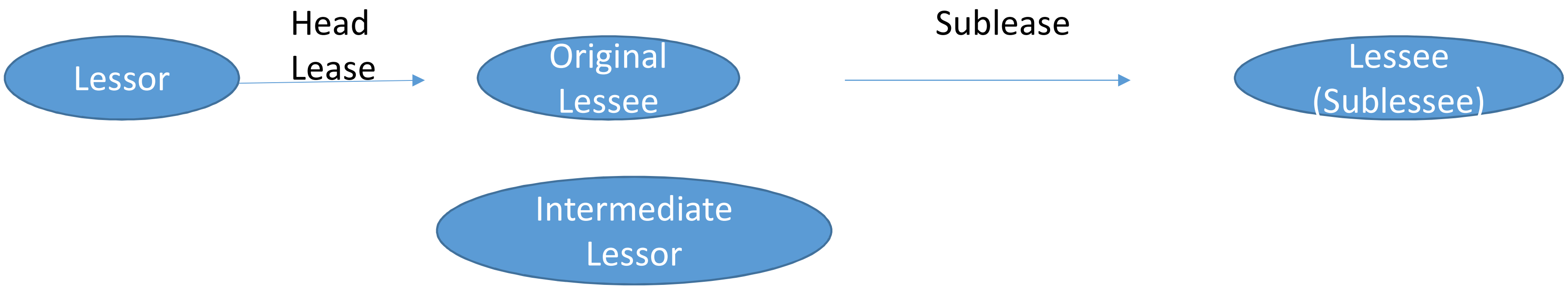
Apply IFRS 9 to the net investment in the lease. Lease re measurement and modification similar to lessees

Accounting by Lessor: Finance Lease

Manufacturer/Dealer Lessors:

Selling Profit: Revenue – cost of sales
As outright sales under IFRS 15
Finance Lease: Initial direct costs in PL
If interest rates are artificially low, restrict the selling profit to that which would apply had the commercial rate been applied

Accounting by Lessor: Sublease



Sublease Operating: Keeps recognising sublease as before
Sublease Financing: Debit Net investment in the lease/ credit ROU asset (difference in PL)
Head Lease = Short Term: Recognition exemption, Sublease = operating

Leases: Disclosure (Lessor)

In tabular format:

For Finance Lease:

- Selling Profit or Loss
- Finance income on net investment in the lease
- Income related to variable lease payment not within lease receivable
- Additional quantitative and qualitative disclosures

For Operating Lease:

- Lease income
- Income related to variable lease payment not depending on an index/rate.

How to adopt IFRS 16 Leases

Full retrospective approach	Modified retrospective approach
Retrospectively to each prior reporting period	Retrospectively with cumulative effect at the date of initial application ➢ Comparatives presented under prior IFRS ➢ IFRS 16 applied to existing and new contracts onwards ➢ Adjustments to opening retained earnings

Sale and Leaseback

Is the transfer of asset a sale under IFRS15?
Did the control of an underlying asset passed
to the buyer?

Yes

Seller: Lessee

- Right of use asset at proportion of the previous carrying amount
- Gain/loss related to the transferred rights only

Buyer : Lessor

- Asset under applicable standards
- Lease under IFRS 16

Leaseback

Transaction not on market terms:

Below Market terms: Prepayments of lease payments (Shortfall in consideration received from the lessor is treated as lease payment made by the lessee)

Above Market terms: Additional financing provided by the buyer/lessor

No

Seller (Lessee)

- Continues to recognise an asset
- Financial liability (IFRS 9)

Buyer (lessor)

- Financial asset (IFRS 9)

Financial Impact of IFRS 16

	IAS 17	IFRS 16
Revenue		
Cost of sales		
Gross Profit		
Operating Costs Net	Operating Lease expenses	
EBITDA	EBITDA under IAS 17	EBITDA under IFRS 16
Depreciation/amortisation		Depreciation of ROU
Profit from operations	Profit from operations under IAS 17	Profit from operations under IFRS 16
Finance expense		Interest expenses
Profit before tax		

On 1 January 20X1 Stamper Co, producer of metal casts, enters into a lease contract to lease the stamping machine. Cash price of machine was 500 000 EUR and Stamper incurred additional costs of 2 000 EUR for arranging the lease contract. The lessors initial direct costs were CU 3 000. Economic life of stamping machine is 6 years. Lease term is 5 years, annual lease payments are 110 000 EUR payable 31 December each year. At the end of the lease term, Stamper has an obligation to purchase the machine for 1 000 EUR. There is no unguaranteed residual value of the lessor.
How would this transaction appear in the financial statements of Stamper Co. at 31 December 20X1?

1. Initial recognition

1.1 Interest rate implicit in the lease:

- put lease payments in the table
- at the lease commencement, put FV of an asset plus lessor's initial direct costs.
- lease commencement = year 0. If the lease payments are in advance, then deduct the 1st payment from the FV of an asset + lessor's initial direct costs
- to the last period, add unguaranteed residual value of the lessor (it's 0 in this case),
- don't forget to add any price of exercising the option, etc. (here: 1 000 added to the last lease payment)

	Year	Cash flow
Lease commencement	0	503,000
20X1	1	-110,000
20X2	2	-110,000
20X3	3	-110,000
20X4	4	-110,000
20X5	5	-111,000
		3.11%

1.2 Present value of the lease payments:

- you don't have to calculate it again - it's 503 000, isn't it? But, let me prove it you in the table below

Year	Lease payment	Discount factor	Present value of lease payments
1	-110,000	0.970	-106,679
2	-110,000	0.941	-103,458
3	-110,000	0.912	-100,334
4	-110,000	0.885	-97,305
5	-111,000	0.858	-95,225
Total			**-503,000**

1.3 Right-of-use asset:

PV of the minimum lease payments:	503,000
nitial direct costs of the lessee:	2,000
	505,000

1.4 Journal entry

Recognition of asset / lease liability:

Debit Right-of-use asset	505,000
Credit Cash	-2,000
Credit Lease liability	-503,000
	0

2. Subsequent measurement

2.1 Allocation of the lease payments

Year	Lease liability b/f	Lease payment	Interest	Decrease in lease liability	Lease liability c/f
1	-503,000	-110,000	-15,660	-94,340	-408,660
2	-408,660	-110,000	-12,723	-97,277	-311,383
3	-311,383	-110,000	-9,694	-100,306	-211,077
4	-211,077	-110,000	-6,571	-103,429	-107,649
5	-107,649	-111,000	-3,351	-107,649	0
				-503,000	

2.2 Calculation of depreciation

Cost of right-of-use asset:	505,000
Useful life in years:	6
Annual depreciation charge (505 000 / 6):	**84,167**

2.3 Journal entries

Depreciation of ROU:

Debit Depreciation expenses	84,167
Credit Accum. dep. - ROU	-84,167
	0

Annual payment in the 1st year:

Debit Interest expense	15,660
Debit Finance lease liability	94,340
Credit Cash	-110,000
	0

Example::::::::

Operating Lease :

Alpha Co leased a machine with a remaining useful life of 10 years to Beta co. The lease commenced on January 1, 20X1 and is for a term of three years. Lease payments of $3,600 are due on 31 December each year. As an incentive, Beta Co was given a rent-free period of two months at the commencement of lease. Alpha co is responsible for maintenance of the machine.

Required :

Discuss the accounting treatment of the above lease in the financial statements of Alpha Co for the year ended 31 December 20X1, including relevant calculations.

Solution:

Alpha co retains the risks and rewards of ownership of the machine evidenced by the fact that the lease is only for a small portion of the useful life of the machine and the fact that Alpha is responsible for maintenance of the machine during the lease term. As such, lease is the operating lease in the financial statements of Alpha Co.

The benefit received from the asset earned over the three years of the lease. However, in the first year, Alpha only receives $3,600*10/12=$3,000. Lease rentals of $10,200 ($3,000+($3,600*2 years)) are received over the 3 year lease term.

In accordance with IFRS 16, Alpha should recognise income of $3,400 ($10,200/3 years) in the year to 31 December, 20X1, and in each of the following two years.

A receivable of $400 should be recognised at 31 December, 20X1 ($3,400-$3,000 cash received)

1.How shall the lessee determine the appropriate discount rate to measure the lease liability?

- It is the interest rate implicit in the lease or the lessee's incremental borrowing rate.
- It is the interest rate implicit in the lease while taking the lessee's initial direct cost into account.
- It is the market rate of interest on the borrowings with similar terms as the lease.
- It is the market yield with securities from the same industry with the same maturity dates as the lease term.

What is the most important factor to decide how to account for the sale & leaseback transaction?

- Whether the sales price is at fair value, above fair value or below fair value.
- Whether the resulting lease is operating or finance.
- Whether the lease payments are at market rentals, below market or above market.
- Whether the transfer of asset is a sale under IFRS 15 Revenue from Contracts with Customers

When does the lessee need NOT to recognize the right-of-use asset and corresponding lease liability under IFRS 16?

- The lessee never needs to recognize the right-of-use asset and the lease liability.
- When the lease term is 12 months or less, or when the underlying asset is of low value when new.
- The lessee always needs to recognize the right-of-use asset and the lease liability.
- When the lease is operating

When there is a change in the lease term, the lessee needs to:

- Remeasure the lease liability with difference recognized in profit or loss, by discounting the revised lease payments by the revised discount rate.
- Remeasure the lease liability as an adjustment of the right-of-use asset, by discounting the revised lease payments by the revised discount rate.
- Remeasure the lease liability as an adjustment of the right-of-use asset, by discounting the revised lease payments by the unchanged discount rate.
- Remeasure the lease liability with difference recognized in profit or loss, by discounting the revised lease payments by the unchanged discount rate.

<u>Example : Transition</u>

ABC, the manufacturing company, needs to adopt the new standard IFRS 16 Leases in the reporting period ending 31 December 2019.
During the preparatory works, ABC discovered that the operating lease contract related to a machine might require some adjustments.
ABC entered into the contract on 1 January 2017 for 5 years, annual rental payments are CU 100 000 in arrears (that is, 31 December each year) and at the end of the lease term, the machine will be returned back to the lessor. The economic life of a machine is 10 years.
How can ABC restate the contract under IFRS 16 using both full retrospective and modified retrospective approach?
Use the discount rate of 3%.

<u>Solution:</u>
Operating lease contract under IAS 17
Here, it’s very simple and straightforward: ABC accounted for all the lease payments from the operating lease *directly in profit or loss*.

Operating lease contract under IFRS 16
Under IFRS 16, ABC needs to recognize the *right of use asset and the lease liability*.
The lease liability is calculated as all the lease payments not paid at the commencement date discounted by the interest rate implicit in the lease or incremental borrowing rate.

Year	Lease payment	Discount factor	Present value of lease payments
1 2017	100 000	0,971	97 087
2 2018	100 000	0,943	94 260
3 2019	100 000	0,915	91 514
4 2020	100 000	0,888	88 849
5 2021	100 000	0,863	86 261
Total	**500 000**		**457 971**

Year	Lease liability b/f (A)	Lease payment	Interest (B=A*3%)	Decrease in lease liability (C=100 000-B)	Lease liability c/f (D=A-C)
1 2017	457 971	100 000	13 739	86 261	371 710
2 2018	371 710	100 000	11 151	88 849	282 861
3 2019	282 861	100 000	8 486	91 514	191 347
4 2020	191 347	100 000	5 740	94 260	97 087
5 2021	97 087	100 000	2 913	97 087	0
Total		**500 000**	**42 029**	**457 971**	

Year		IAS 17 Lease expense (A)	IFRS 16 Interest (B)	Depreciation (C)	Total (D=B+C)	Difference (impact on equity) (E=D-A)
1	2017	100 000	13 739	91 594	105 333	5 333
2	2018	100 000	11 151	91 594	102 745	2 745
3	2019	100 000	8 486	91 594	100 080	80
4	2020	100 000	5 740	91 594	97 335	-2 665
5	2021	100 000	2 913	91 594	94 507	-5 493
Total		500 000	42 029	457 971	500 000	0

Full retrospective approach:

ABC adopts IFRS 16 in its financial statements for the year ending 31 December 2019, and that means that ***the transition date is 1 January 2018***.

Debit ROU asset: CU 366 377 (CU 457 971 less depreciation of CU 91 594)

Debit Retained earnings in equity: CU 5 333 (-100 000+13 739+91 594, or see table 3 for the year 1)

Credit Lease liability: CU 371 710 (CU 457 971 less the lease liability repayment of CU 86 261, or see table 2 for the year 1)

Restatement of the comparative period (year 2018):

Debit Lease liability: CU 88 849
Debit Interest (profit or loss of 2018): CU 11 151
Debit Depreciation (profit or loss of 2018): CU 91 594
Credit ROU asset: CU 91 594
Credit Operating lease expenses (profit or loss of 2018): 100 000
The numbers come from table 2 for the year 2 (2018).

Restatement of the current period (year 2019):

Debit Lease liability: CU 91 514
Debit Interest (profit or loss of 2019): CU 8 486
Debit Depreciation (profit or loss of 2019): CU 91 594
Credit ROU asset: CU 91 594
Credit Operating lease expenses (profit or loss of 2019): 100 000

Statement of financial position (extract)

	2019	*2018 (restated)*	*1-1-2018 (restated)*
ROU asset			
	183 188	274 782	366 377
Equity - accumulated profit (effect of restatement)	8 159	8 079	5 333
Lease liability			
Long-term	97 087	191 347	282 861
Short-term	94 260	91 514	88 849
	191 347	***282 861***	***371 710***

Statement of comprehensive income (extract)

	2019	*2018 (restated)*
Depreciation of ROU asset	91 594	91 594
Interest (lease liability)	8 486	11 151

Modified retrospective approach

Under the modified approach, ABC needs to make an ***equity adjustment on 1 January 2019*** – that is at the beginning of the current reporting period.
Comparative numbers remain the same as presented before – so no restatement.
This is a way easier method to apply than the full retrospective approach, because ***you do not restate the previous years' numbers***.

Debit ROU asset: CU 274 782 (CU 457 971 less depreciation of CU 91 594*2)
Debit Retained earnings in equity: CU 8 079 (-200 000+24 890+183 188, or see table 3 for the years 1 and 2)
Credit Lease liability: CU 282 861 (CU 457 971 less the lease liability repayments of CU 86 261 and CU 88 849, or see table 2 for the years 1 and 2)

Restatement of the current period (year 2019): It's the same as under the full retrospective approach and if you have accounted for your operating leases under IAS 17 during the whole 2019, then you need to do this adjustment:
Debit Lease liability: CU 91 514
Debit Interest (profit or loss of 2019): CU 8 486
Debit Depreciation (profit or loss of 2019): CU 91 594
Credit ROU asset: CU 91 594
Credit Operating lease expenses (profit or loss of 2019): 100 000

Statement of financial position (extract)

	2019	2018
ROU asset	183 188	0
Equity - accumulated profit (effect of restatement)	8 159	0
Lease liability		
Long-term	97 087	0
Short-term	94 260	0
	191 347	**0**

Statement of comprehensive income (extract)

	2019	2018
Operating lease expenses	0	100 000
Depreciation of ROU asset	91 594	0
Interest (lease liability)	8 486	0

Thank You!