FINANCIAL MANAGEMENT WORKSHOP for SMEs

IFRS 16 LEASES: AN OVERVIEW

Nairobi Safari Club, Lilian Towers, 24th March 2017

Overview

- Issued in January 2016
- Effective for annual periods beginning on or after 1 January 2019
- Earlier adoption is permitted if IFRS 15 *Revenue from Contracts with Customers* is applied at or before the date of initial application of IFRS 16

Overview

- IFRS 16 supersedes:
  - IAS 17 Leases
  - SIC - 15 Operating Leases Incentives
  - SIC - 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease
  - IFRIC 4 Determining Whether an Arrangement Contains a Lease

Overview

Key Changes

- A single lessee accounting model
  - A lessee accounts for all leases in the same way
  - No distinction between operating and finance leases
  - Recognize assets and liabilities for all leases (with limited exceptions)
  - All leases (with limited exceptions) will be accounted for in the same way as we currently account for finance leases
- No substantial changes to lessor accounting

Why a new leasing standard?

- Currently analysts adjust financial statements for off-balance sheet leases

- Under IFRS 16, companies will bring these leases on balance sheet, using a common methodology

IFRS 16 – Main Features

LESSEE ACCOUNTING

- IFRS 16 introduces a **single lessee accounting model** and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.

- A lessee is required to recognise a **right-of-use asset** representing its right to use the underlying leased asset and a **lease liability** representing its obligation to make lease payments.

Main Features

- A lessee measures right-of-use assets similarly to other **non-financial assets** (such as property, plant and equipment) and lease liabilities similarly to other **financial liabilities**.
- As a consequence, a lessee recognises **depreciation** of the right-of-use asset and **interest** on the lease liability, and also classifies cash repayments of the lease liability into a **principal portion and an interest portion** and presents them in the statement of cash flows applying IAS 7 *Statement of Cash Flows.*

Main Features

- Assets and liabilities arising from a lease are initially measured on a **present value basis**.

- The measurement includes **non-cancellable lease payments** (including inflation-linked payments), and also includes payments to be made in **optional periods** if the lessee is reasonably certain **to exercise an option** to extend the lease, or **not to exercise an option** to terminate the lease.

Main Features

- IFRS 16 contains disclosure requirements for lessees.

- Lessees will need to apply **judgement** in deciding upon the information **to disclose** to meet the objective of providing a basis for **users** of financial statements **to assess the effect** that leases have on the financial position, financial performance and cash flows of the lessee.

Main Features

LESSOR ACCOUNTING

- IFRS 16 substantially carries forward the lessor accounting **requirements in IAS 17**.

- Accordingly, a lessor continues to classify its leases as **operating leases or finance leases**, and to account for those two types of leases differently.

Main Features

- IFRS 16 also requires **enhanced disclosures** to be provided by lessors that will improve information disclosed about a lessor's risk exposure, particularly to **residual value risk**.

Effective Date

The big change for lessees

The end of the road for operating leases!

The new IFRS 16 Leases introduces **a single lessee accounting model** where all leases will be accounted for in a similar manner to the way in which finance leases are currently accounted for.

Example

- Background information

Entity A entered into a **<u>3 year lease</u>** of an administration building with the following lease payments, **<u>payable at the end of each year</u>**:

- Kshs. 50,000 per month for the first year;
- Kshs. 60,000 per month for the second year; and
- Kshs. 70,000 per month for the third year.

It is the responsibility of the lessor to repair and insure the building

Example

- Accounting Treatment in terms of the Current IAS 17
  - Operating lease
  - Why?
    - The lease does not transfer substantially all the risks ad rewards incidental to ownership of the building to the lease

Example

- Accounting Treatment in terms of the **current IAS 17**
- The even operating lease expense over the 3 years of the operating lease can be calculated as follows:

	Kshs.
– Lease payments in year 1 (50,000x12)	600,000
– Lease payments in year 2 (60,000x12)	720,000
– Lease payments in year 3 (70,000x12)	840,000
Total Lease payments over the lease term	**2 ,160,000**

Even operating lease expense for the year 1 – 3

(2,160,000 / 3 years) = 720,000

Example

- Accounting Treatment in terms of the **Current IAS 17**
- Journal entries for year 1

Dr. Operating lease expense	720,000	
Cr. Bank		600,000
Cr. Accrual Liability		120,000

- Journal entries for year 2

Dr. Operating lease expense	720,000	
Cr. Bank		720,000

Example

- Accounting Treatment in terms of the **Current IAS 17**
- Journal entries for year 3

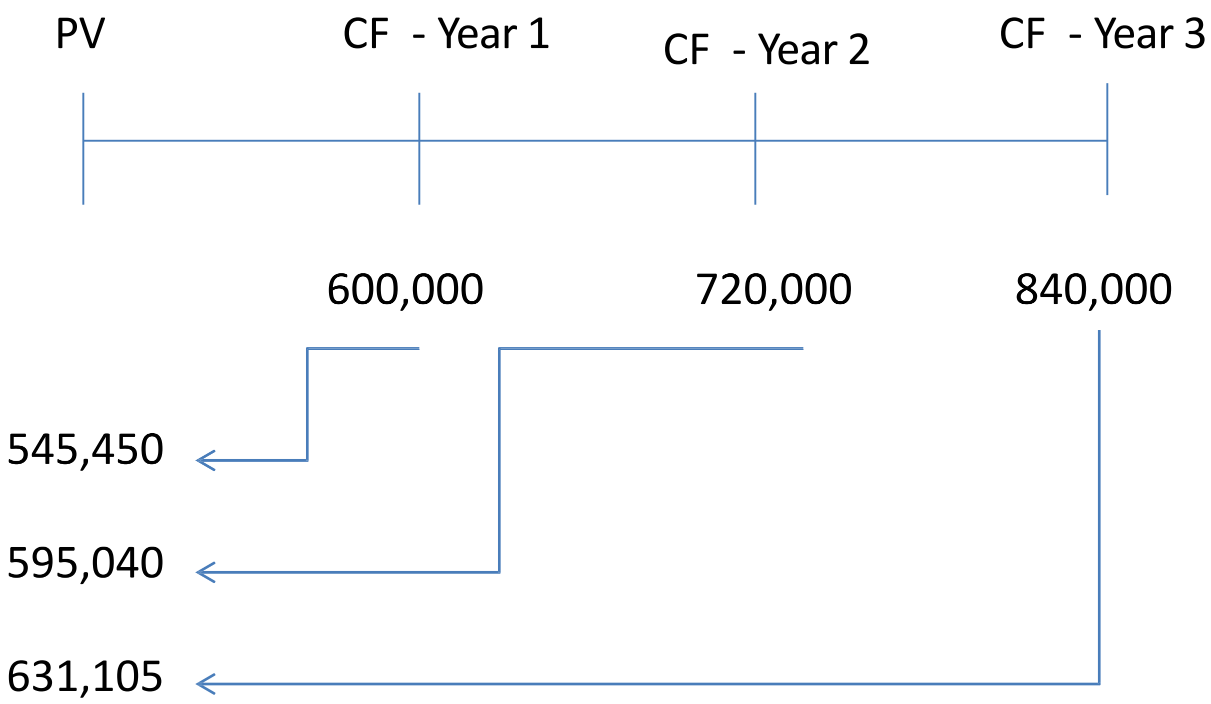
Dr. Operating lease expense	720,000	
Dr. Accrual Liability	120,000	
Cr. Bank		840,000

Example

Accounting Treatment in terms of the **<u>New IFRS 16</u>**

Time Line

@ 10%



PV of Future Cash Flows = 1,771,595

Example

- Accounting Treatment in terms of the **New IFRS 16**
- **Amortization Table**

Year	Cash lease payments	Interest expense @ 10%	Principal repaid	Closing Balance
0	-	-	-	1,771,595
1	600,000	177,160	422,840	1,348,755
2	720,000	134,875	585,125	763,630
3	840,000	76,370	763,630	-
Total	2,160,000	388,405	1,771,595	-

Example

Accounting Treatment in terms of the **New IFRS 16**

Journal entry of day 1 of the lease

Dr. Right-of-use asset	1,771,595	
Cr. Lease liability		1,771,595

Journal entry for the year 1 of lease

Dr. Interest expense	177,160	
Dr. Lease liability	422,840	
Cr. Bank		600,000

Dr. Amortization expense	590,532	
Cr. Accumulated amrt exp		590,532

(1,771,595 / 3 years = 590,532)

Example

Accounting Treatment in terms of the New IFRS 16

Journal entry for the year 2 of lease

Dr. Interest expense	134,875	
Dr. Lease liability	585,125	
Cr. Bank		720,000

Dr. Amortization expense	590,532	
Cr. Accumulated amrt exp		590,532

(1,771,595 / 3 years = 590,532)

Example

Accounting Treatment in terms of the New IFRS 16

Journal entry for the year 3 of lease

Dr. Interest expense	76,370	
Dr. Lease liability	763,630	
Cr. Bank		840,000
Dr. Amortization expense	590,531	
Cr. Accumulated amrt exp		590,531

(1,771,595 / 3 years =590,531.66)

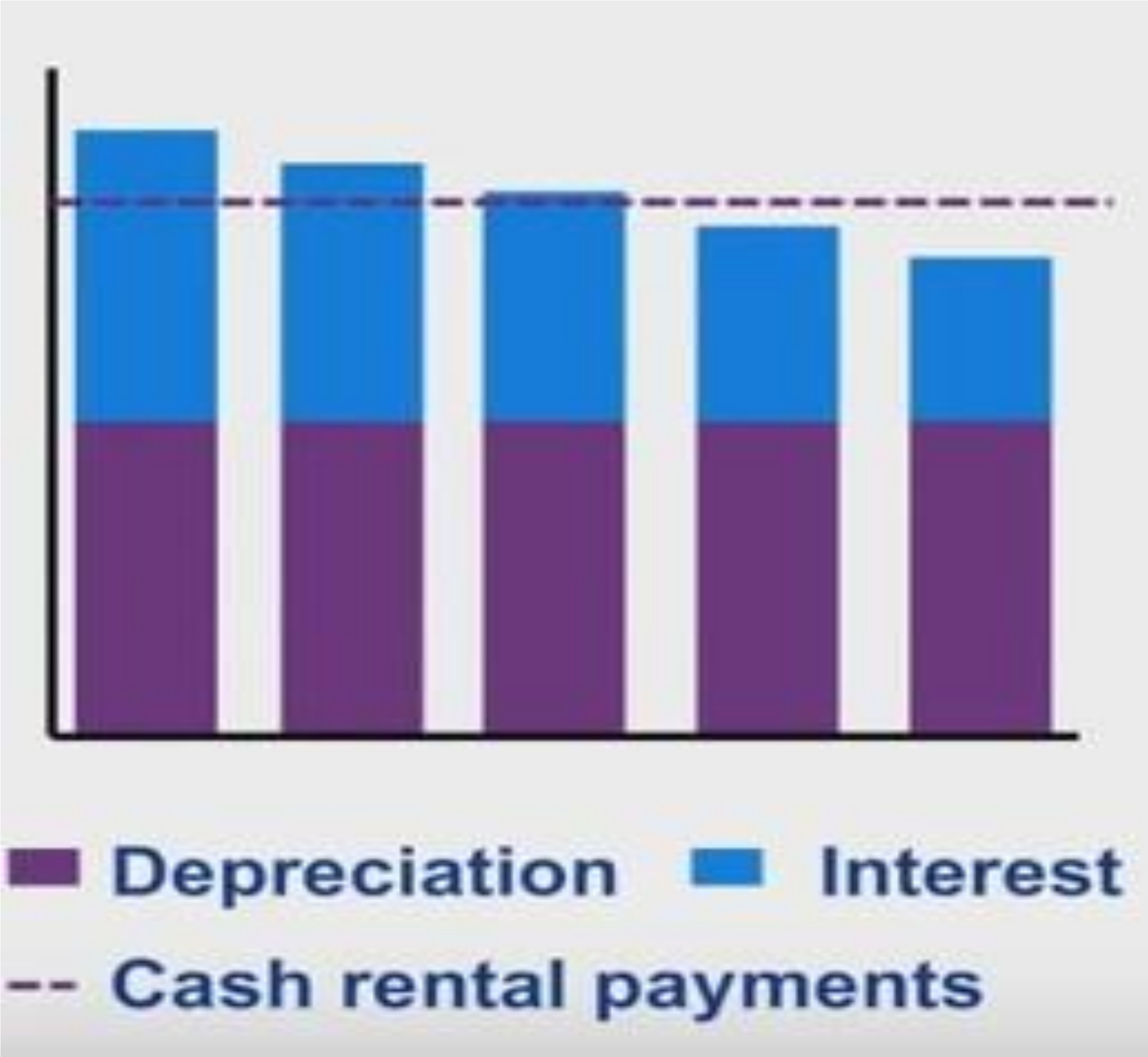
Example

Impact on the **Statement of Profit or Loss**

SOPL	Year 1		Year 2		Year 3	
	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16
Operating lease exp	720,000		720,000		720,000	
Interest expense		177,160		134,875		76,370
Amortization expense		590.532		590,532		590,532
Total expense	**720,000**	**767,692**	**720,000**	**725,407**	**720,000**	**666,902**

Impact on Statement of Profit and loss

Total lease expense will now be **<u>front-loaded</u>** even when cash rentals are constant



Example

Impact on the **<u>Statement of Cash Flows</u>**

SOCF	Year 1		Year 2		Year 3	
	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16
Operating cash flows	(600,000)	(177,160)	(720,000)	(134,875)	(840,000)	(76,370)
Financing cash flows	0	(422,840)	0	(585,125)	0	(763,630)
Total impact	(600,000)	(600,000)	(720,000)	(720,000)	(840,000)	(840,000)

Impact on Statement of Financial position

Companies with operating leases will now appear to be **<u>more asset-rich</u>**, but also more **<u>heavily indebted</u>**

Example

Impact on the **Statement of Cash Flows**

SOCF	Year 1		Year 2		Year 3	
	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16
Operating cash flows	(600,000)	(177,160)	(720,000)	(134,875)	(840,000)	(76,370)
Financing cash flows	0	(422,840)	0	(585,125)	0	(763,630)
Total impact	(600,000)	(600,000)	(720,000)	(720,000)	(840,000)	(840,000)

Reasons for issuing IFRS 16

- **<u>Greater transparency</u>** of the lessee's
  - Financial leverage, and
  - Capital employed

- **<u>Complete and understandable picture</u>** of an entity's leasing activities

- Address concerns around "**<u>off-balance sheet</u>**" finance through the use of operating leases

Financial Impacts - Lessee

Profit/loss	Balance sheet	Ratios
EBITDA	Total assets	Gearing
EPS (in early years)	Net assets	Interest cover Asset turnover

Financial impacts - Lessee

Capitalization of former operating leases

- Some financial ratios and measures will change for the worse
- But all companies will be impacted to some degree

Key Ratios/Measures	Effect of IFRS 16
EBITDA	+
Gross Margin	None
Operating Efficiency Ratio	+
Current Ratio	- (more liabilities)
Quick Ratio	- (more liabilities)
Net Worth	None
Debt/Equity Ratio	- (more debt plus less equity)
Return on Assets (RoA)	- (more assets plus front ended costs)
Return on Equity (RoE)	+/- (?) (less equity but front ended costs)

Determine when to apply IFRS 16

- **Step 1**

  Identify a lease

- **Step 2**

  Chose whether to apply the practical expedients

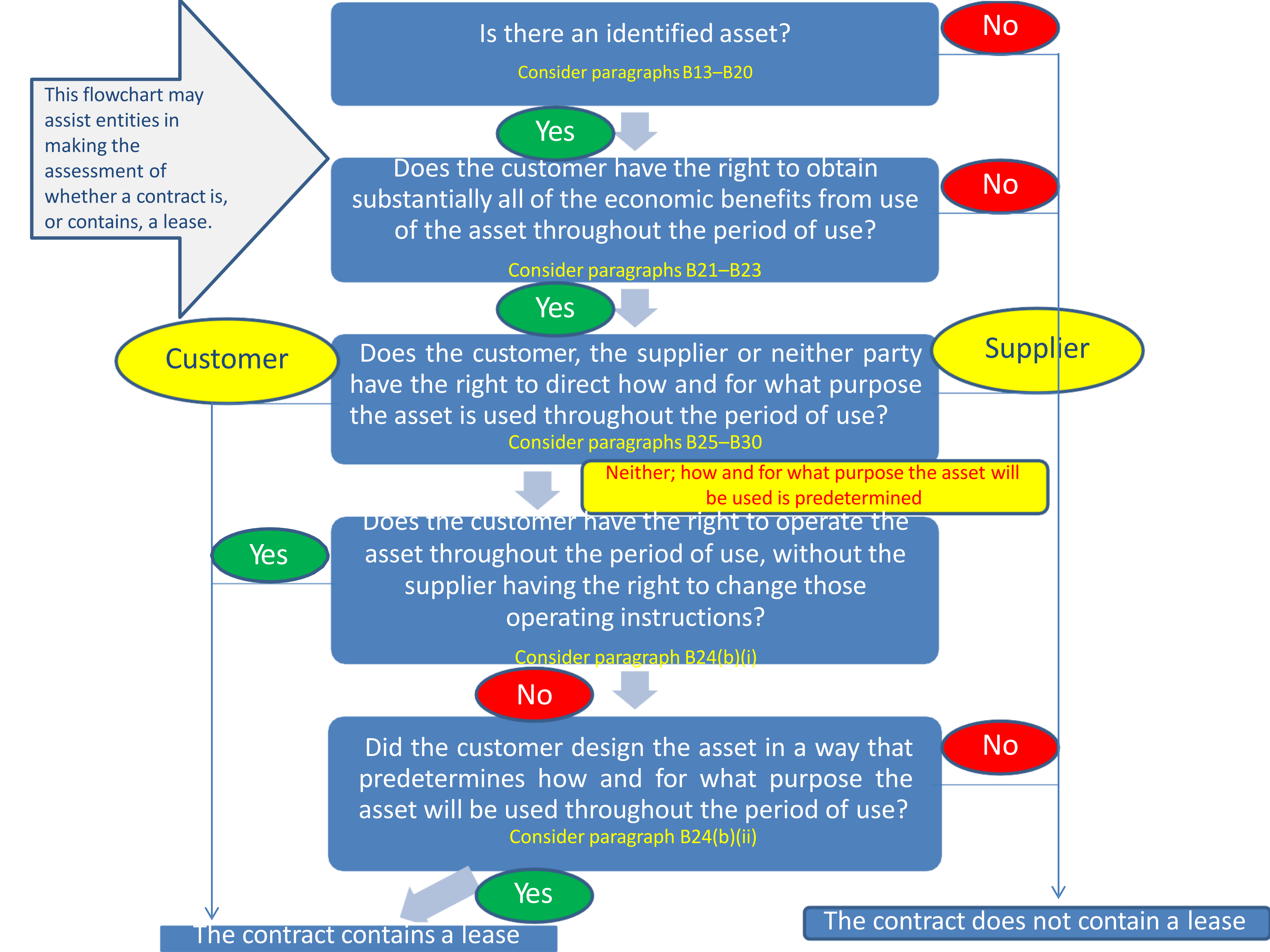
- **Step 3**

  Separate Lease and Non-lease Components

Step 1 – Identify a lease

- At inception of a contract, an entity shall assess whether the **contract is**, or **contains**, a lease

- A contract is an agreement between two or more parties that creates **enforceable** rights and obligations


This flowchart may assist entities in making the assessment of whether a contract is, or contains, a lease.
Is there an identified asset?
Consider paragraphs B13–B20
No
Yes
Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?
Consider paragraphs B21–B23
No
Yes
Customer
Does the customer, the supplier or neither party have the right to direct how and for what purpose the asset is used throughout the period of use?
Consider paragraphs B25–B30
Supplier
Neither; how and for what purpose the asset will be used is predetermined
Yes
Does the customer have the right to operate the asset throughout the period of use, without the supplier having the right to change those operating instructions?
Consider paragraph B24(b)(i)
No
Did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use?
Consider paragraph B24(b)(ii)
No
Yes
The contract contains a lease
The contract does not contain a lease

Identified asset

- **Explicitly** specified in a contract

- **Implicitly** specified at the time that the asset is made available for use by the customer

– Even if an asset is specified, a customer does not have the right to use an identified asset if the **supplier has the substantive right to substitute** the asset throughout the period of use

Identified asset

- A supplier's right to substitute an asset is **substantive** only if both of the following conditions exist:
  - The supplier has the **practical ability to substitute** alternative assets **throughout the period** of use; and
  - The **supplier would benefit economically** from the exercise of its right to substitute the asset

Rights to obtain economic benefits from use

- Directly or indirectly, such as **by using, holding or subleasing the asset**
  - Example, exclusive use of the asset throughout that period
- The **economic benefits** from use of an asset include:
  - Its primary output;
  - By-products (including potential cash flows derived from these items); and
  - Other economic benefits from using the asset that could be realized from a commercial transaction with a third party

Step 2 – Choose whether to apply the practical expedients

Two Practical Expedients

A lessee may elect to **not apply the single lessee accounting model** to

1. **Short-term** leases; and
2. Leases for which the underlying asset is of **low value**

Short Term Leases

- A lease that at the commencement date, has a lease term of **12 months or less**.
- A lease that contains a **purchase option** is not a short-term lease
- Election is made **by class of underlying asset**

Underlying asset is of low value

- Value of an underlying asset based on the value of the asset **when it is new**, regardless of the age of the asset being leased
- The assessment of whether an underlying asset is of low value is performed on an **absolute basis**
- Leases of low-value assets qualify for the accounting treatment as operating lease **regardless of whether those leases are material to the lessee**
- The assessment is **not affected by the size, nature** or circumstances of the lessee
- **Different lessees are expected to reach the same** conclusions about whether a particular underlying asset is of low value

Underlying asset is of low value

- If a lessee **subleases an asset**, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset

- **Examples** of low-value underlying assets can include:
  - Tablet and personal computers,
  - Small items of office furniture, and
  - Telephones

Step 3 – Separating Components of a Contract

- Account for each lease component within the **contract as a lease separately from non-lease components** of the contract, unless the entity applies the practical expedient
- Practical expedient

– A lessee may elect, by class of underlying asset not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component

Clear Division

- IFRS 16 introduces a clear dividing line between **leases and service contracts**
  - Leases will be brought **on-balance sheet**
  - Service contracts will remain **off-balance sheet**

Accounting treatment in records of lessees

- Recognition
  - At the commencement date, a lessee shall recognize:
    - A **right-of-use asset**, and
    - A **lease liability**

Initial Measurement of right – of – use asset

- At the commencement date a lessee shall measure the right-of-use asset **at cost**
- The cost of the right-of-use asset shall comprise:
  - The amount of the initial measurement of the **lease liability**
  - Any **lease payments made** at or before the commencement date, less any lease incentives received;
  - Any **initial direct costs** incurred by the lessee; and
  - An estimate of costs to be incurred by the lessee in **dismantling and removing** the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

Initial measurement of the lease liability

- At the commencement date, a lessee shall measure the lease liability at the **present value** of the lease payments that are not paid at the date
- The lease payments shall be discounted using the **interest rate implicit in the lease**, if that rate can be readily determined
- If the rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate

Subsequent measurement of the right-of-use asset

- Subsequent measurement of the right-of-use asset
  - Cost model – IAS 16
  - Investment property at fair value - IAS 40
  - Revaluation model IAS 16

Subsequent measurement of the lease liability

- After the commencement date, a lessee shall measure the lease liability by:
  - Increasing the carrying amount to reflect **interest on the lease liability**;
  - Reducing the carrying amount to reflect the **lease payments made**; and
  - Re-measuring the carrying amount to reflect any **reassessment or lease modifications** or to reflect revised in-substance fixed lease payments

Presentation

- A lessee shall either present in the statement of financial position, or disclose in the notes:
  - Right-of-use assets **separately from other assets**. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
    - Include right-of-use assets within the **same line item** as that within which the corresponding underlying assets would be presented if they were owned; and
    - **Disclose which line items** in the statement of financial position include those right-of-use assets
  - Lease liabilities **separately from other liabilities**, if the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall:
    - **Disclose which line items** in the statement of financial position include those liabilities

Disclosure

- **Depreciation charge** for right-of-use assets by class of underlying asset
- **Interest expense** on lease liabilities
- **The expense relating to short-term leases** accounted for applying the practical expedient. This expense need not include the expense relating to leases with a lease term of one month or less
- **The expense relating to leases of low-value assets** accounted for applying the practical expedient

Disclosure

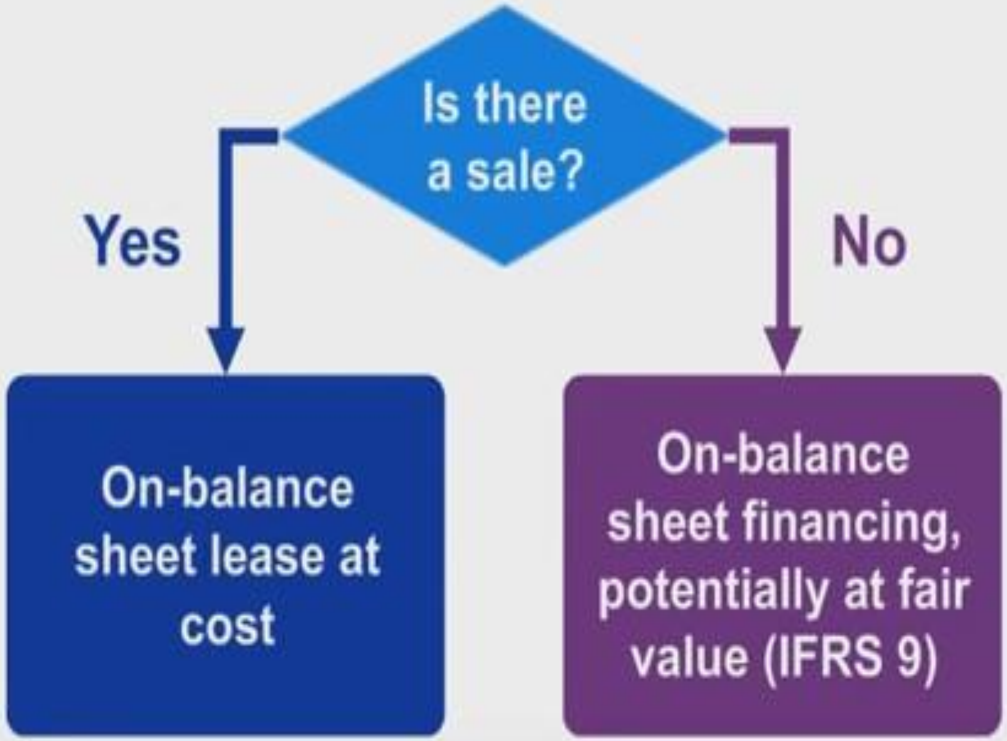
- **The expense relating to variable lease payments** not included in the measurement of lease liabilities
- **Income from subleasing right-of-use assets**
- **Total cash outflow** for leases
- **Additions** to right-of-use assets
- **Gains or losses arising from sale and leaseback** transactions
- The **carrying amount of right-of-use assets** at the end of the reporting period by class of underlying asset

Accounting Treatment in the Records of Lessors

- Status Quo
- IFRS 16 **substantially carries forward** the lessor
- accounting requirements in the IAS 17
- Accordingly, a lessor continues to classify its leases as **operating leases or finance leases**, and to account for those two types of leases differently
- IFRS 16 also requires **enhanced disclosures** to be provided by lessors that will improve information disclosed about a lessor's **risk exposure**, particularly to residual value risk

Sales-and-leaseback

IFRS 16 essentially kills sale-and-leaseback as an off-balance sheet financing structure



Key points to remember

- New leases standard will impact most companies
- Process of assessing impact should start now
- Additional training and guidance on its way

Conclusion

- Discussion

- Questions?