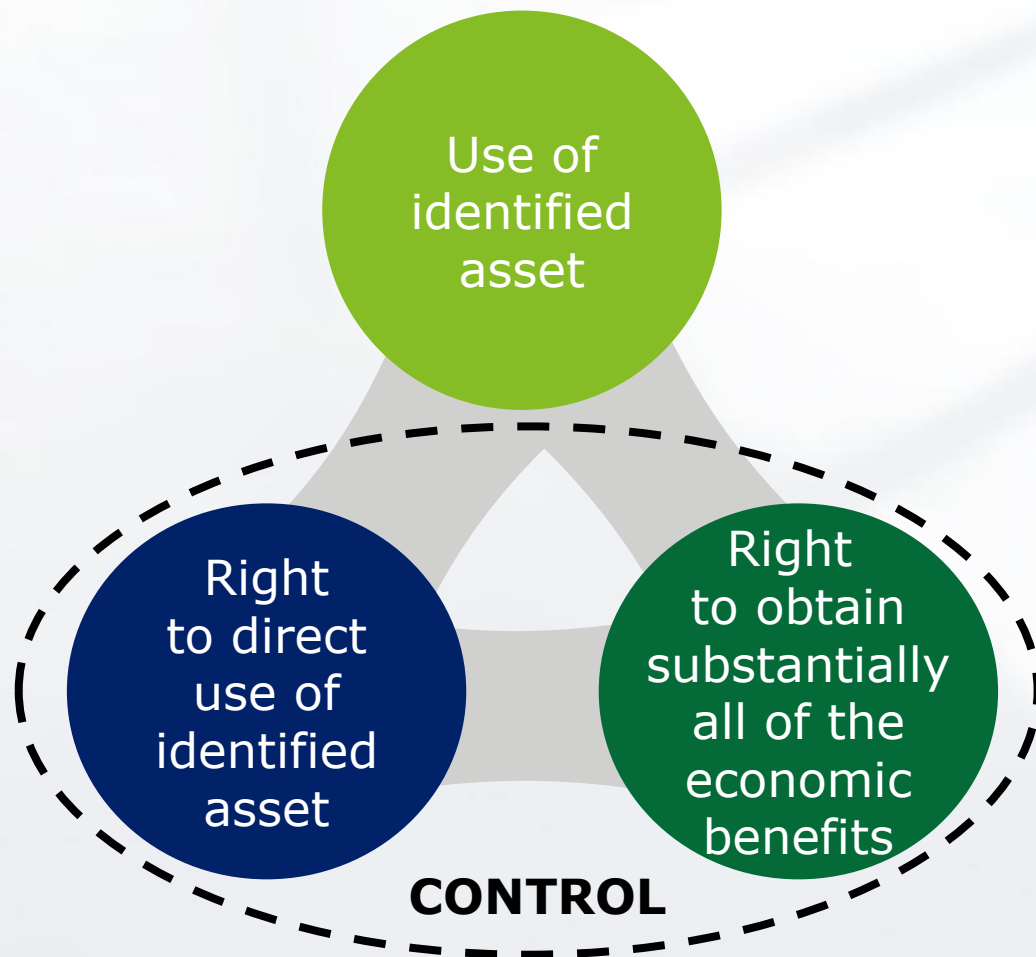


## **Identifying a Lease**

IFRS 16 *Leases* Pre-implementation Considerations

# When Does a Contract Contain a Lease?



**A contract is a lease or contains a lease if it meets **both** criteria:**

Fulfilment of lease depends on use of an **identified asset** and

Contract conveys right to **control** use of identified asset for a period of time in exchange for consideration.

## Contract Extracts



'Vehicles: The Supplier hereby supplies to the Customer the vehicles...'

'...the Customer agrees to pay the Supplier \$30,000 monthly...'

'The Supplier will provide Vehicle Operators 9am – 5pm, Monday to Saturday...'

'...The vehicles during the term of the contract may not be used for any other purpose...'

'...The delivery destinations will be based on a schedule provided by the Customer each Sunday and Wednesday. The schedule will indicate the date, estimated time and location of each delivery. The Vehicle Operators will abide by the schedule provided by the Customer...'

'...Vehicles must not have previously delivered toxic materials or imported food...'

## Additional Facts

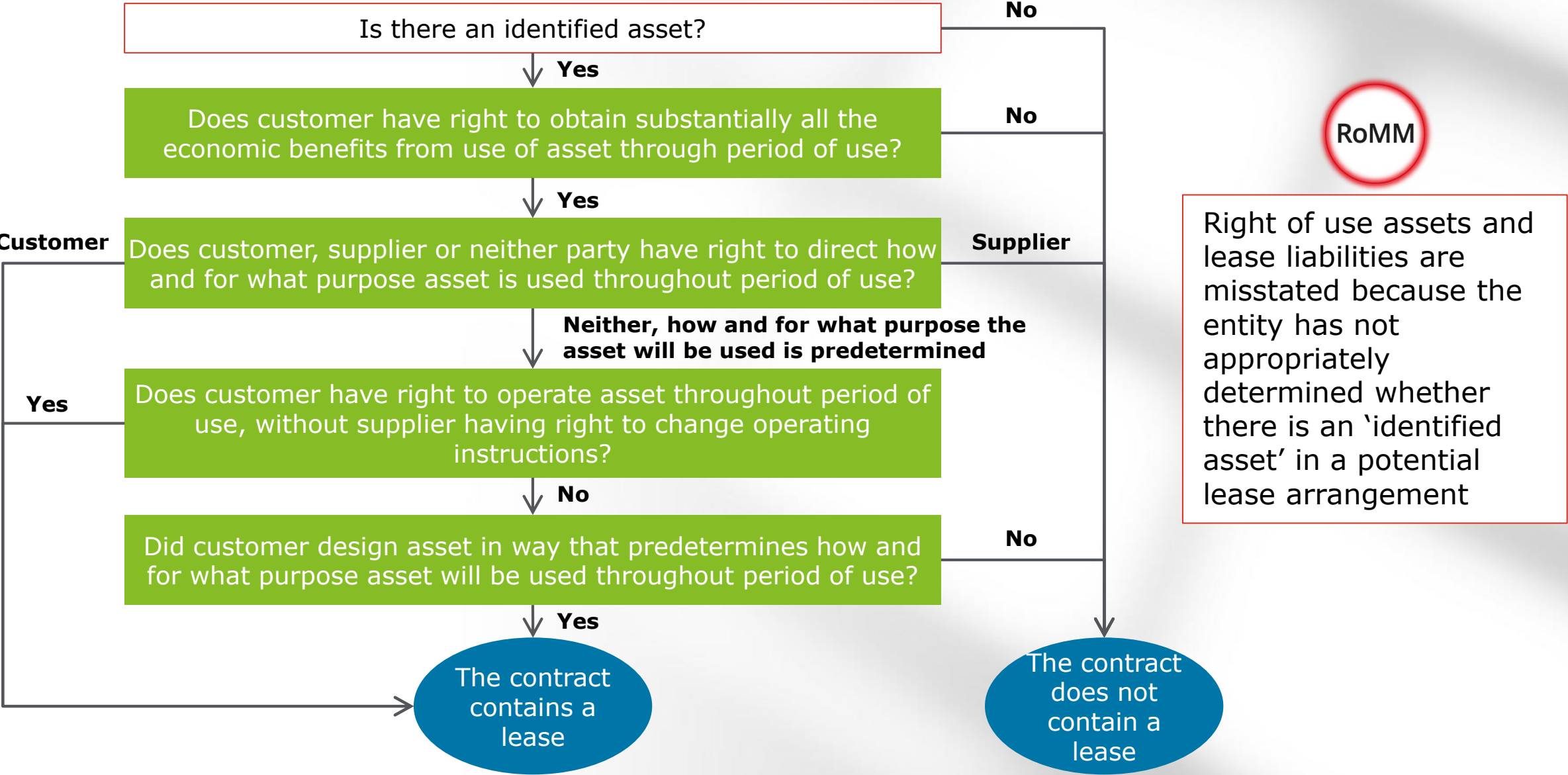
Vale Logistics has five trucks – all same size, vehicle make, age and condition

The Grocer is Vale's only customer

Trucks are in abundant supply and can be rented at reasonable price



# Identified Asset





## Knowledge Check

*the Grocer's*  
management has  
determined trucks  
are identified asset  
in the contract



**Do you agree with management's assessment?**

**A** Yes, trucks are explicitly identified in the contract

**B** Yes, trucks are implicitly identified in the contract

**C** No, identified asset in this contract are trucks **and** drivers



## Knowledge Check

*the Grocer's*  
management has  
determined trucks  
are identified asset  
in the contract



**Do you agree with management's assessment?**

**A**

Yes, trucks are explicitly identified in the contract

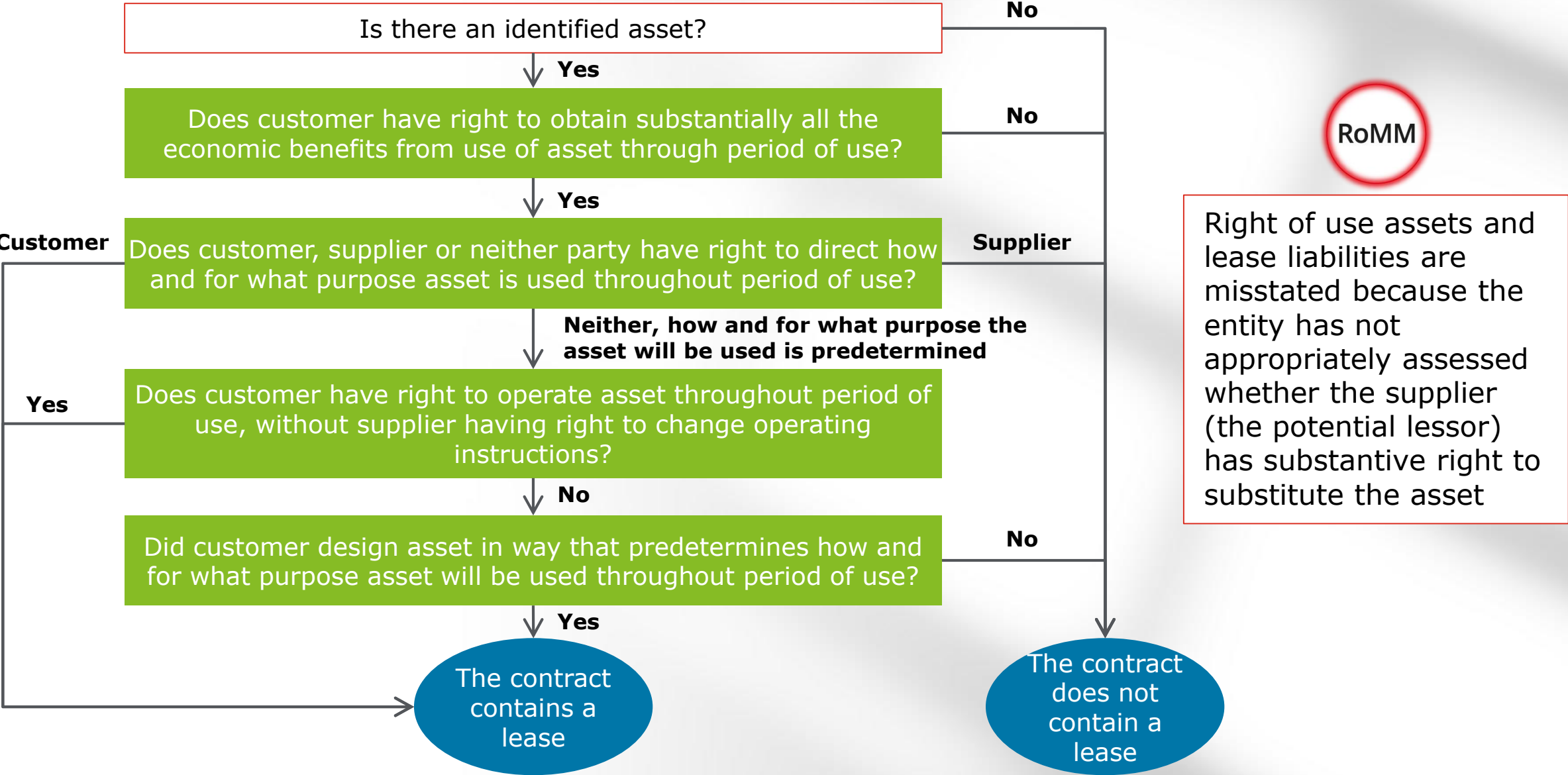
**B**

Yes, trucks are implicitly identified in the contract

**C**

No, identified asset in this contract are trucks **and** drivers

# Substantive Right to Substitute the Asset







## Knowledge Check

*the Grocer's*  
management has  
determined there  
are no substantive  
rights in substituting  
trucks



**Do you agree with management's assessment?**

**A**

**No**, Vale has ability to substitute its trucks because they are not specialized, are in abundant supply and can be easily rented at reasonably low price, should it need to use its own five trucks for other purposes. This indicates Vale has ability to substitute trucks and will economically benefit

**B**

**Yes**, Vale does not have ability to substitute its trucks. Vale would not benefit from substitution



## Knowledge Check

*the Grocer's*  
management has  
determined there  
are no substantive  
rights in substituting  
trucks



**Do you agree with management's assessment?**

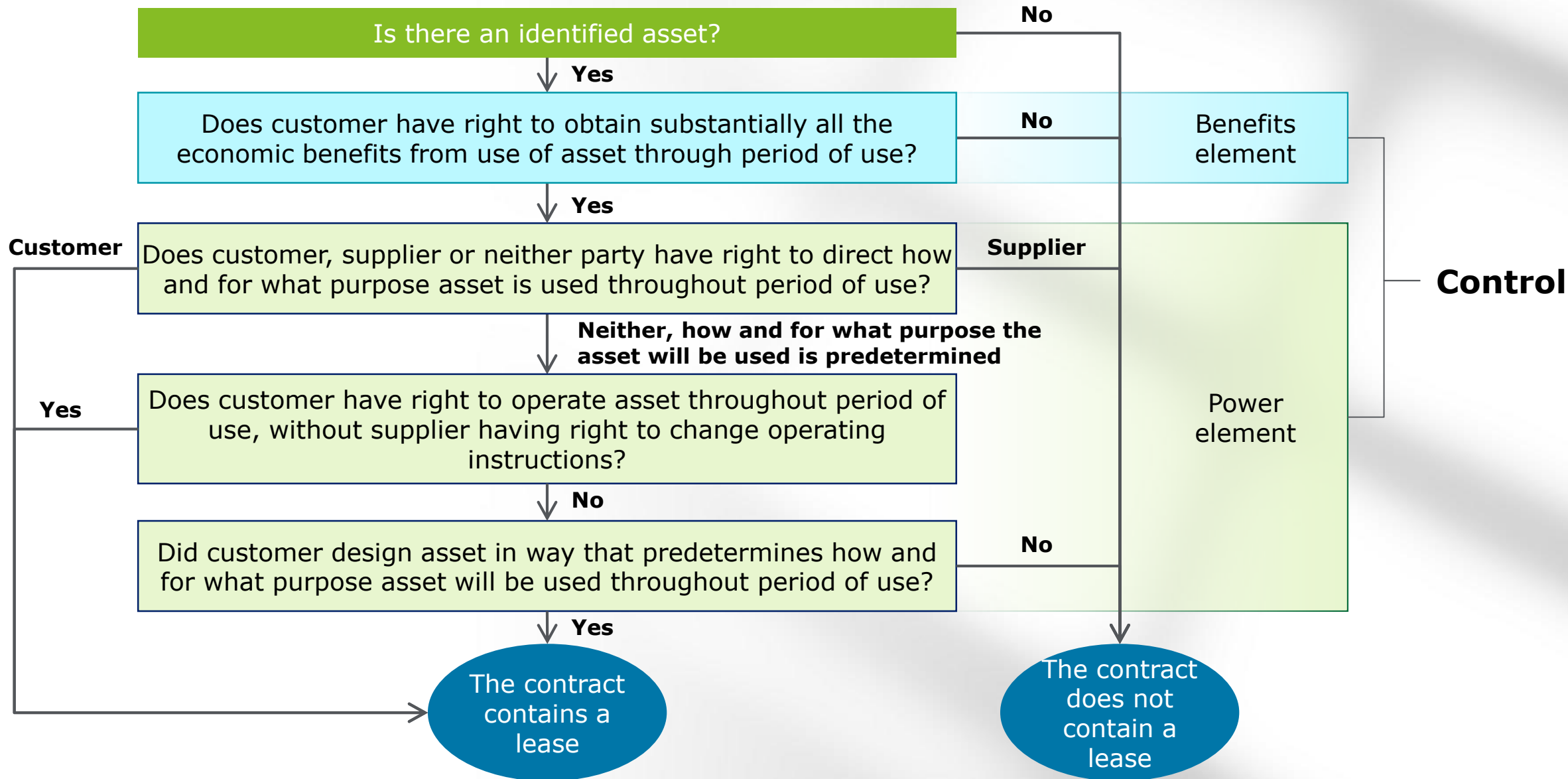
**A**

**No**, Vale has ability to substitute its trucks because they are not specialized, are in abundant supply and can be easily rented at reasonably low price, should it need to use its own five trucks for other purposes. This indicates Vale has ability to substitute trucks and will economically benefit

**B**

**Yes**, Vale does not have ability to substitute its trucks. Vale would not benefit from substitution

# Benefits and Power Elements



The flowchart is titled "Benefits element" in a large, bold, black font. It starts with a light blue box containing the question: "Does customer have right to obtain substantially all the economic benefits from use of asset through period of use?". To the right of this box, there is a small diagram showing a hierarchy of boxes with "No" and "Benefits element" labels. Below the main question box, a light green box asks: "Does customer have right to operate asset throughout period of use, without supplier having right to change operating instructions?". If the answer is "Yes", the flow goes to a blue oval labeled "The contract contains a lease". If the answer is "No", the flow goes to another light green box asking: "Did customer design asset in way that predetermines how and for what purpose asset will be used throughout period of use?". If the answer is "Yes", the flow goes to the "The contract contains a lease" oval. If the answer is "No", the flow goes to a blue oval labeled "The contract does not contain a lease". A red circle with the text "RoMM" is placed near the "No" answer to the second question. A red-bordered box on the right contains the text: "Right of use assets and lease liabilities are misstated because the entity has not appropriately determined whether it has obtained substantially all of the economic benefits from use of the asset".

```
graph TD; Q1[Does customer have right to obtain substantially all the economic benefits from use of asset through period of use?] --> Q2[Does customer have right to operate asset throughout period of use, without supplier having right to change operating instructions?]; Q2 -- Yes --> R1([The contract contains a lease]); Q2 -- No --> Q3[Did customer design asset in way that predetermines how and for what purpose asset will be used throughout period of use?]; Q3 -- Yes --> R1; Q3 -- No --> R2([The contract does not contain a lease]);
```

Does customer have right to obtain substantially all the economic benefits from use of asset through period of use?

Neither, how and for what purpose asset will be used is predetermined

Does customer have right to operate asset throughout period of use, without supplier having right to change operating instructions?

Yes

No

Did customer design asset in way that predetermines how and for what purpose asset will be used throughout period of use?

Yes

No

The contract contains a lease

The contract does not contain a lease

RoMM

Right of use assets and lease liabilities are misstated because the entity has not appropriately determined whether it has obtained substantially all of the economic benefits from use of the asset



## Knowledge Check

*the Grocer's* management has determined it has obtained substantially all of the economic benefits from use of the asset



**Do you agree with management's assessment?**

**A**

**Yes.** The Grocer has ability to obtain all economic benefits from the trucks

**B**

**No.** The Grocer only uses trucks Monday to Saturday, for eight hours (rather than 24 hours, 7 days a week.) In addition, The Grocer's use is constrained by terms of the contract – it can only deliver to 20 mile radius and not within Excluded Areas



## Knowledge Check

*the Grocer's* management has determined it has obtained substantially all of the economic benefits from use of the asset



**Do you agree with management's assessment?**

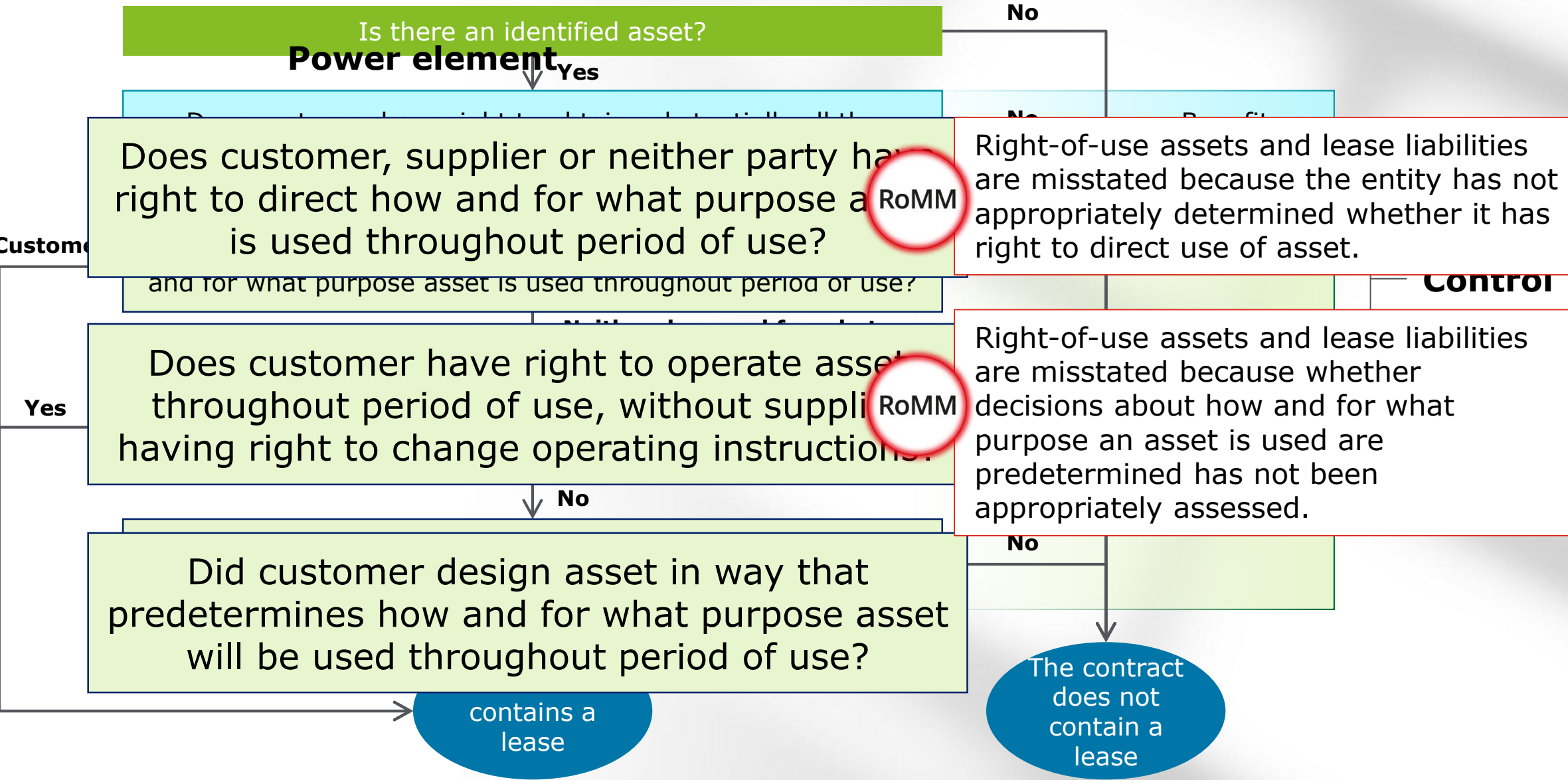
**A**

**Yes.** The Grocer has ability to obtain all economic benefits from the trucks

**B**

**No.** The Grocer only uses trucks Monday to Saturday, for eight hours (rather than 24 hours, 7 days a week.) In addition, The Grocer's use is constrained by terms of the contract – it can only deliver to 20 mile radius and not within Excluded Areas

# Right to Direct the Use & Pre-determined Decision-Making Rights



## Right to Direct the use & Pre-determined Decision-making Rights (cont.)

**A customer has right to direct use of an identified asset throughout period of use only if it either:**

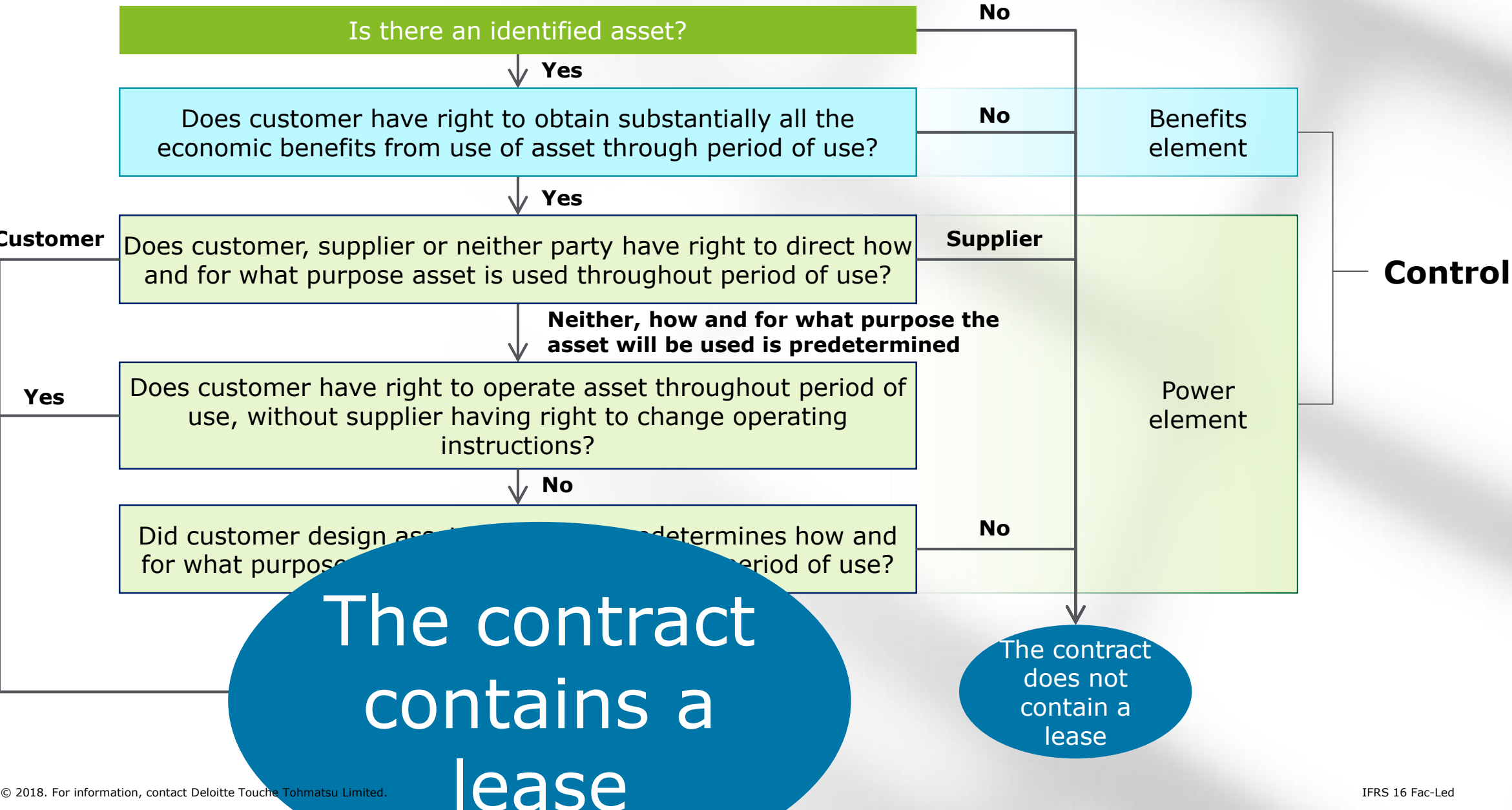
Has right to direct how and for what purpose asset is used, **or** the relevant decisions about how and for what purpose asset is used are predetermined, subject to further requirements

**Customer has right to direct use of identified asset throughout period of use if relevant decisions about how and for what purpose asset is used are predetermined and:**

- Customer has right to operate asset (or direct others to operate asset in manner it determines) throughout period of use, without supplier having right to change operating instructions **or**
- Customer designed asset (or specific aspects of asset) in way that predetermines how and for what purpose asset will be used throughout period of use



# Does the Contract Contain a Lease?





## Knowledge Check

**One year later, Vale has acquired three additional new trucks to expand their business**



**Given change in facts and circumstances, does contract remain a lease?**

**A**

**No.** Vale has substantive right to substitute as it has additional trucks to practically do so

**B**

**Yes.** It is not necessary to reassess whether contract is a lease as there has not been a change to any contractual terms

**C**

It depends. More information needed



## Knowledge Check

**One year later, Vale has acquired three additional new trucks to expand their business**



**Given change in facts and circumstances, does contract remain a lease?**

**A**

**No.** Vale has substantive right to substitute as it has additional trucks to practically do so

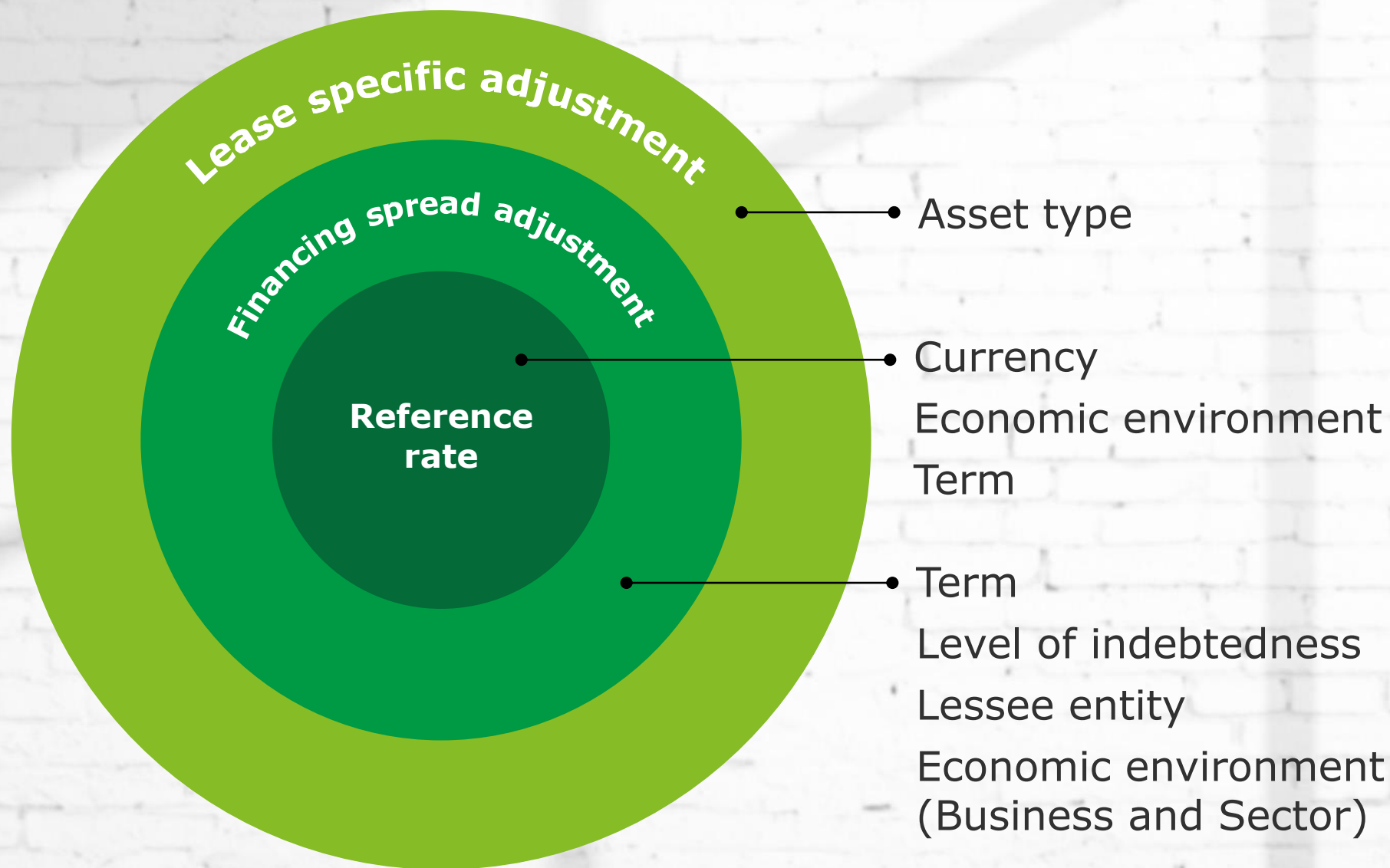
**B**

**Yes.** It is not necessary to reassess whether contract is a lease as there has not been a change to any contractual terms

**C**

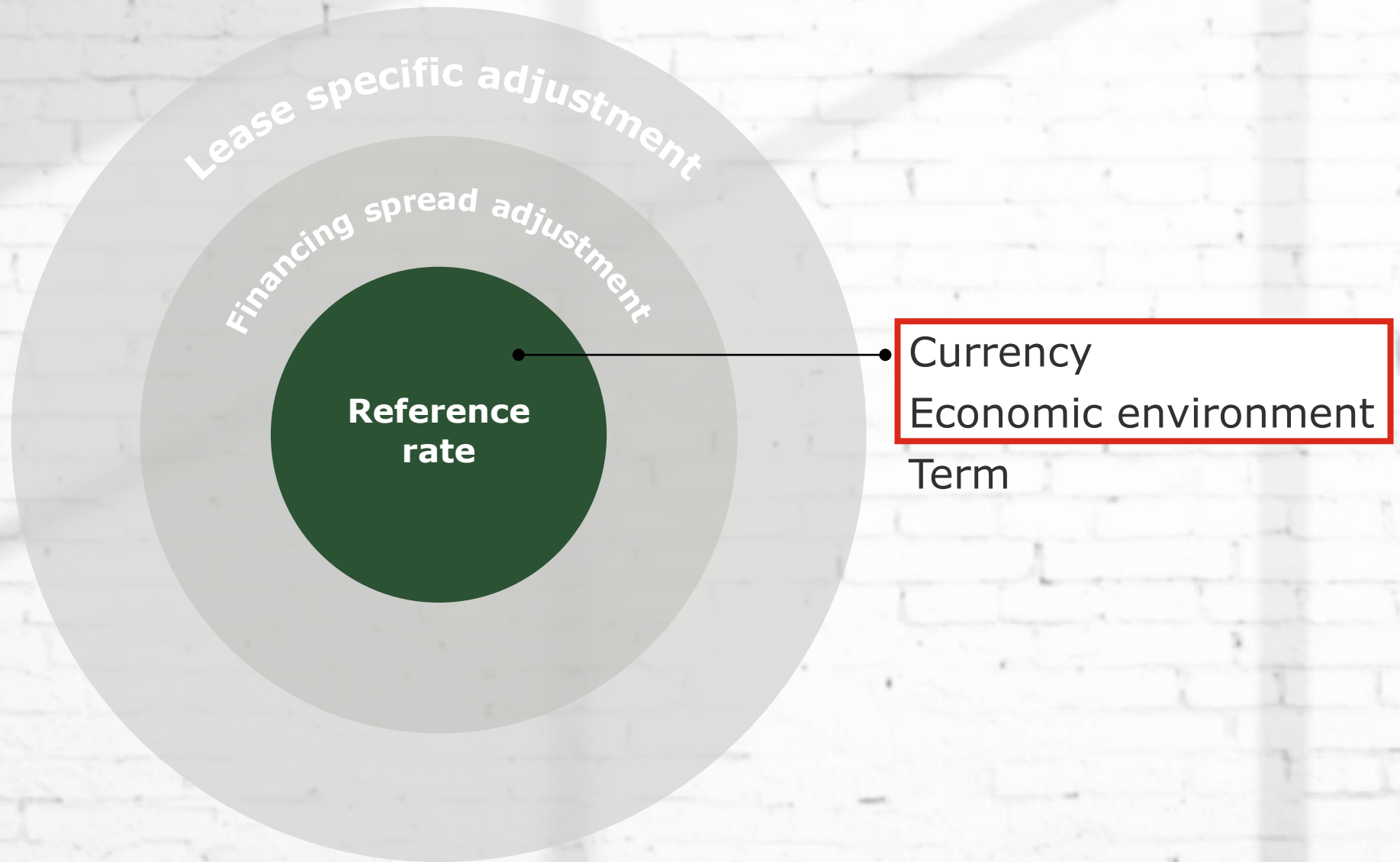
**It depends. More information needed**

# Determining the Incremental Borrowing Rate



## Step 1 Determine the Reference Rate

**The reference rate is typically a risk-free rate**





## Knowledge Check

**A subsidiary of the Brockhart Group has a lease denominated in a currency (USD) that is different from its functional currency (EUR)**



**What currency should lessee use to determine its IBR for the lease?**

**A** USD

**B** EUR

**Why?**



## Knowledge Check

**A subsidiary of the Brockhart Group has a lease denominated in a currency (USD) that is different from its functional currency (EUR)**



**What currency should lessee use to determine its IBR for the lease?**

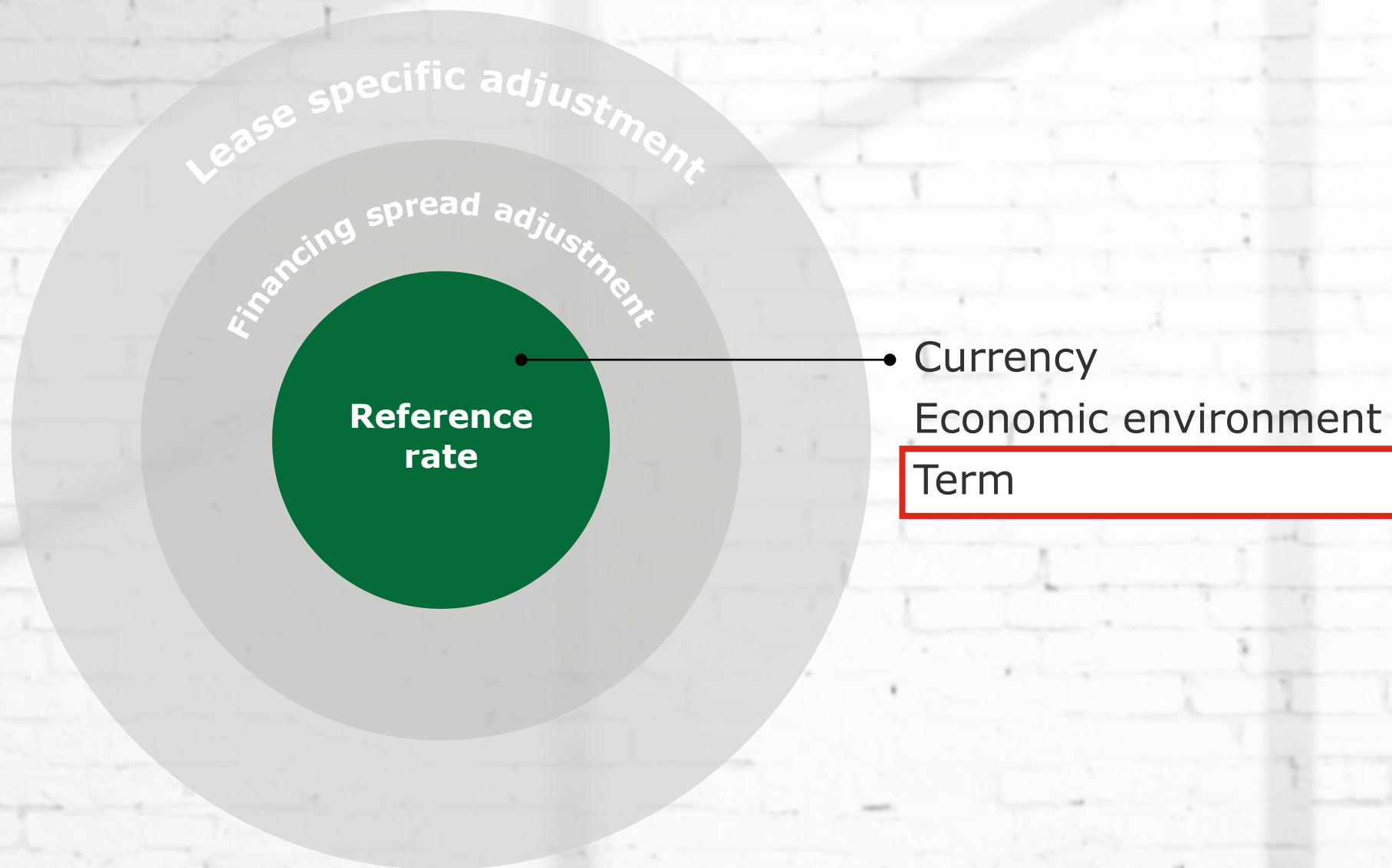
**A** USD

**B** EUR

**Why?**

# Step 1 Determine the Reference Rate

**The reference rate is typically a risk-free rate**







## Knowledge Check

*the Grocer* has lease with 15 year term where lease payments are made on monthly basis. *the Grocer* proposes to use 15 year government bond rate as reference rate.



Is this approach acceptable for determining reference rate?

**A** Yes

**B** No

**C** It depends

**Why?**



## Knowledge Check

*the Grocer* has lease with 15 year term where lease payments are made on monthly basis. *the Grocer* proposes to use 15 year government bond rate as reference rate.



Is this approach acceptable for determining reference rate?

A Yes

B No

C It depends

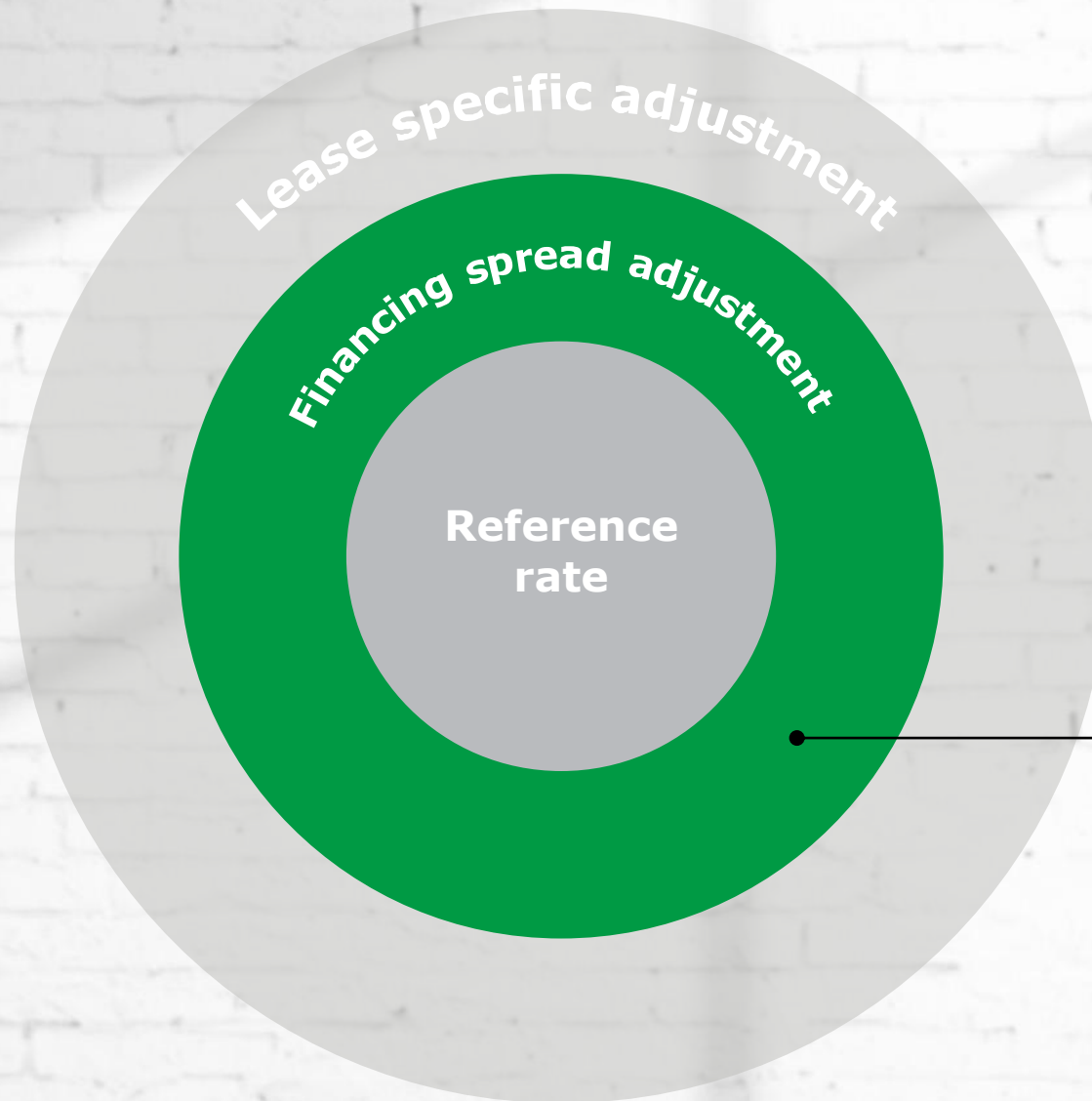
Why?



## Step 2 Determine the Financing Spread Adjustment



**A financing spread is the additional margin applied to reference rate that reflects risks of the lessee**



**This is an area where audit teams should consider engaging an expert to check adjustments are complete, reasonable, and can be substantiated.**

- Term
- Level of indebtedness
- Lessee entity
- Economic environment (Business and Sector)



## Knowledge Check

*the Grocer* conducts all its financing at consolidated group level with **Finance Co.**



Can *the Grocer* default to the use of an average group rate to discount its leases?

**A** Yes

**B** No

**C** It depends

**Why?**



## Knowledge Check

*the Grocer* conducts all its financing at consolidated group level with **Finance Co.**



Can *the Grocer* default to the use of an average group rate to discount its leases?

A

Yes

B

No

C

It depends

**Why?**

# Factors to Consider when Determining Financing Spread

## Factors change over time

What was applicable previously, may not be applicable now

### Consider an entity's:

History of borrowing and paying debts when due	Borrowing rates of other facilities	Its credit rating	Length of credit history	Evidence of default	Current ability to repay debts	Leverage	Its future economic outlook
--	-------------------------------------	-------------------	--------------------------	---------------------	--------------------------------	----------	-----------------------------



## Knowledge Check

*the Grocer* subsidiary owns investment properties with retail stores acquired 4 years ago

Properties were funded 80% external borrowings, 20% share capital

Subsidiary has leased another retail store



The Grocer is proposing to use WACC to discount the lease. Is this acceptable?

**A** Yes

**B** No

**Why?**





## Knowledge Check

*the Grocer* subsidiary owns investment properties with retail stores acquired 4 years ago

Properties were funded 80% external borrowings, 20% share capital

Subsidiary has leased another retail store



The Grocer is proposing to use WACC to discount the lease. Is this acceptable?

A

Yes

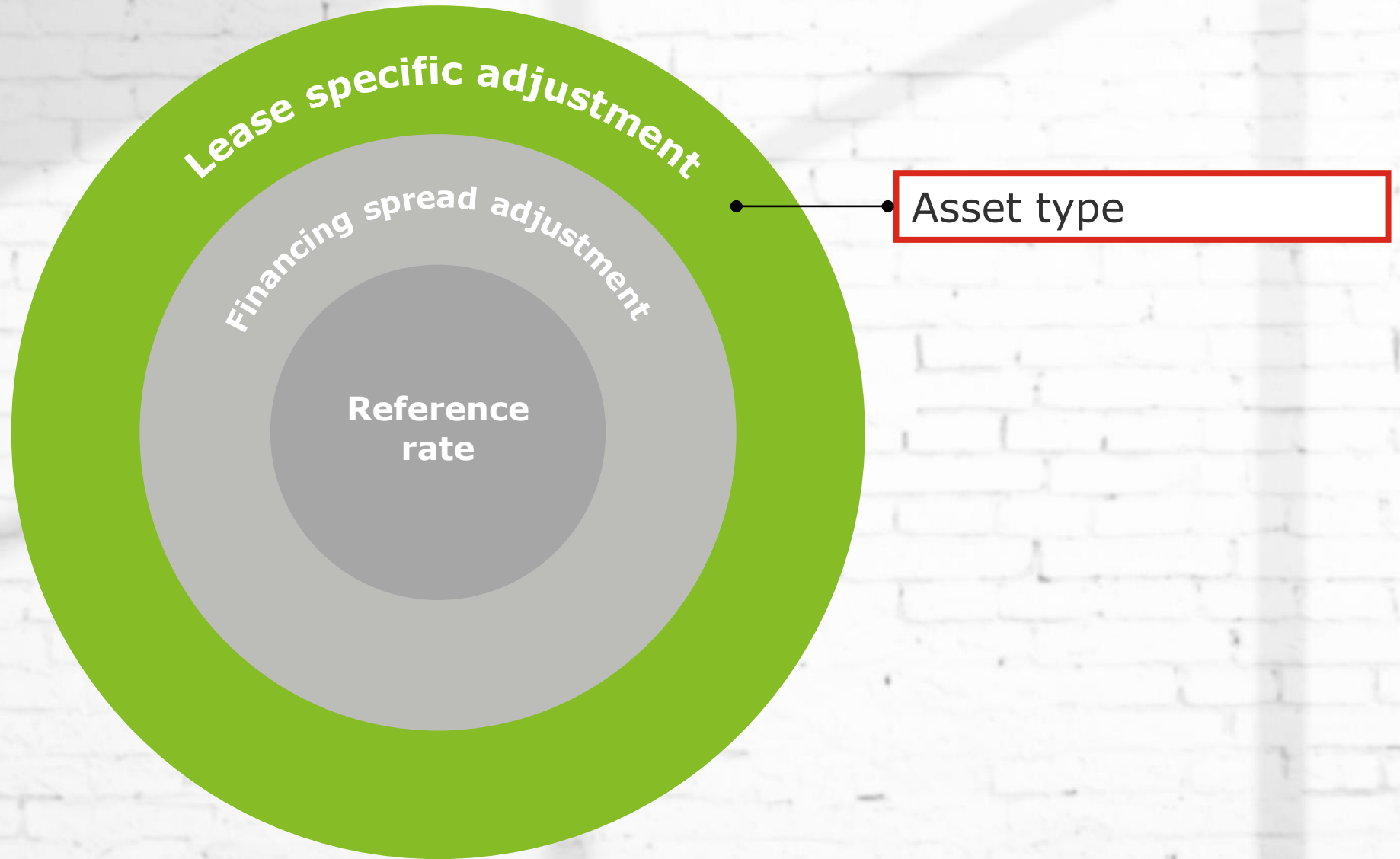
B

No

Why?

## Step 3 Determine the Lease Specific Adjustment

**Adjustment to  
reflect secured  
position of  
lessor**





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## **Determining the Discount Rate**

IFRS 16 *Leases* Pre-implementation Considerations

## Discount Rate Impacts



**More pronounced front-loading of total lease expense**

# Discount Rate

**Lease payments should be discounted using:**

**Interest rate implicit in lease**

**Rate that causes present value of lease payments and unguaranteed residual value = sum of fair value of underlying asset and any initial direct costs of lessor**

**If implicit interest rate cannot be readily determined:**

**Lessee's incremental borrowing rate (IBR)**

**Rate lessee would have to pay to borrow funds necessary (over similar term with similar security) to obtain similar-value asset to right-of-use asset, in similar economic environment**

Expected that use of lessee's IBR as discount rate to be widespread in practice



## **Determining the Lease Term**

IFRS 16 *Leases* Pre-implementation Considerations

# Lease Term

Determined at lease commencement date based on **non-cancellable** period, together with periods covered by option to:

Extend lease if lessee is **reasonably certain** to exercise and

Terminate lease if lessee is **reasonably certain not** to exercise



# Three-step approach to Assess Lease Term

## Step 1

Determine Non-cancellable Period of the Lease

## Step 2

Determine Enforceability of Options in the Lease

## Step 3

Assess Extension and Termination Options of Lessee for 'Reasonable Certainty' of Exercise

## Step 1 – Determine Non-cancellable Period of the Lease

### Step 1

When assessing non-cancellable period, entity shall apply definition of a contract

Contract is considered to exist only when it creates rights and obligations that are **enforceable**

## Step 2 – Determine the Enforceable Period of the Lease

### Step 1

When assessing non-cancellable period, entity shall apply definition of a contract

Contract is considered to exist only when it creates rights and obligations that are **enforceable**

### Step 2

To be part of a contract, any options to extend or terminate lease must also be **enforceable**

To be enforceable, lessee must have unilateral right to extend lease beyond non-cancellable period

Enforceability is a matter of law and not a probability threshold

## Step 3 – Assess Extension and Termination Options of Lessee for 'Reasonable Certainty' of Exercise

### Step 1

When assessing non-cancellable period, entity shall apply definition of a contract

Contract is considered to exist only when it creates rights and obligations that are **enforceable**

### Step 2

To be part of a contract, any options to extend or terminate lease must also be **enforceable**

To be enforceable, lessee must have unilateral right to extend lease beyond non-cancellable period

Enforceability is a matter of law and not a probability threshold

### Step 3

Reasonably certain is a **high hurdle**



Requires consideration of all relevant facts and circumstances that create economic incentive for lessee to exercise (or not exercise) option

Includes any expected changes in facts and circumstances from commencement date until option exercise date

# Revising the Lease Term

Subsequent to commencement date lessee should:

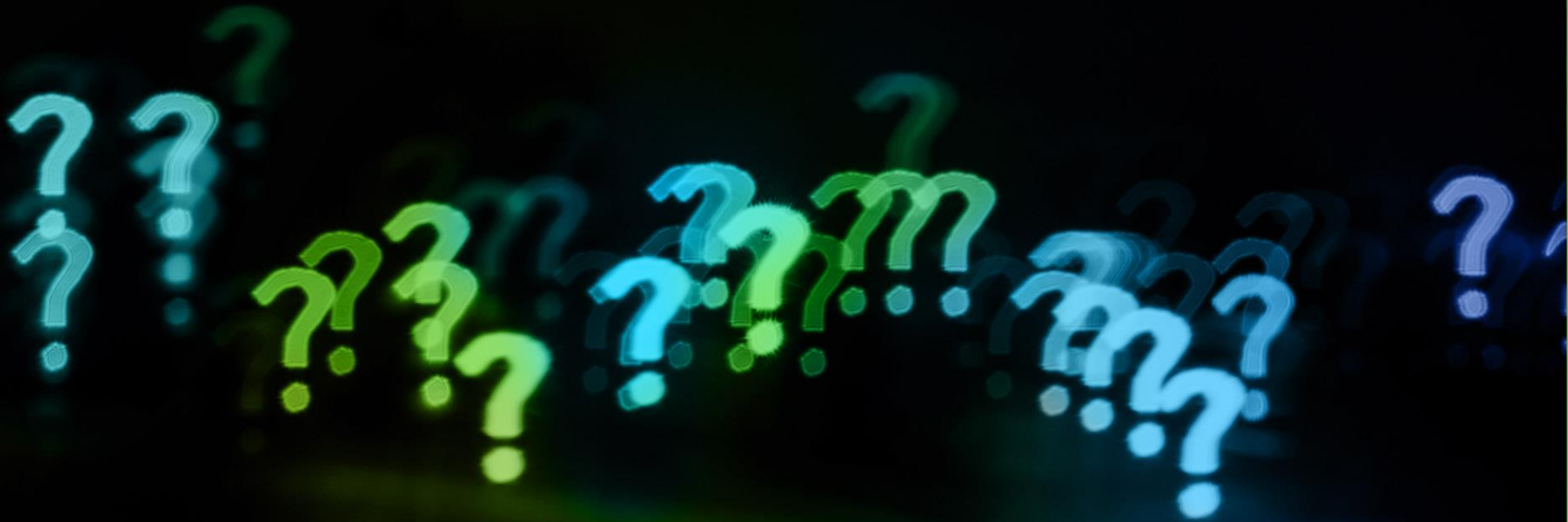
**Reassess whether it is reasonably certain to exercise option upon a significant event or change in circumstances that:**

- Is within control of lessee and
- Affects initial assessment of whether option is reasonably certain to be exercised

**Revise lease term, when there is a change in non-cancellable period of lease**

**Deloitte.**

Are **you** ready?





## Knowledge Check

**Contract is for two years, with option to extend for additional year.**

*the Grocer* can extend lease after end of year three on annual basis with **Vale Logistics'** agreement.



**When determining lease term, should management consider possibility of extending the lease beyond year three?**

**A**

**Yes.** If exercise of option is reasonably certain

**B**

**No.** Option to extend lease is not enforceable



## Knowledge Check

**Contract is for two years, with option to extend for additional year.**

*the Grocer* can extend lease after end of year three on annual basis with **Vale Logistics'** agreement.



**When determining lease term, should management consider possibility of extending the lease beyond year three?**

**A**

**Yes.** If exercise of option is reasonably certain

**B**

**No.** Option to extend lease is not enforceable





## Knowledge Check – Alternate Scenario

**Assume no option to extend lease term after two years in original lease. Instead, parties renegotiated new lease 1.5 years into the lease with same terms (e.g. same lease payments, same duration) to commence directly after existing lease ends.**



**How should management account for lease?**

**A**

Record right-of-use asset and lease liability as separate lease at start of year three when new lease starts

**B**

New terms are treated as modification to existing contract



## Knowledge Check – Alternate Scenario

**Assume no option to extend lease term after two years in original lease. Instead, parties renegotiated new lease 1.5 years into the lease with same terms (e.g. same lease payments, same duration) to commence directly after existing lease ends.**



**How should management account for lease?**

**A**

Record right-of-use asset and lease liability as separate lease at start of year three when new lease starts

**B**

New terms are treated as modification to existing contract

## Background

General Manager of each of The Grocer's stores is authorized to enter contracts

The Grocer's management use existing PP&E module to record right-of-use assets and excel for other calculations

Finance Co. has debt covenant and was close to breaching last period

Group looking to raise funds for expansion





## Activity

**10**   
minutes

### Read: Guide 1

**Based on facts and circumstances provided, discuss what could be potential risk of material misstatement for *the Grocer* when determining lease term?**

Consider:

Lease accounting process

Organizational structure

Metrics





## Activity – Solution

**10**   
minutes

### Potential risks of material misstatement:

**Lease term determined at lease commencement date is not appropriate**

RoMM

- Decentralized environment
- Factors considered regarding options are not consistent
- Management incentives



### Potential risks of material misstatement:

***the Grocer's* lease terms are not being re-assessed and resulting impact on financial statements are not calculated correctly in accordance with IFRS 16**

RoMM

- Decentralized environment
- Unsophisticated software





## Learning Highlights

**Lease term is determined at lease commencement date based on non-cancellable term of lease**

**To be part of a contract, any options to extend or terminate lease included in lease term must be enforceable**

**Management's assessment whether it is reasonably certain it will or will not exercise an option, requires judgment**

**Lease term should be revised when there is change in non-cancellable period of lease, or following reassessment whether extension option is reasonably certain to be exercised, or termination option is reasonably certain not to be exercised**





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