

# IFRS 16 Leases

CPA Stephen Obock  
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# Why is this session important?

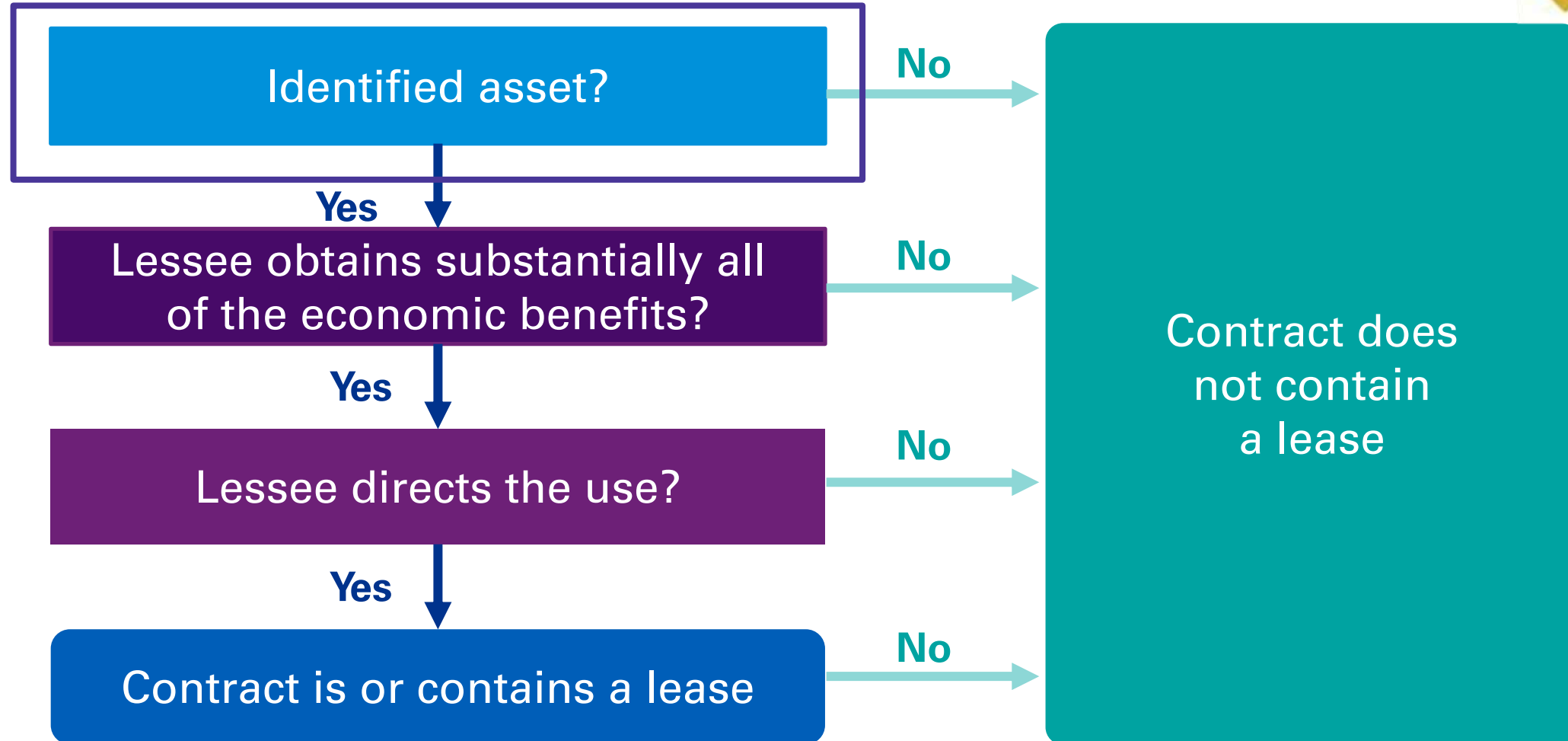
- New lease definition
- Operating leases becomes on-balance
- Many judgemental issues.



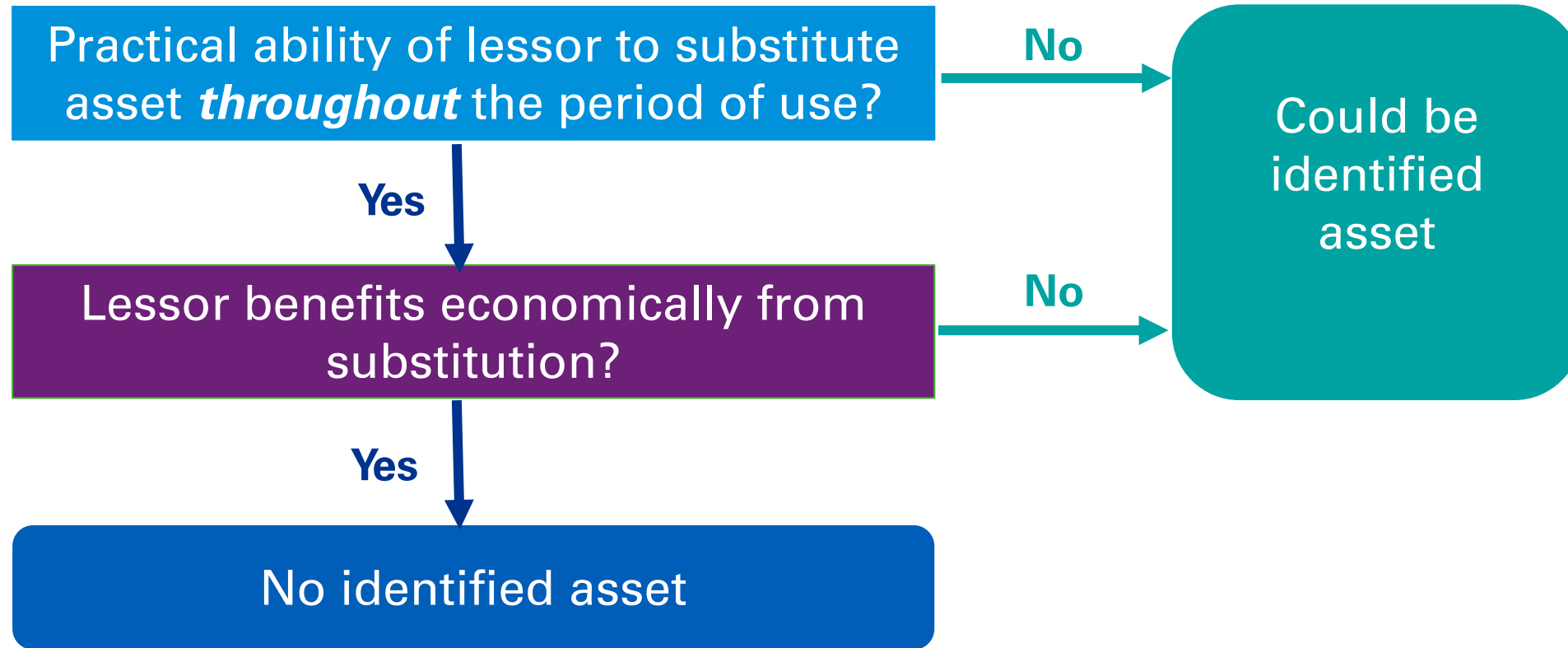
# Lease definition

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

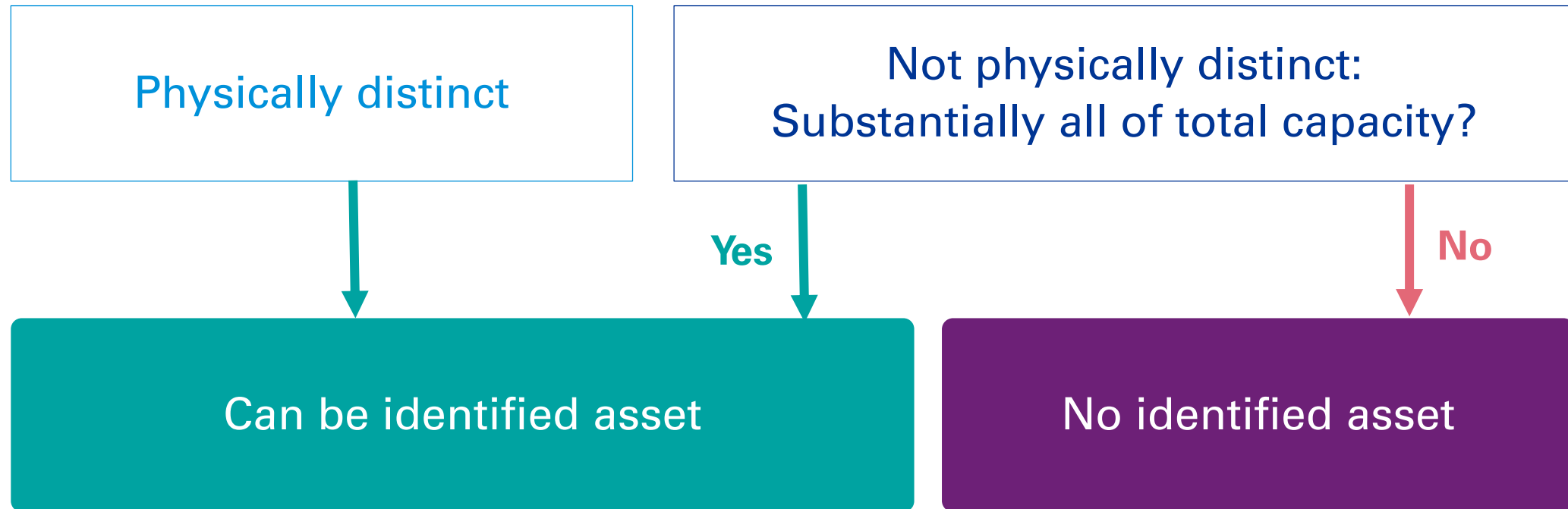
# Overview



# Substantive substitution rights



# Capacity portions



# Economic benefits



25-year contract for customised solar panel output. Supplier receives renewable energy credits.



Office contract. Tenant sublets 25% of space.



Retail store contract. Rental = fixed amount + 20% of revenue.



Car hire contract. Limited to 20,000 miles per year and inside country X.



2-years jet charter. Share access and use with another party.

Primary output



+ Other benefits



n/a

n/a

n/a

= **Substantially all economic benefits**



# Directing the right to use

Who takes the '*how and what purpose*' decisions throughout the period of use?

Customer

Predetermined

Customer  
***operates asset***  
or directs  
others to do so

Customer  
designed  
asset

Other

Supplier

Contract is or contains a lease\*

Contract does not contain  
a lease

***Protective rights*** of the supplier

\* If other criteria are met.



# Examples

Case A	Case B	Case C
<ul style="list-style-type: none"><li>Contract specifies the cargo to be transported and dates of pickup and delivery.</li><li>Supplier operates and maintains the ship, is responsible for safe passage of cargo on board.</li></ul>	<ul style="list-style-type: none"><li>Contract specifies the cargo to be transported and dates of pickup and delivery.</li><li>Customer hires the captain, supplier provides the rest of the crew which is crucial in operating the ship and maintains it.</li></ul>	<ul style="list-style-type: none"><li>Customer decides whether and what cargo will be transported and when the ship sails between Kenya and Djibouti.</li><li>Supplier operates and maintains the ship, is responsible of safe passage of cargo on board.</li></ul>

Is this a  
lease?



Judgement  
required



# Exemptions and Scope for lessees



Short term leases

≤ 12 months and  
no purchase option



Leases of low value  
items

(Judgement used)  
and not subject to a  
sublease



Lessors



# IFRS 16 Leases: Accounting models



# Lessee accounting - overview



# Single lease accounting model



## Balance sheet

### Asset

= 'Right-of-use' (ROU) of underlying asset

### Liability

= Obligation to make lease payments

## P&L

### Lease expense

Depreciation

+ Interest

= Front-loaded total lease expense

# Sir David Tweedie's aircraft



Five year  
lease of an  
aircraft



CU1,000,000  
per annum due  
at 31 Dec



No renewal  
no purchase  
option



Discount  
rate: 7%



Aircraft  
useful life:  
20 years

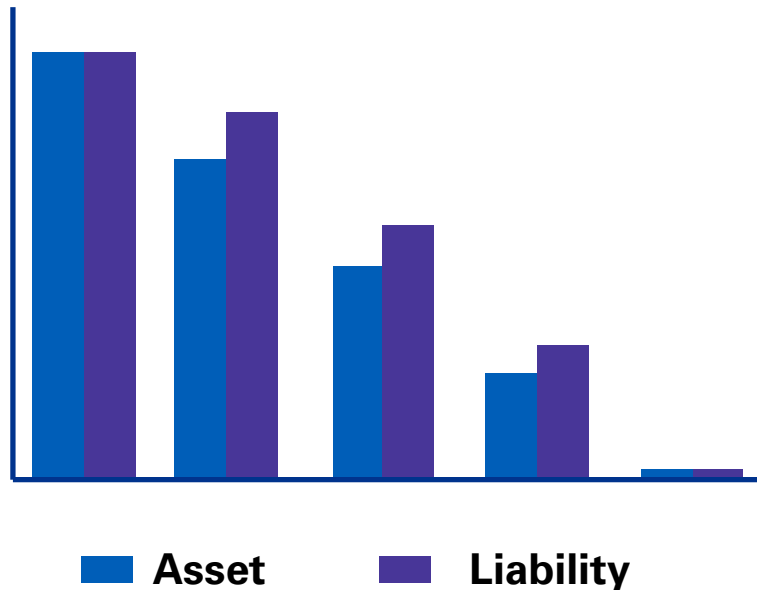
# Journal entries



1 January 20X1	Debit (CU)	Credit (CU)
ROU asset (present value of 5 x CU1,000,000 @ 7%)	4,100,000	
Lease liability		4,100,000
31 December 20X1		
Depreciation expense (CU4,100,000/5)	820,000	
ROU asset		820,000
Interest expense (CU4,100,000 * 7%)	287,000	
<b>Total P&amp;L expense</b>	<b>1,107,000</b>	
Lease liability	713,000	
Cash		1,000,000

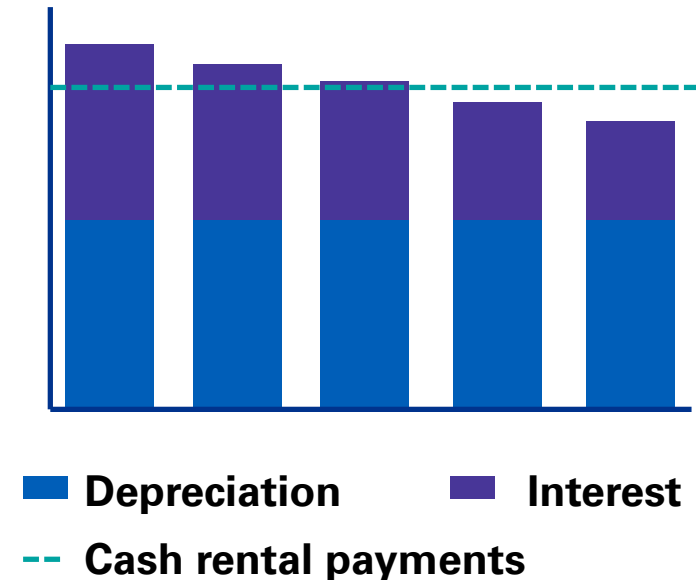
# What's the impact?

## Balance sheet



- Airline appears to be more ***asset-rich***, but also more ***heavily indebted***.

## Profit/loss



- Total lease expense is ***front-loaded*** even when cash rentals are constant.



# Impact on financial ratios



## Profit/loss

## Balance sheet

## Ratios



**EBITDA**

**Total assets**

**Gearing**



**EPS**  
(in early years)

**Net assets**

**Interest cover**  
**Asset turnover**

# Lessee accounting - initial measurement



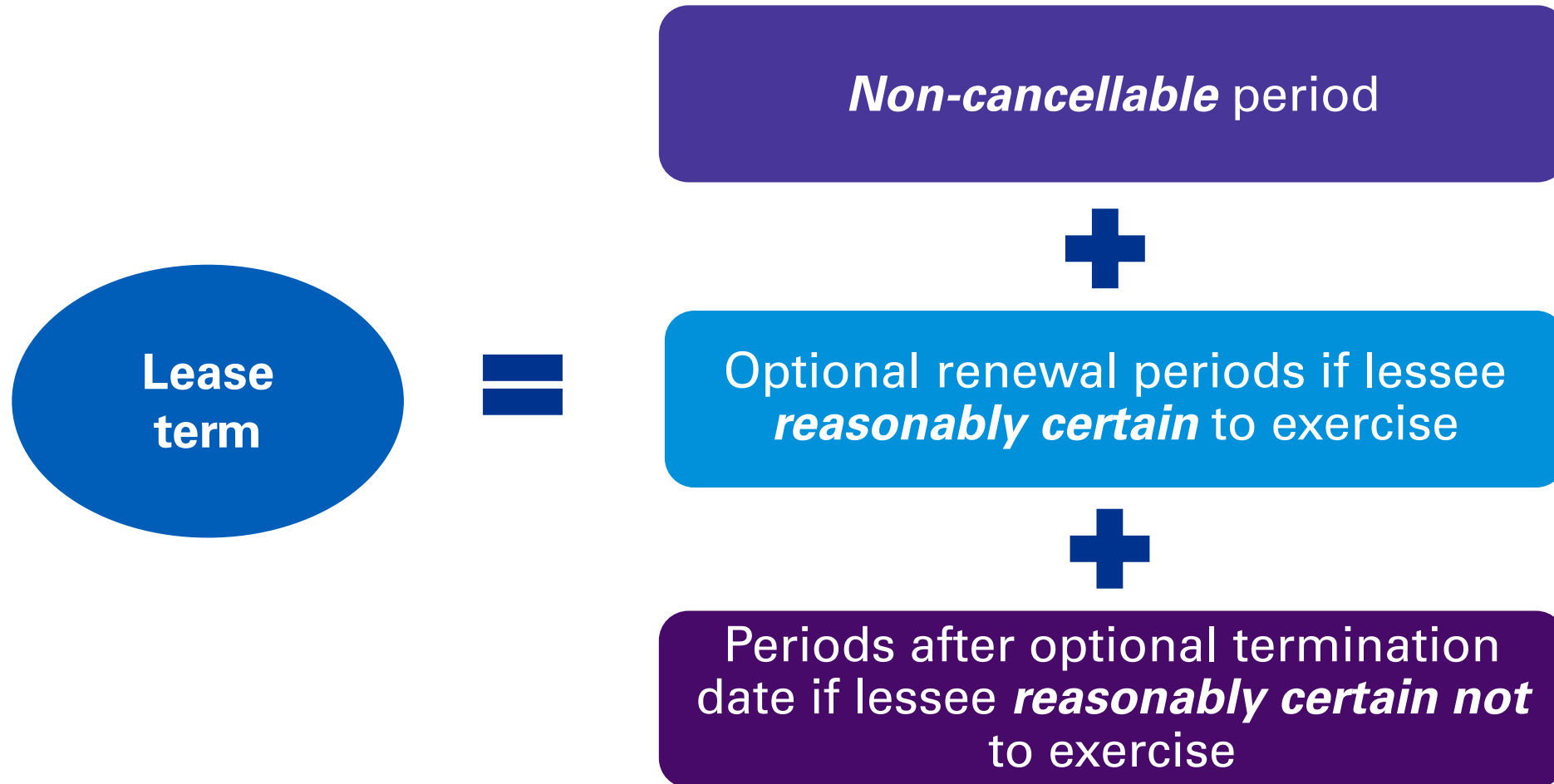
# Measuring the lease liability



**Key inputs**



# Lease term



# Lease term – economic factors

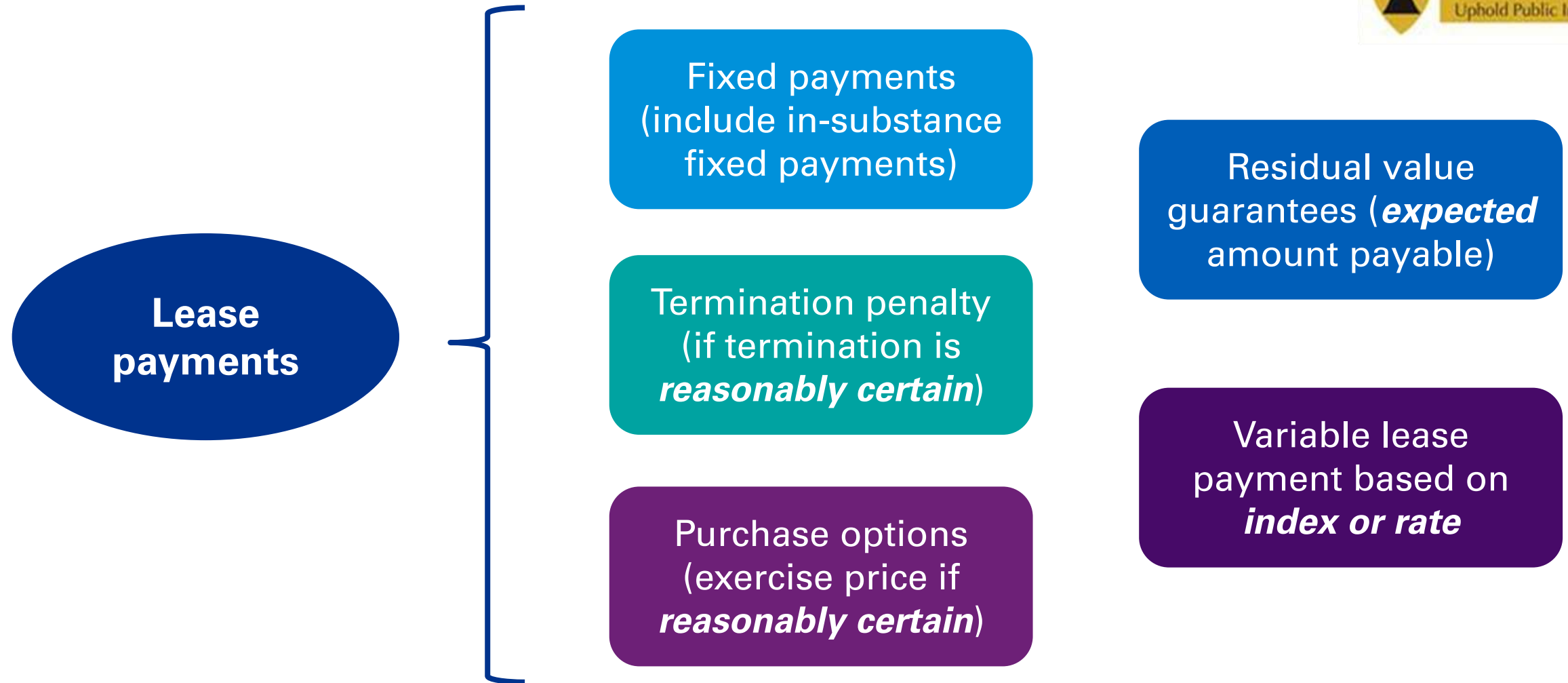
## Contractual/market

- Level of rentals in secondary period compared to market rates.
- Contingent payments.
- Renewal and purchase options.
- Costs relating to the termination of the lease and the signing of a new replacement lease.
- Returning costs of the underlying asset.

## Asset

- Nature of item (specialised).
- Location.
- Availability of suitable alternatives.
- Existence of significant leasehold improvements.

# Lease payments



# Discount rate

**The rate implicit in the lease, if readily available**

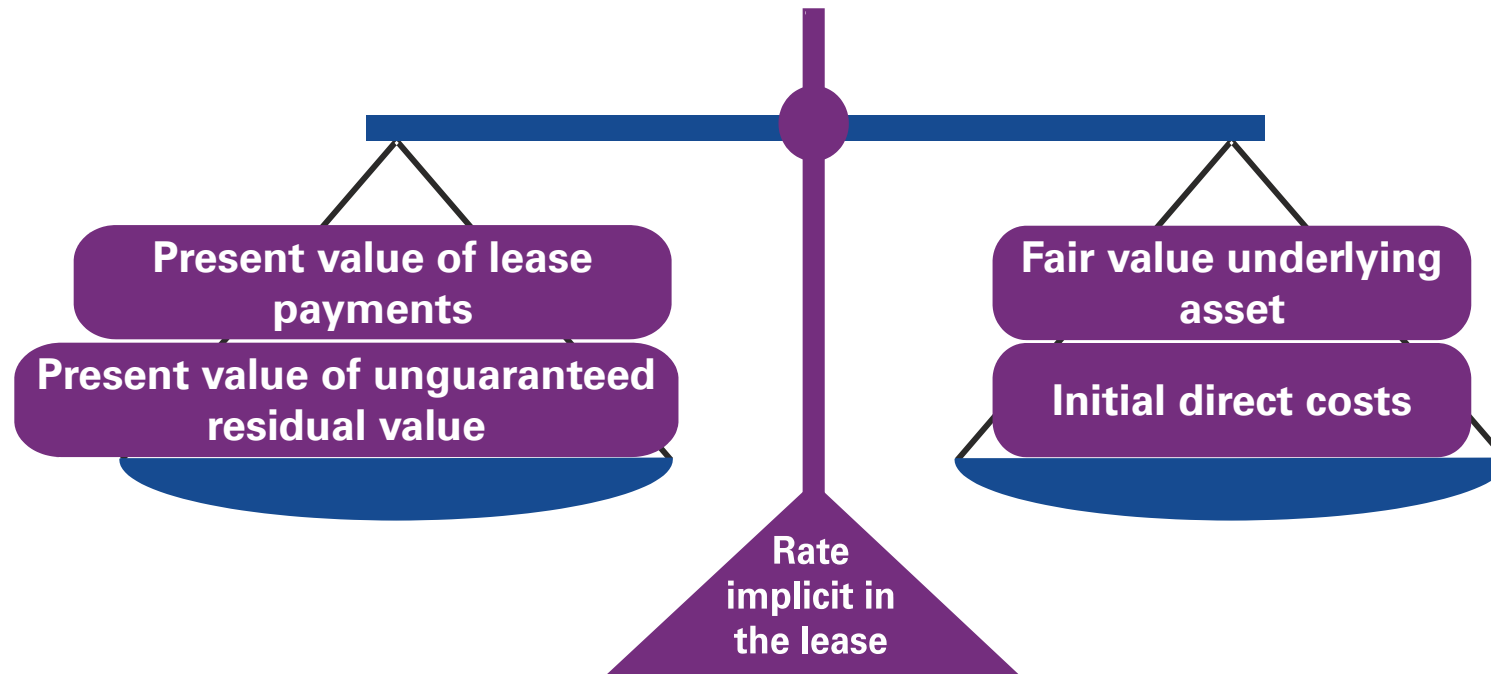
**OR**

**The lessee's incremental borrowing rate**

**“Why is the discount rate important?”**

Discount rate	Lease liability (5 year lease @ CU10,000 per annum)
3%	CU46,000
5%	CU43,000
7%	CU41,000
10%	CU38,000

# Discount rate – rate implicit in the lease





# Measuring the right-of-use (ROU) asset

ROU asset

=

Lease  
liability

+

Initial direct  
costs

+

Prepaid  
lease  
payments

+

Costs to  
dismantle or  
restore  
(IAS 37)

-

Lease  
incentives

# Lessee accounting - subsequent measurement

# Subsequent measurement

## Lease liability

- Amortised cost using the effective interest method.

## ROU asset (cost model)

- Depreciated in accordance with IAS 16 *Property, Plant & Equipment*.
- Depreciation period is the shorter of lease term/useful life.
- Impairment testing under IAS 36 *Impairment*.

## ROU asset (alternative models)


- Revaluation model under IAS 16.
- Fair value model under IAS 40 *Investment Property*.

# Lessor accounting

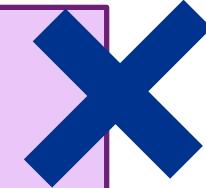


# Lessor accounting

## Same as IAS 17

- Lease classification test.
  - Finance lease model.
  - Operating lease model.
- 

## Different to IAS 17

- Definition of a lease.
  - Sale-and-leaseback guidance.
  - Sub-lease guidance.
  - Accounting for lease modifications.
  - Disclosure requirements.
- 

**No symmetry between lessee and lessor accounting!**

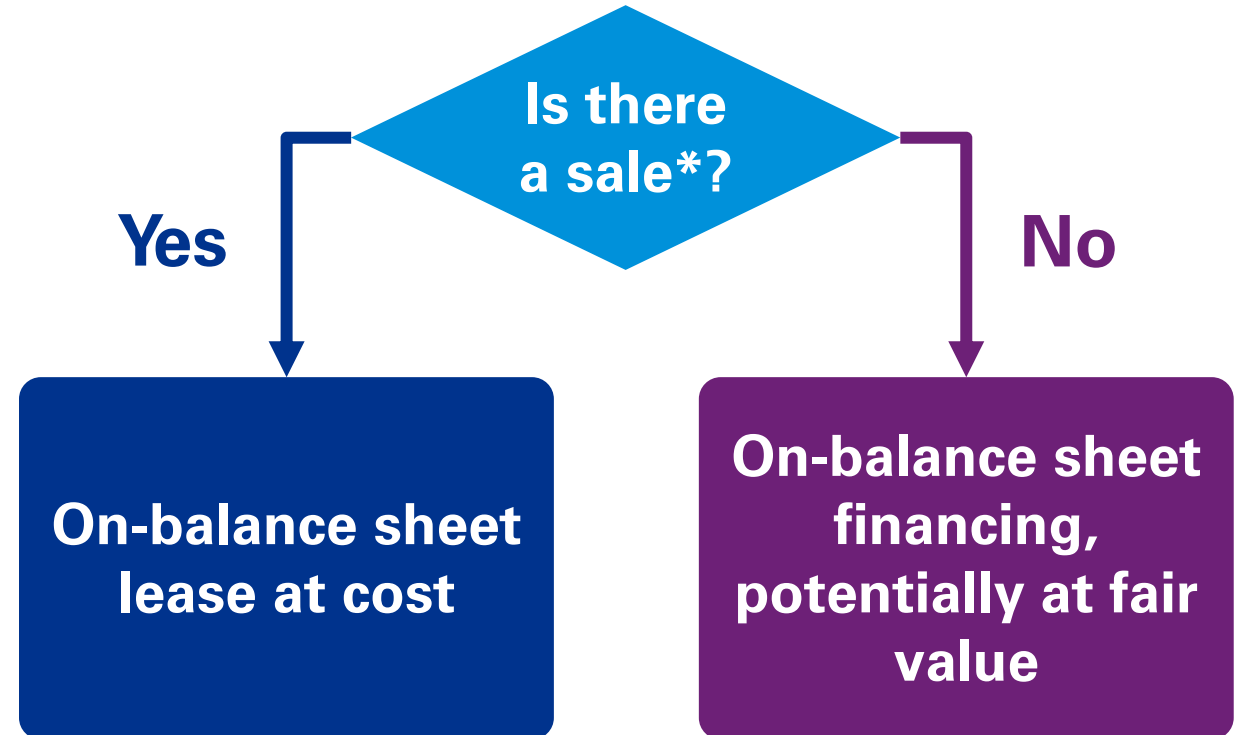


# Other lease accounting topics



# Sale-and-leaseback

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



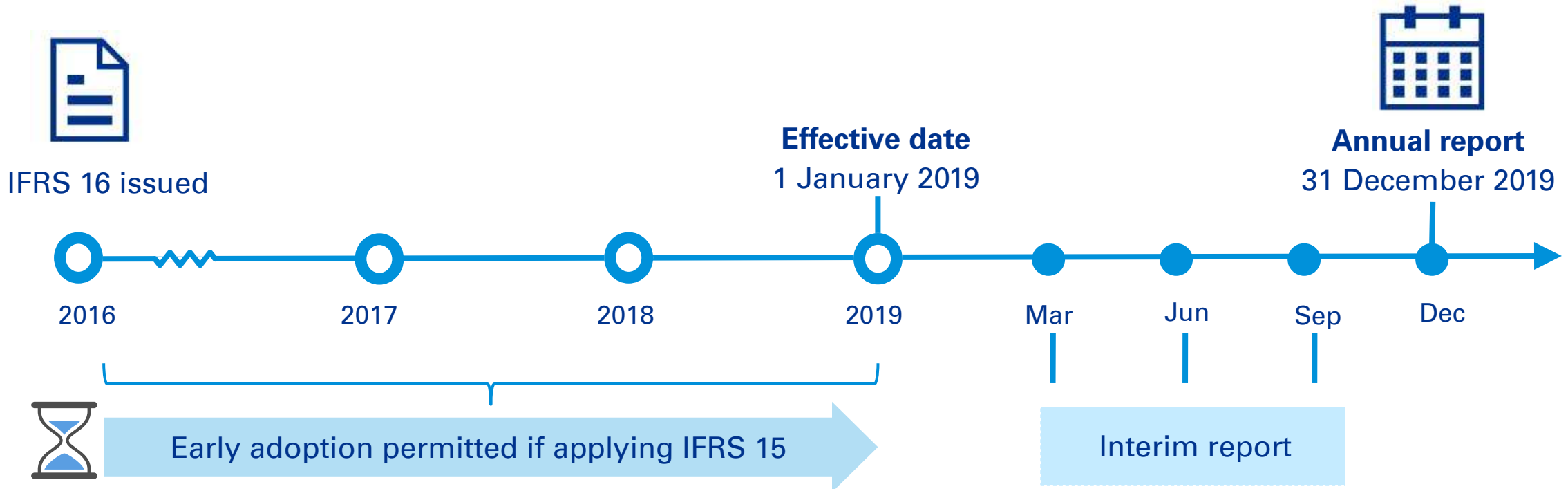
\*Apply IFRS 15 *Revenue from Contracts with Customers* to assess whether there is a sale

# IFRS 16 Leases: Transition options





# Effective date



# IAS 17 to IFRS 16 – transition impact

Lessee operating lease	Lessee finance lease	Lessor operating lease	Lessor finance lease
Full retrospective	Full retrospective	No adjustment	
Modified retrospective with practical	Modified retrospective		
High	Medium	Low	

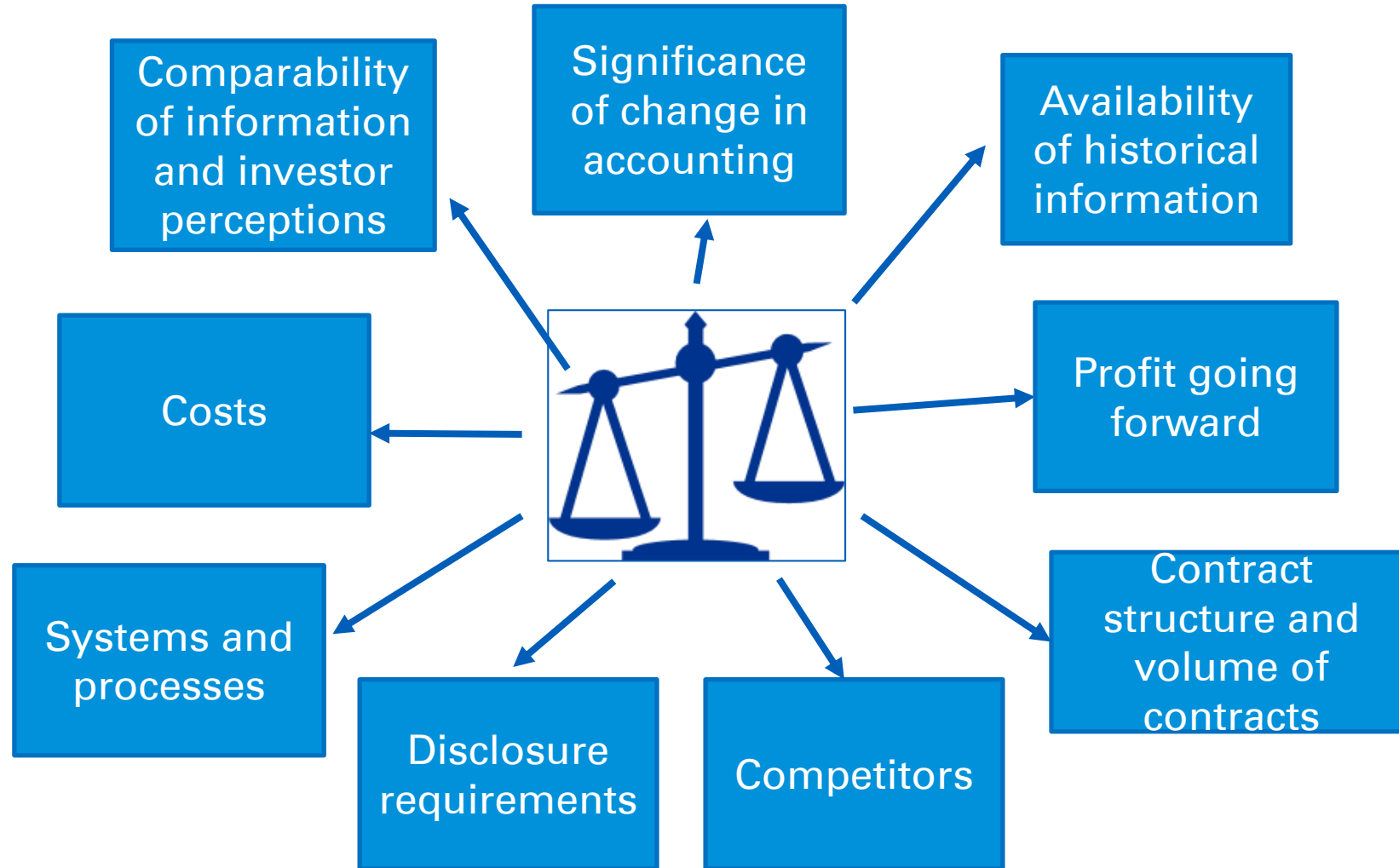


# Transition options

Approach	2018	2019	Date of equity adjustment
Full retrospective (no practical expedients)	IFRS 16 IAS 17	IFRS 16	1 January 2018
Modified retrospective (with practical expedients)	IAS 17	IFRS 16	1 January 2019

- Full retrospective: parallel systems for 2018.
- Modified retrospective approach: additional disclosure.

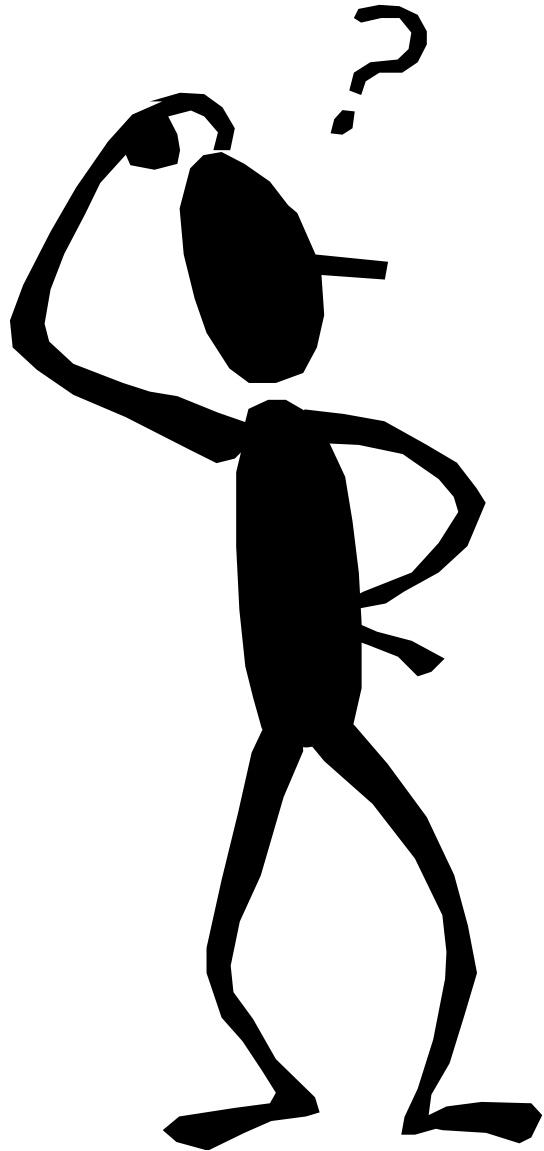
# Additional factors to consider by lessee



# Key points to remember!

- Lease definition changes – there may be fewer leases under IFRS 16.
- Lessee-only exemptions for short term leases and leases of low value items.
- Different scope exclusions for lessees and lessors.
- Lessee accounting under IFRS 16 is different from today.
- Lessee recognises leases on-balance sheet.
- IFRS 16 changes many financial ratios.





Questions and feedback ?