IFRS 16 Leases

CPA Anthony M. Njiru
September 2019
0722 241 005

Preamble

Superseded Standards

IFRS 16 replaces the following standards and interpretations:

- IAS 17 *Leases*
- IFRIC 4 *Determining whether an Arrangement contains a Lease*
- SIC-15 *Operating Leases - Incentives*
- SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

Objective

IFRS 16 establishes principles for the recognition, measurement, presentation and disclosure of leases, with the objective of ensuring that lessees and lessors provide relevant information that faithfully represents those transactions

Scope

IFRS 16 Leases applies to all leases, including subleases, except for:

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

leases of biological assets held by a lessee (see IAS 41 Agriculture);

service concession arrangements (see IFRIC 12 Service Concession Arrangements);

licences of intellectual property granted by a lessor (see IFRS 15 Revenue from Contracts with Customers); and

rights held by a lessee under licensing agreements for items such as films, videos, plays, manuscripts, patents and copyrights within the scope of IAS 38

Long-term leases of land

The IASB considered, but decided against, a scope exclusion for long-term leases of land

Therefore, such leases should be accounted for in accordance with IFRS 16.

Leases of investment property

If a lessee applies IAS 40's fair value model to its owned investment property, it is also required to apply that fair value model to right-of-use assets that meet the definition of investment property.

Derivatives embedded in a lease

The IASB noted that the lease accounting model in IFRS 16 was not developed with derivatives in mind and, consequently, IFRS 16 would not provide an appropriate basis on which to account for derivatives.

Recognition exemptions

Instead of applying the recognition requirements of IFRS 16 described below, a lessee may elect to account for lease payments as an expense on a straight-line basis over the lease term or another systematic basis for the following two types of leases:

- leases with a lease term of 12 months or less and containing no purchase options – this election is made by class of underlying asset; and

- leases where the underlying asset has a low value when new

Identifying a lease

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration

Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use

Is it a lease?

Identified asset

Right to control the use of an identified asset

Right to obtain substantially all economic benefits from use

Right to direct the use

Identification of an asset – general

The asset that is the subject of a lease must be specifically identified. This will be case if either of the following applies:

- the asset is explicitly specified in the contract (e.g. a specific serial number); or
- the asset is implicitly specified at the time that it is made available for use by the customer (e.g. when there is only one asset that is capable of being used to meet the

- the asset is explicitly specified in the contract (e.g. a specific serial number); or
- the asset is implicitly specified at the time that it is made available for use by the customer (e.g. when there is only one asset that is capable of being used to meet the contract terms).

Substantive Substitution Rights

Even if an asset is specified a customer is not considered to have the right to use an identified asset (and, therefore, the contract is not a lease) if the supplier has a substantive right to substitute the asset throughout the period of use.

The ‘period of use’ is “the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)

If a substitution clause is not substantive because it does not change the substance of the contract that substitution clause does not affect an entity’s assessment as to whether a contract contains a lease.

Asset Portion

A capacity portion of an asset is still an identified asset if it is physically distinct (e.g. a floor of a building).

A capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all the capacity such that the customer obtains substantially all the economic benefits from using the asset.

Separating components of a contract

For a contract that contains a lease component and additional lease and non-lease components, such as the lease of an asset and the provision of a maintenance service, lessees shall allocate the consideration payable on the basis of the relative stand-alone prices

Lease vs 'in-substance' sale or purchase

When assessing the nature of a contract, an entity should consider whether the contract transfers control of the underlying asset itself (as opposed to conveying the right to control the use of the underlying asset for a period of time). If so, the transaction is a sale or purchase within the scope of other Standards

Leases vs service contracts

If a customer controls the use of an identified asset for a period of time, then the contract contains a lease.

In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service

Accounting by lessees

Accounting by lessees

Upon lease commencement a lessee recognises a right-of-use asset and a lease liability

The right-of-use asset is initially measured at the amount of the lease liability plus any initial direct costs incurred by the lessee.

Right To Use

After lease commencement, a lessee shall measure the right-of-use asset using a cost model, unless:

i) the right-of-use asset is an investment property and the lessee fair values its investment property under IAS 40; or

ii) the right-of-use asset relates to a class of PPE to which the lessee applies IAS 16's revaluation model

Cost Model

Under the cost model a right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment.

Lease Liability Measurement

The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined.

If that rate cannot be readily determined, the lessee shall use their incremental borrowing rate

Variable Lease Payments - Index

Variable lease payments that depend on an index or a rate are included in the initial measurement of the lease liability and are initially measured using the index or rate as at the commencement date.

Amounts expected to be payable by the lessee under residual value guarantees are also included.

Subsequent Variable Costs

Variable lease payments that are not included in the measurement of the lease liability are recognised in profit or loss in the period in which the event or condition that triggers payment occurs, unless the costs are included in the carrying amount of another asset under another Standard

Subsequent Measurent Lease Liability

The lease liability is subsequently remeasured to reflect changes

- In the lease term (using a revised discount rate);
- In the assessment of a purchase option (using a revised discount rate)

- the amounts expected to be payable under residual value guarantees (using an unchanged discount rate); or
- future lease payments resulting from a change in an index or a rate used to determine those payments (using an unchanged discount rate).

Treatment Remesurement

The remeasurements are treated as adjustments to the right-of-use asset

Accounting by lessors

- Lessors shall classify each lease as an operating lease or a finance lease
- A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise a lease is classified as an operating lease

Accounting by lessors

Lessors shall classify each lease as an operating lease or a finance lease

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Otherwise a lease is classified as an operating lease

Accounting by lessors

Upon lease commencement, a lessor shall recognise assets held under a finance lease as a receivable at an amount equal to the net investment in the lease

Accounting by lessors

A lessor recognises finance income over the lease term of a finance lease, based on a pattern reflecting a constant periodic rate of return on the net investment

Operating lease

A lessor recognises operating lease payments as income on a straight-line basis or, if more representative of the pattern in which benefit from use of the underlying asset is diminished, another systematic basis.

Transition

Retrospective application or cumulative catch-up approach? This is a single choice that must be applied to all leases

Option 1 – Retrospective

- **Restate comparatives as if IFRS 16 always applied**

Option 2 – Cumulative catch-up

- Leave comparatives as previously reported
- Any difference between asset and liability recognised in opening retained earnings at transition
- Carry forward existing finance lease liabilities
- Calculate outstanding liability for existing operating leases using incremental borrowing rate at date of transition
- Choose how to measure asset on lease-by-lease basis:

Option 2A –
Measure asset as if IFRS 16 had been applied from lease commencement (but using incremental borrowing rate at date of transition)

Option 2B –
Measure asset at amount equal to liability (adjusted for accruals and prepayments)

IFRS 16
Key judgements, policy choices and exemptions

Judgement: Identifying a lease will sometimes require a significant amount of judgement based on the elements of the definition of a lease

Judgement: Determining whether it is reasonably certain that an extension or termination option will be exercised

Judgement: Identifying the appropriate rate to discount the lease payments may involve significant judgement

Exemption: Exemptions may be taken for short-term leases (by class of asset) or low-value asset leases (lease-by-lease basis)

Policy choice: Requirements of IFRS 16 can be applied to a portfolio of similar leases provided that such aggregation is not expected to have a material effect

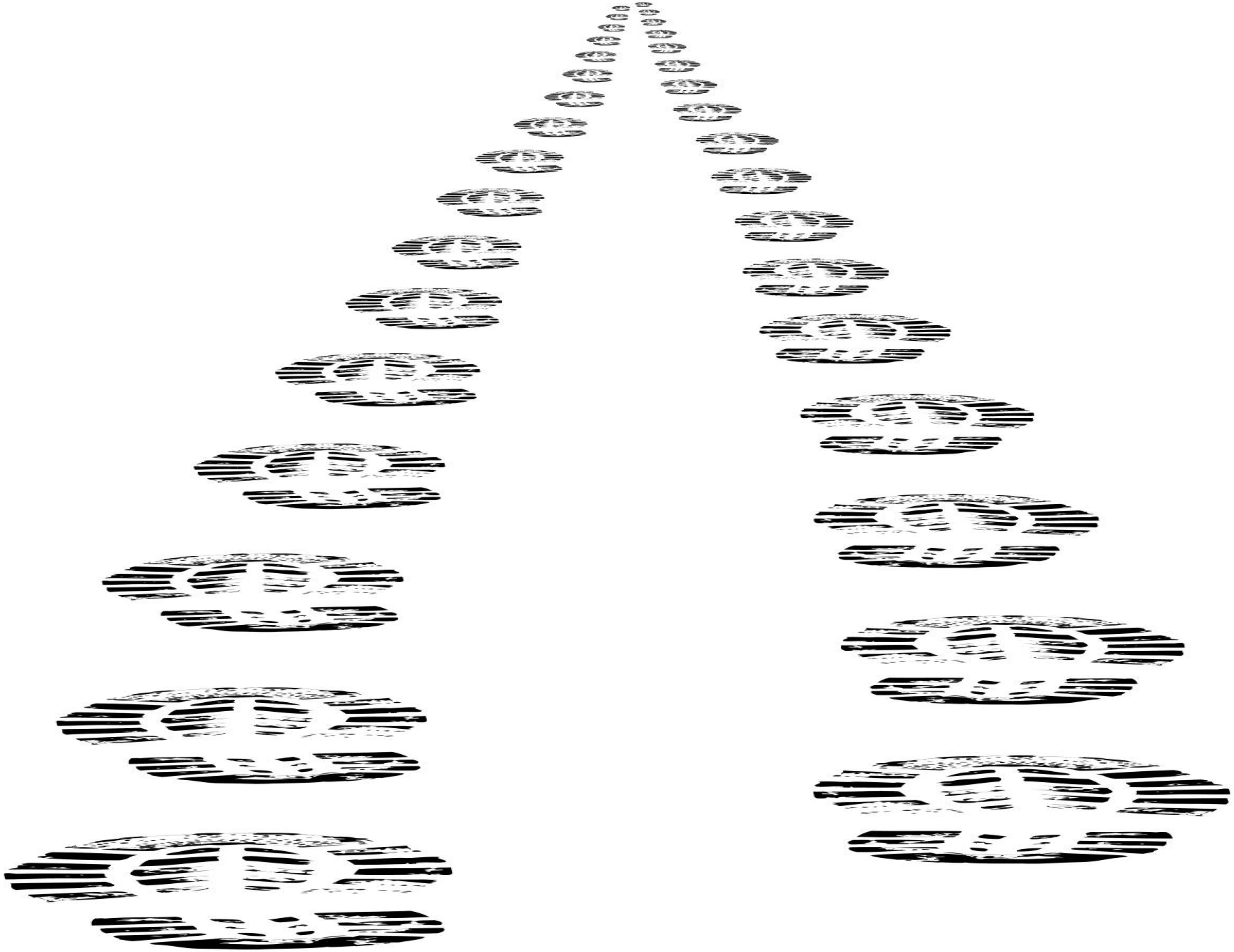
Policy choice: Lessee may elect not to separate non- lease components from lease components by class of asset

Policy choice: Lessee may, but is not required to, apply IFRS 16 to leases of intangible assets

Policy choice: The transition choices available are: full retrospective approach or cumulative catch-up approach,
all or none, initial direct costs in measurement of right- of-use asset – choice lease-by-lease, and other practical expedients on transition

Questions & comments

0722 241 005
Njiru@ffifinance.com
Training Consultant



ICPAK
Uphold Public Interest

End

GOD BLESS YOU ALL