Lease Accounting under IFRS 16

On 13th January 2016 the International Accounting Standards Board (IASB) finished its long-standing project on lease accounting and published IFRS 16, Leases (hereinafter referred to as IFRS 16 or the new standard). The new standard provides a comprehensive model for identification of lease arrangements and their treatment in the financial statements of both lessees and lessors and sets out recognition, measurement, presentation and disclosure principles with respect to leases. IFRS 16 is designed to provide more transparency for investors and other stakeholders and will bring in significant change to the way companies account for leases. The biggest change, however, is for lessees - many of which have significant lease commitments that currently don't appear on their balance sheets. Read on to know more…

CA. Anjani Kumar Khetan

(The author is a member of the Institute. He can be reached at anjanikhetan@gmail.com.)

Background

The IASB has calculated that listed companies following IFRS or US GAAP - have approximately US$3.3 trillion of lease commitments and more than 85 per cent of those commitments don't appear on their balance sheets. To set this right, the new standard, IFRS 16 Leases, will require most of these leases to be recorded on balance sheet.

IFRS 16 seeks to usher in significant changes to lessee accounting with distinction between operating and finance lease removed and assets and liabilities recognised in respect of all leases barring limited exceptions for short-term leases and lease of low-value assets. Some of the other key changes brought in by the new standard include a new definition of a lease, new lease accounting models and the separation of the lease and non-lease components of a lease contract.

Further, the new standard introduces a clear demarcation between lease agreements and service contracts–wherein leases are brought on the balance sheet, whereas service contracts will normally remain off-balance sheet, unless the lessee decides to apply a practical expedient envisaged in paragraph 15 of IFRS 16.

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply IFRS 15 *Revenue from Contracts with Customers* on or before the date of initial application of IFRS 16.

Identification of a Lease

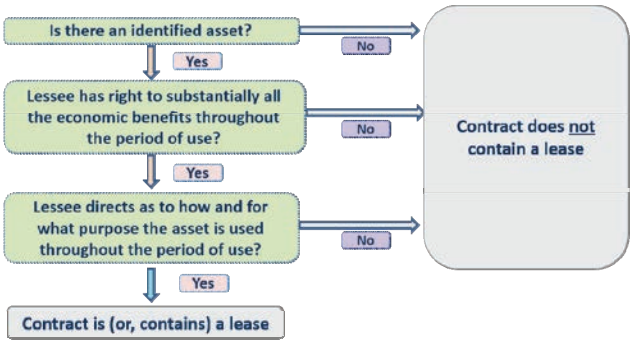
Paragraph 9 of IFRS 16 requires an entity to assess, at the inception of a contract, as to whether the contract is (or, contains) a lease. It further stipulates that a contract is (or, contains) a lease if the contract conveys the right to control the use of an ***identified asset*** for a ***period of time*** in ***exchange for consideration***.

Accordingly, to be considered as a lease, a contract must convey the right to control the ***use of an identified asset***. Typically, an asset is ***specifically identified*** in a contract, though it can also be ***implicitly identified*** at the time it is made available for use by the customer.

However, where a lessor has a ***substantive right of substitution*** throughout the period of use, the lessee does not have a right to use an identified asset.

In contrast, a contract is considered to convey the *right to control the use of an identified asset* if, throughout the period of use, the lessee has the right to (a) obtain substantially all of the economic benefits from the use of the identified asset and (b) direct the use of the identified asset (i.e., direct how and for what purpose the asset is used).

The following chart depicts the key elements that an entity considers in determining whether a contract is, or contains, a lease:



Identifying and Separating Lease and Non-Lease Components

In many situations, a contract may contain a lease coupled with additional non-lease components. For instance, lease of an asset may be accompanied with provision of a maintenance service. In these situations, the non-lease components are *normally* identified and accounted for separately from the lease component, unless the lessee decides to apply a practical expedient envisaged in paragraph 15 of IFRS 16. In cases where a lessee elects to apply a practical expedient, by class of *underlying asset*, then it is not required to separate non-lease components from lease components; rather it can account for each lease component and any associated non-lease components as a single lease component.

If, however, the lessee exercises this policy choice, it is required to allocate the consideration in the contract to the lease and non-lease components on a *relative standalone price basis* in accordance with the principles laid down in IFRS 15 to allocate the consideration in the contract.

Lessee Accounting under IFRS 16

IFRS 16 envisages fundamental changes to the accounting treatment of leases by lessees. Under IAS 17, a lessee is required to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet). However, IFRS 16 eliminates the classification of leases as either operating leases or finance leases ***for a lessee***. Instead, it introduces a ***single, on-balance sheet lease accounting model*** that is similar to current finance lease accounting under IAS 17. IFRS 16 now requires a lessee to recognize (i) a 'right-of-use asset' for virtually all lease contracts and (ii) a corresponding lease liability reflecting future lease payments.

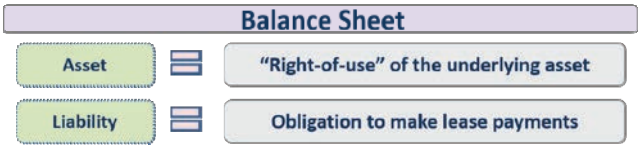
Applying the *single, on-balance sheet lease accounting model*, a lessee is required to recognize:

- assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value; and
- depreciation of lease assets separately from interest on lease liabilities in the income statement

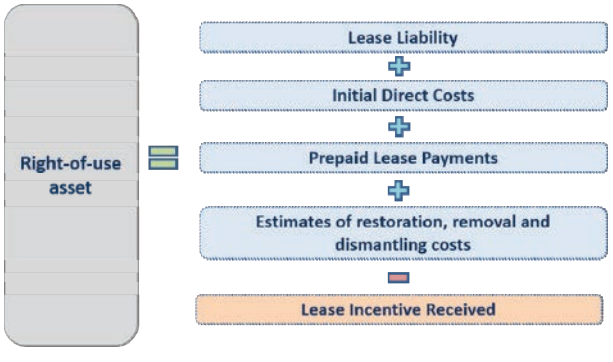
Put differently, IFRS 16 requires that leases are 'capitalized' by recognizing the *present value of the lease payments* and showing them either as *lease assets (right-of-use assets)* or together with property, plant and equipment.

Initial Recognition and Measurement

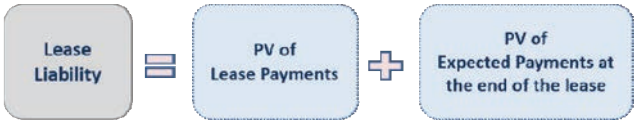
- Paragraph 22 of the new standard requires that a lessee, on commencement of lease, recognizes (i) a right-of-use asset; and (b) a lease liability.
- The *commencement date of the lease* is defined in Appendix A to IFRS 16 as the date on which a lessor *makes an underlying asset available for use by a lessee*.
- Accordingly, a lessee is required to ***initially*** recognize (i) a ***right-of-use asset*** for the right to use the underlying asset for the lease term; and (ii) a lease liability for the obligation to make lease payments – as shown in the below chart:

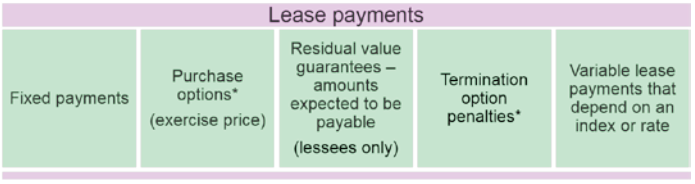


- The right-of-use asset is ***initially measured* at cost**, viz. at the amount of the lease liability, as adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (say, commission) and an estimate of restoration, removal and dismantling costs–as shown in the below chart:



- Likewise, the lease liability-at lease commencement date-is measured at the present value of the lease payments to be made over the lease term, using the effective interest method–as depicted in the below charts:





* Include only if reasonably certain of exercise.

- For this purpose, the lease payments are discounted using the ***interest rate implicit in the lease***, if that rate can be readily determined– else, the ***incremental borrowing rate for the lessee*** is used as the discount rate.
- However, a lessee may elect not to apply the recognition requirements envisaged in IFRS 16 to the following categories of leases:
  - o leases with a lease term of 12 months or less (i.e. short-term leases); or
  - o leases for which the underlying asset is of low value when it is new (even if the effect is material in aggregate)

  It is pertinent to note that the accounting policy election by a lessee for a short-term leases is made by class of *underlying asset*, whereas that relating to leases of low-value assets can be made on a *lease-by-lease basis*.
- If a lessee elects to apply either of the above recognition exemptions, then the lease payments are recognized as an expense on either a straight-line basis over the lease term, or another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

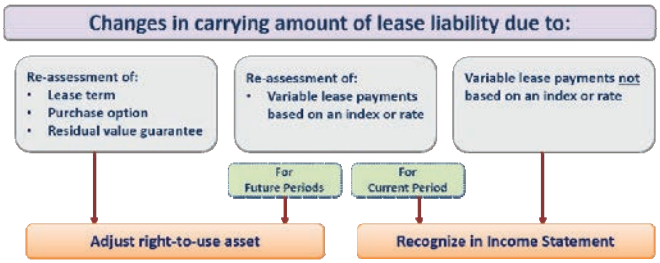
Subsequent Measurement

- After the commencement date, a lessee generally measures the right-of-use asset by applying a cost model at:

  Cost *less* accumulated depreciation *less* accumulated impairment
- However, in the following two situations, *alternative subsequent measurement bases* for the right-of-use asset is potentially applicable for a lessee:
  - o If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee shall also apply that ***fair value model*** to right-of-use assets that meet the definition of investment property in IAS 40; and
  - o If right-of-use assets relate to a class of property, plant and equipment (PPE) to which the lessee applies the revaluation

model in IAS 16, then a lessee may elect to apply that revaluation model to *all of the right-of-use assets* that relate to *that class of the PPE*.

- The related right-of-use asset is depreciated in accordance with the depreciation requirements of IAS 16 Property, Plant and Equipment.
- Further, right-of-use assets are subject to impairment testing and hence a lessee shall apply IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.
- After the commencement date, a lessee – as per para 36 of IFRS 16 – shall measure the lease liability by:
  - o *increasing* the carrying amount to reflect interest on the lease liability;
  - o *reducing* the carrying amount to reflect the lease payments made; and
  - o *re-measuring* the carrying amount to reflect any reassessment or lease modifications specified in paragraphs 39 to 46 of IFRS 16
- Thus, the lease liability is re-measured by the lessee upon the occurrence of certain events (e.g., change in the lease term, change in variable rents based on an index or rate). The following chart summarizes how changes in the carrying amount of lease liability triggered from various events are accounted for:



Presentation

The following table summarizes how a lessee will present leases in its financial statements in accordance with the requirements of the new standard:

Balance Sheet	Income Statement	Cash Flow Statement
Right-of-use assets are either presented separately from other assets on the balance sheet or disclosed separately in the notes to the financial statements	In the Income Statement, Interest expense on the lease liability is presented separately from the depreciation charge for the right-of-use asset	Cash payments for the principal portion of the lease liability is classified within financing activities
Right-of-use assets that meet the definition of investment property under IAS 40 are presented within Investment Property	Interest expense on the lease liability is a component of finance cost, and is presented separately in the income statement	Cash payments for the interest portion of the lease liability is presented consistently with other interest payments
Lease liability is either presented separately from other liabilities on the balance sheet or disclosed separately in the notes to the financial statements		Short-term lease payments, payments for lease of low-value assets and variable lease payments not included in the measurement of lease liability within operating activities

Lessor Accounting under IFRS 16

IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17. Accordingly, a lessor continues to classify each of its leases as either an operating lease or a finance lease, using the same classification principles as in IAS 17.

Initial Recognition and Measurement

- Lessors classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases, viz. *operating leases* and *finance leases*.
- Accordingly, a lease that transfer substantially all the risks and rewards incidental to ownership of the underlying asset is classified by the lessor as a finance lease and all other leases are classified as operating leases.
- For operating leases, a lessor will continue to recognize the underlying asset.
- However, for finance leases, lessors will de-recognize the underlying asset and recognise a net *investment in the lease*-similar to today's requirements in IAS 17. Any selling profit or loss is recognised at lease commencement.

Subsequent Measurement

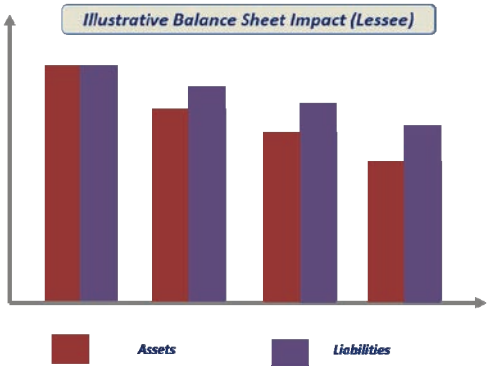
- For operating leases, lessors recognize lease income on either a straight-line basis or another systematic basis that is more representative of the pattern in which benefit from the use of the underlying asset is diminished.
- For finance leases, lessors recognize interest income for the accretion of the net investment in the lease and reduce that investment for payments received.

- The net investment in the lease is subject to de-recognition and impairment requirements in IFRS 9 Financial Instruments.

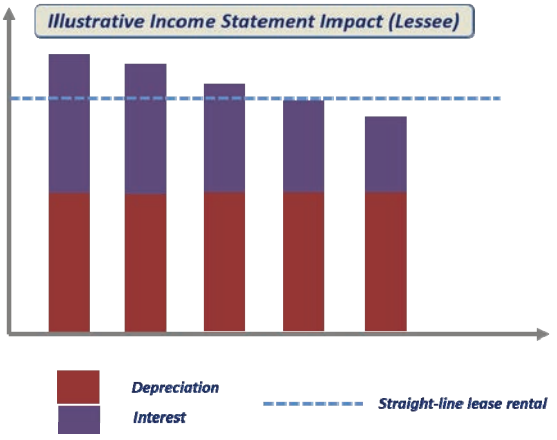
In general, one can say that the *lessor accounting model under IFRS 16* essentially remains unchanged from IAS 17.

Potential Impact of IFRS 16 on Lessee

IFRS 16 is likely to have a significant impact on the financial statements of a number of lessees. The most significant effect of the new requirements in IFRS 16 will be an increase in lease assets and financial liabilities. This is because a lessee is required to account for a right-to-use asset *and* lease liability onto its balance sheet for practically all leases. For companies with material off balance sheet leases, there will be a change to key financial metrics derived from the company's assets and liabilities (for example, leverage ratios). Depending on the particular industry and the number of lease contracts previously classified as operating leases under IAS 17, the new approach will result in a significant increase in debt on the balance sheet. This may impact bank covenants such as Debt/Equity ratio. Entities will need to consider revising bank covenants likely to be impacted upon adversely on adopting IFRS 16. This is depicted in the following chart:



From an Income Statement perspective, under the existing guidance in IAS 17, operating leases are typically expensed on a straight line basis. However, under the requirements of the new standard, a lessee will have to present separately interest expense on the lease liability *and* depreciation on the right-of-use asset in their income statement. In comparison to operating leases under IAS 17, this will change not only the *expense category* but also the *total amount of expenses recognized* for each period of the lease term. The combination of straight-line depreciation of the right-of-use asset and the effective interest rate method applied to the lease liability will result in a ***higher total charge*** to profit or loss in the *initial years of the lease*, and decreasing expenses during the *latter part of the lease term*. In other words, IFRS 16 will have the effect of ***front loading of expenses in the income statement***, which will reduce over the life of the lease. This is depicted in the following chart:



The new guidance under IFRS 16 will also change the cash flow statement, because lease payments that relate to contracts that have previously been classified as operating leases are no longer presented as operating cash flows in full. Only the part of the lease payments that reflects interest on the lease liability can be presented as an operating cash flow (if it is the entity's policy to present interest payments as operating cash flows). Cash payments for the principal portion of the lease liability are classified within financing activities. Payments for short-term leases, for leases of low-value assets, and variable lease payments not included in the measurement of the lease liability are presented within operating activities.

Transition

The new standard permits lessees to use either a full retrospective or a modified retrospective approach on transition for leases existing at the date of transition, with options to use certain transition reliefs. However, once a choice is made by the lessee on the transition methodology, it should be applied consistently to all of its leases. It is pertinent to note that in case a lessee elects to follow modified retrospective approach, then it is not required to restate comparative information. Rather, the cumulative effect of initial application of the new standard is recorded as an ***adjustment to equity*** as at the date of initial application of IFRS 16.

Next Steps

From the preceding discussion, it is evident that IFRS 16 is a significant change from current IFRS – more specifically for lease accounting by lessees. In the best interest, entities should initiate preliminary impact assessment as soon as possible, to determine how the new lease accounting requirement under IFRS 16 will affect their financials and the business processes. Entities will also need to ensure that they have systems, processes and internal controls in place to collect the necessary information to implement the new standard. ■

No one can make you feel inferior without your consent. - Eleanor Roosevelt