

IFRS 16 Leases: Drilling Down

Emerging Economies Group
May 2018

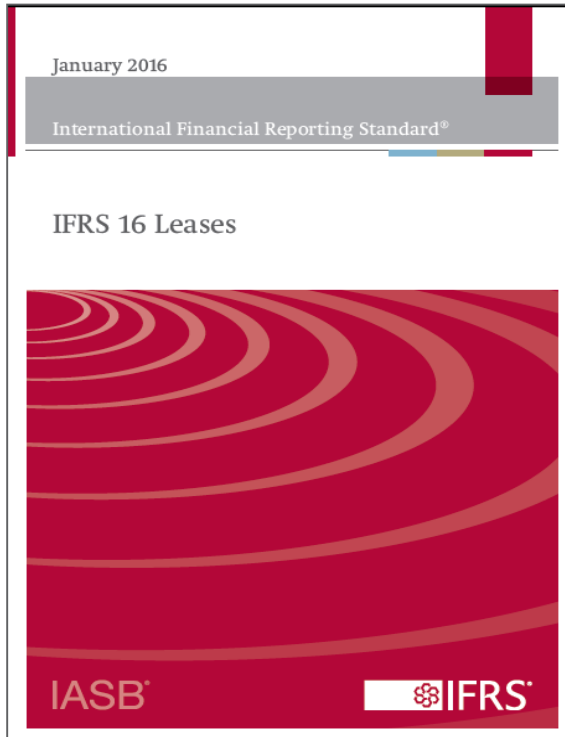
Agenda paper 1A

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

Copyright © IFRS Foundation. All rights reserved

New Leases Standard

2



- **IFRS 16** *Leases* published in January 2016
 - **replaces IAS 17** and related interpretations
 - **changes lessee accounting** substantially
 - little change for **lessors**
- Effective date **1 January 2019**
 - early application permitted (only with application of IFRS 15 *Revenue from Contracts with Customers*)

Program for today

Drilling Down

- Definition of a lease
- Exceptions
- Measurement
- Modifications
- Enforceable rights
- Transition

Definition of a lease

Identified Asset

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



Identified Asset

Substantive Substitution Rights

If the supplier has a **substantive right to substitute** the asset, there is no identified asset and no lease

Supplier has practical ability to substitute



eg: alternative assets are readily available and customer cannot prevent the substitution

AND

Supplier would benefit economically from substituting



eg: ie: benefits of substituting exceed costs

Identified Asset

Portions of assets

A portion of a bigger asset is an identified asset if it is

physically distinct

eg: a **floor of a building**
could be an identified
asset

eg: a **capacity portion**
of a fibre optic cable
is unlikely to be an
identified asset

Right to control the use

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

Right to obtain substantially all **economic benefits**

from use of the asset throughout the period of use

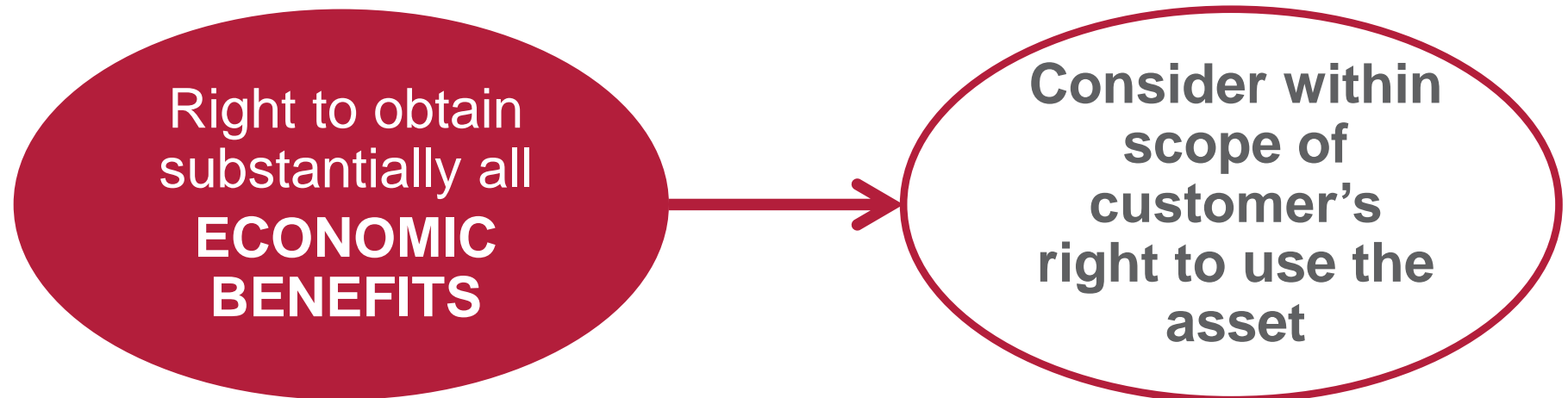
AND

Right to **direct the use**

of the identified asset throughout the period of use

Right to control the use

Economic benefits



Right to control the use

Direct the use

10

Key consideration is which party directs **how and for what purpose** the asset is used throughout the period of use:

Customer

Customer has the right to direct the use

Predetermined

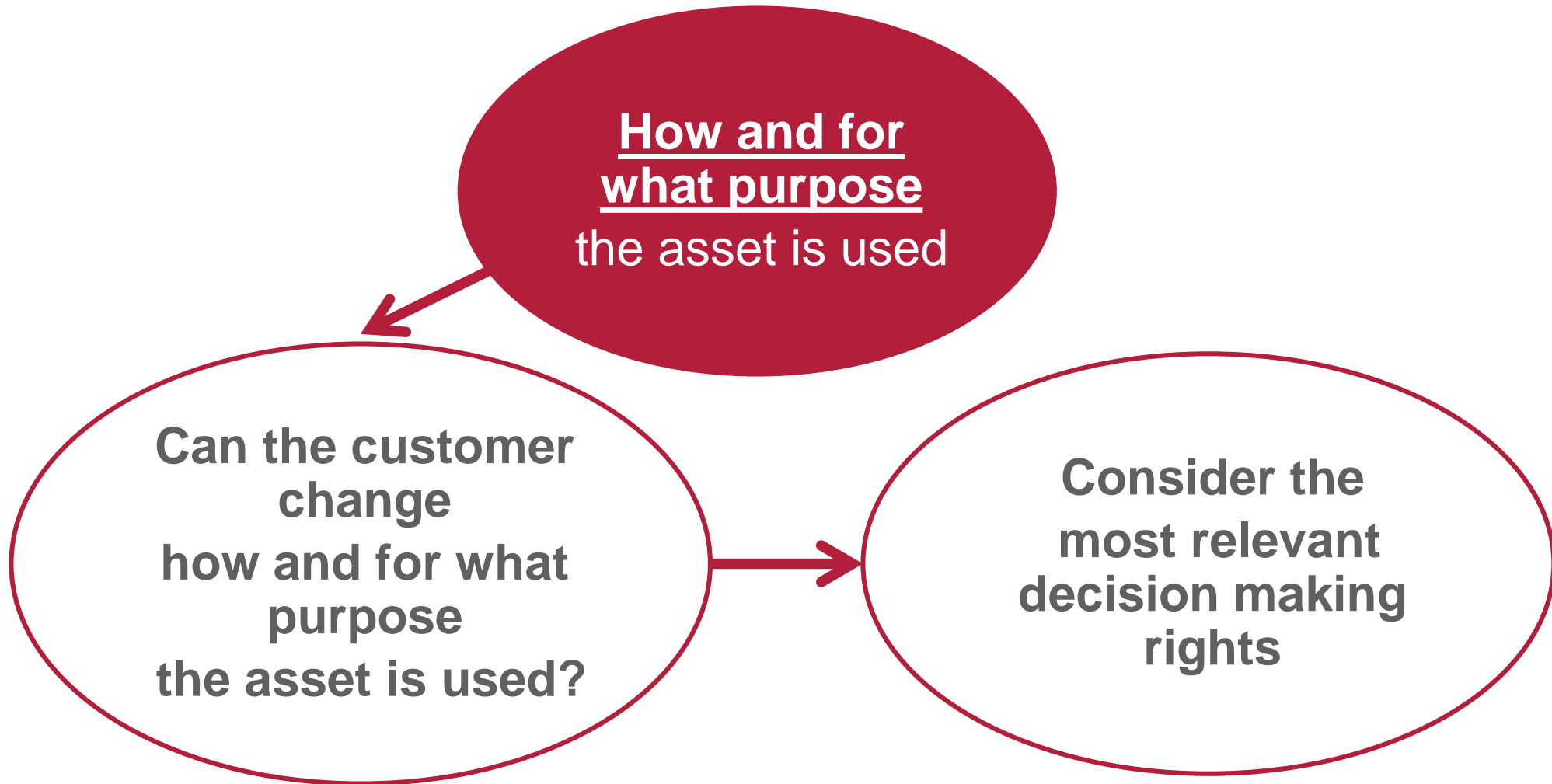
Customer has the right to direct the use **if**:

- customer has the right to operate the asset throughout the period of use; **or**
- customer designed the asset in a way that predetermined how and for what purpose it will be used

Right to control the use

Direct the use

11



IFRS 16

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

IAS 17

An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time

IFRIC 4

An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset.

Example 1

Retail space

Facts:

- Contract for use of retail unit in shopping centre.
- Contract says unit can be used only to operate Retailer's well known brand during hours that centre is open.
- Customer decides on mix of goods sold, selling prices, and inventory held.
- Contract also includes cleaning, security and advertising services.

Factor	Met ?	Comments
Identified asset	√	Retail space is explicitly specified—no substantive substitution rights.
Right to obtain economic benefits from use	√	Retailer has exclusive use of retail space for the contract term.
Right to direct the use	√	Retailer makes all decisions about use of retail space, including the mix and pricing of goods sold. Restrictions on use do not prevent Retailer from controlling the use.



Conclusion:

Example 2

Airport concession

Facts:

- Contract for specified amount of space in airport.
- Space may be at any one of several boarding areas—Airport Operator can change space allocated to Coffee Co at any time.
- Minimal costs associated with changing space—Coffee Co's kiosk can be moved easily.

Factor	Met ?	Comments
Identified asset	X	Coffee Co does not have exclusive use of a particular piece of space in airport.
Right to obtain economic benefits from use	X	Contract is for a specified amount of space but this space can change at any time at direction of Airport Operator.
Right to direct the use	X	N/A.



Conclusion:

Example 3

Shipping Contract

Facts:

- Contract for use of ship (oil tanker).
- Customer decides when and to which ports the ship sails, and the oil to be transported, throughout contract term.
- Shipowner’s crew operate and maintain the ship, and eg decide if waters too hazardous to travel.
- Contract prevents Customer from hiring another operator.

Factor	Met ?	Comments
Identified asset	√	Ship is explicitly specified—no substantive substitution rights.
Right to obtain economic benefits from use	√	Customer has exclusive use of ship for the contract term.
Right to direct the use	√	Customer makes decisions about how and for what purpose the ship is used—it decides where, when and if the ship sails, and what oil is transported.



Conclusion:

Example 4

Outsourcing Contract

Facts:

- Contract to purchase particular type, quality and quantity of shirts.
- Supplier has only one factory that meets needs of Customer—capacity of factory exceeds quantities ordered by Customer.
- Supplier makes all decisions about operations of factory.

Factor	Met ?	Comments
Identified asset	√	Factory is implicitly specified.
Right to obtain economic benefits from use	X	Customer does not have exclusive use of factory—Supplier can decide to use excess capacity to fulfil other customers' contract.
Right to direct the use	X	Customer only specifies output at the beginning of the contract—it has same rights as other customers purchasing shirts.



Conclusion:

Exemptions

Lessee accounting for exempt leases

18

- Recognise **P&L expense** over the life of a lease
 - Typically straight-line
 - Similar to IAS 17 operating leases
 - No balance sheet assets and liabilities (other than prepaid and accrued lease payments)
- **Disclose** expense relating to each exemption in the notes to the financial statements
- Exemptions are **optional**

Short term lease exemption

Requirements

Can be applied to leases with a *lease term of 12 months or less*

Cannot be applied to leases containing a *purchase option*

Apply *by class* of underlying asset

Lease term as defined in IFRS 16—ie need to make *reasonably certain* assessment

Leases of low-value assets exemption

Requirements

20

Can be applied to leases of underlying assets that are of low value



- Low value assessment applies:
- To the value of the underlying asset **when new**
 - On an **absolute basis**, and
 - Irrespective of **materiality**

Apply the exemption on a lease by lease basis

Leases of low-value assets exemption

Requirements

Exemption **cannot** be applied:

- if the underlying asset is **highly dependent on** or **highly interrelated with** other assets
- if the lessee cannot benefit from using the underlying asset **on its own or with other readily available resources**
- if the nature of the underlying asset, when new, is **not typically low value**
- to the **head lease** in a sublease arrangement

Measurement

Measurement of Lease Liability

Overview

23

Determine Lease term

- Extension options
 - Termination options
- } 'Reasonably certain' assessment

Identify lease payments

- Fixed payments
 - including in-substance fixed payments
- Variable lease payments
 - based on an index or a rate
- Residual value guarantees
- Lease incentives
- Exercise price of purchase options
- Termination penalties

Apply Discount rates

- Rate implicit in lease, if readily determinable
- Otherwise, incremental borrowing rate

Determine lease term

Reasonably certain assessment

Is there an *economic incentive* to lease for the longer lease term?

For example:

- ***Favourable terms*** compared to market rates
- Significant ***leasehold improvements***
- Termination or relocation ***costs***
- ***Specialised asset*** or lack of available alternative assets

Other considerations:

Interaction with other contract terms

Past practice

Length of non-cancellable period

Identify lease payments

Variable lease payments

25

Include Variable Lease Payments that depend on an index or a rate

For example:

- Consumer Price Index (*CPI*)
- Benchmark interest rate (eg *LIBOR*)
- Payments that vary with *market rentals*

Initially measure based on index or rate at commencement date

do not forecast future changes in the index or rate

Remeasure only when cash flows change

generally, do not change discount rate

Identify lease payments

In-substance fixed payments

Variable lease payments—how a lessor might cover their risk:

Example:
Minimum rent
clause

E.g. if sales
are less than
CU100, rent
is CU5

In-substance fixed lease
payments of CU5p.a.
included in lease liability

Example: Higher
variable
payments to
compensate risk
of zero return

E.g. variable
payments
based on 7%
of sales

Genuine variability: variable
payments not included in
lease liability, recognise in
P&L when incurred

Interest rate implicit in the lease



Use *if* it can be **readily determined** by the lessee *if not*



Lessee's incremental borrowing rate



The rate of interest that a lessee would have to pay to borrow over a **similar term**, and with a **similar security**, the funds necessary to obtain an asset of a **similar value** to the right-of-use asset in a **similar economic environment**.

Lease liability, adjusted if necessary for:



Prepayments



Lease incentives



Initial direct costs

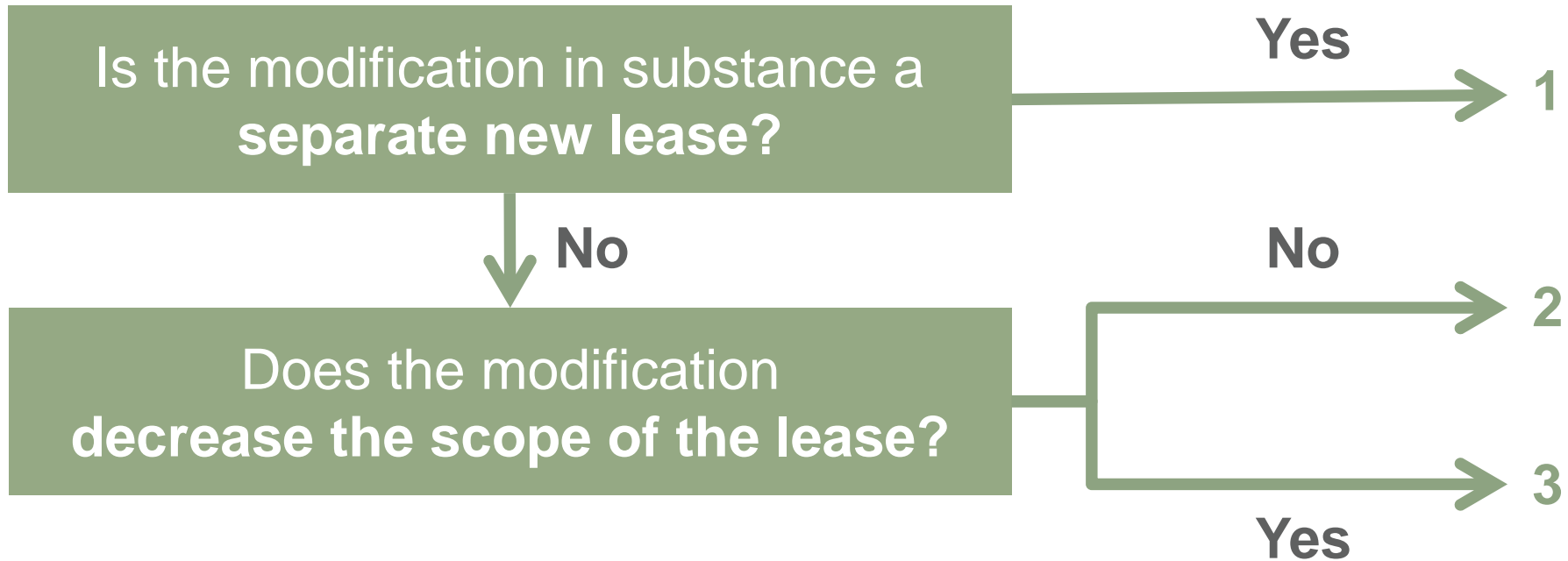


Dismantling/restoration costs

Modifications

Overview: Lease modifications

There are three possible accounting treatments:



1: Separate new lease

A modification is accounted for as a separate new lease **IF**:

- It increases the scope of the lease by adding the right to use one or more underlying assets; **AND**
- Consideration increases by an amount commensurate with the stand-alone price for the increase in scope

In this case, account for the separate new lease
like any other new lease

2&3: NOT a separate new lease

In all cases, need to calculate the **modified lease liability**:

- a. allocate consideration;
- b. determine lease term;
- c. remeasure lease liability by discounting the **revised lease payments** using a **revised discount rate**

Then work out the accounting entries:

- These depend upon whether the modification **decreases the scope of the lease**

2: No decrease in scope

Eg: change in consideration or an increase in scope without a commensurate increase in consideration



- **Adjust lease liability** to reflect the remeasurement
- Make a **corresponding adjustment to the ROU asset**

Eg. **Dr ROU asset**; Cr lease liability

→ Reflects a **change in cost** of the ROU asset

3: Decrease in scope

Eg: less floor space in a property lease or shorter lease term



- Decrease pre-modification ROU asset (and pre-modification lease liability) to reflect partial or full termination
- Recognise any gain or loss in P&L



Eg:
Dr lease liability;
Cr ROU asset;
Dr/Cr loss/gain

For any other elements of the modification (eg change in consideration for remaining ROU asset), make a corresponding adjustment to ROU asset as per previous slide

Effective date of lease modifications

35

Effective date of a lease modification = Date that both parties agree to the modification (ie: date the modified contract is signed)

IFRS 16, 45: Measure the modified lease liability on this date*

Q When should the modified lease liability be recognise

Decrease in scope

Increase in scope, other than lease term

Increase in lease term

*Unless the modification is accounted for as a separate lease

Example:

Effective date before decrease in scope

36

- 10 year lease of 2 floors of a building;
- At the end of year 4, modified contract is signed
- **Modification:** in years 6-10, the lease will be for only 1 floor. The 2nd floor will be returned to the lessor at the end of year 5.

Q

- Why does the lessee recognise the modification, including any gain/loss on partial termination, a year before the 2nd floor is returned?
- How does this reconcile with recognition at commencement of a lease?

Example:

Effective date before increase in scope

37

- 10 year lease of 2 floors of a building;
- At the end of year 4, modified contract is signed
- Modification: in years 6-10, the lease will be for 3 floors. The lessee will get access to the 3rd floor at the end of year 5. The price for the additional floor is not commensurate with the stand-alone price.

- Q
- Does the lessee recognise a right-of-use asset and lease liability with respect to the 3rd floor at the end of year 4 or year 5?

Example:

Modification that increases lease term

38

- 5 year lease of a property;
- At the end of year 4, modified contract is signed
- Modification: lease is extended for a further 5 years (so 10 years in total).

- Q
- Should a lessee account for this modification as a separate new lease?
 - If not, is it correct that a lessee accounts for the 'new' additional lease liability and right-of-use asset at the end of year 4?

IFRS 16, para 45(c)



Re-measure the lease liability using
a **revised discount rate**

Q

The Illustrative Examples on lease modifications use both original and revised discount rates – can you clarify when to use which rate?

Example:

(IFRS 16 Illustrative Example 18)

- 10 year lease of 2,000m² of space;
- Lease payments are £100,000pa
- At the end of year 5, modified contract is signed.
- Modification: (i) include an additional 1,500m² of space; (ii) reduce lease term to 8 years; and (iii) increase annual lease payments to £150,000

Important to remember that **two** things are happening:

- Decrease in scope (reduced lease term); **AND**
- Increase in scope (more space)

Example:

(IFRS 16 Illustrative Example 18)

- Calculate the partial termination of the original lease using the original discount rate (IFRS 16, para 46(a))
 - Calculate reduction in ROU asset and reduction in lease liability; any difference is gain or loss on partial termination
- Calculate the modified lease liability using the modified discount rate (IFRS 16, para 45(c));
 - Make corresponding adjustment to ROU asset (IFRS 16; para 46(b))

- **Unless** there is a separate **new lease**:
 - **measurement** takes place at **effective date of modification**;
 - **recognition** will depend upon **when the lessee has access** to the modified right-of-use asset
- If there are **multiple elements** to a modification (eg an increase AND a decrease in scope), think about each element separately
- Use **modified discount rates** unless calculating the gain or loss on a partial termination/decrease in scope
- Use **Illustrative Examples**. IE15-19 cover different lease modification scenarios in detail, including double entry

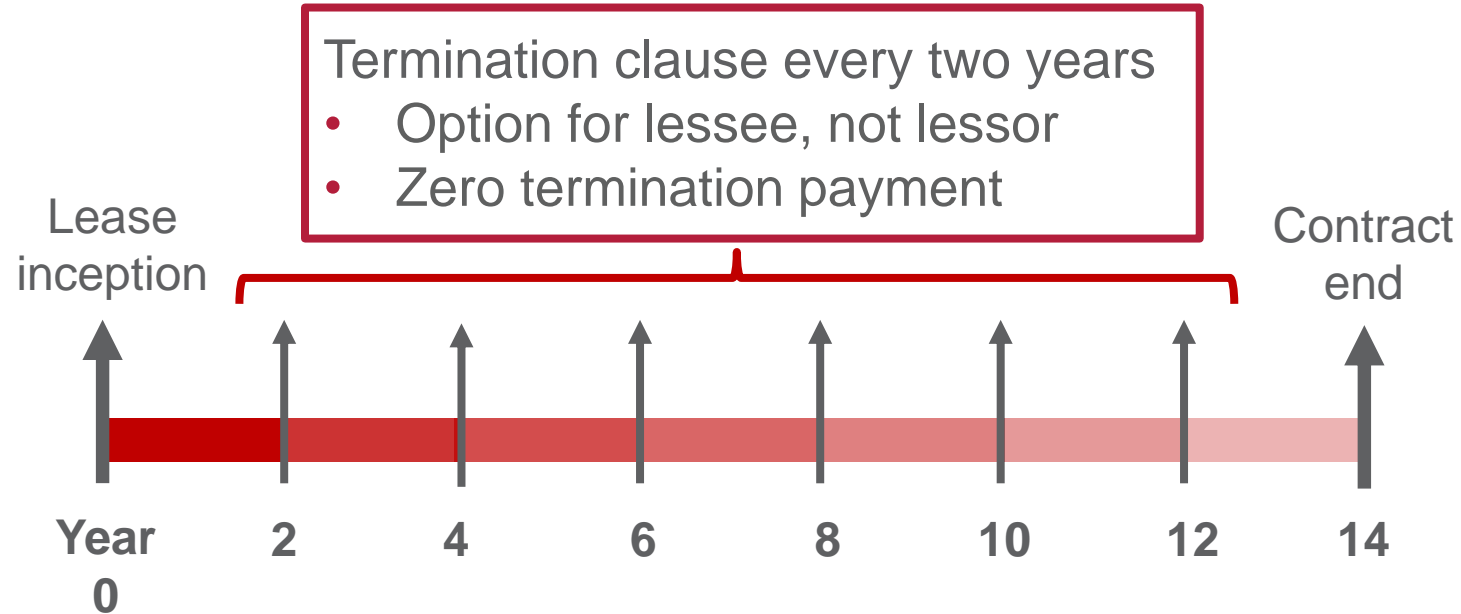
Enforceable rights

IFRS 16; paragraph B34:

....A lease is no longer enforceable when the lessee and the lessor each has the **right to terminate** the lease without permission from the other party with **no more than an insignificant penalty**

Example 1

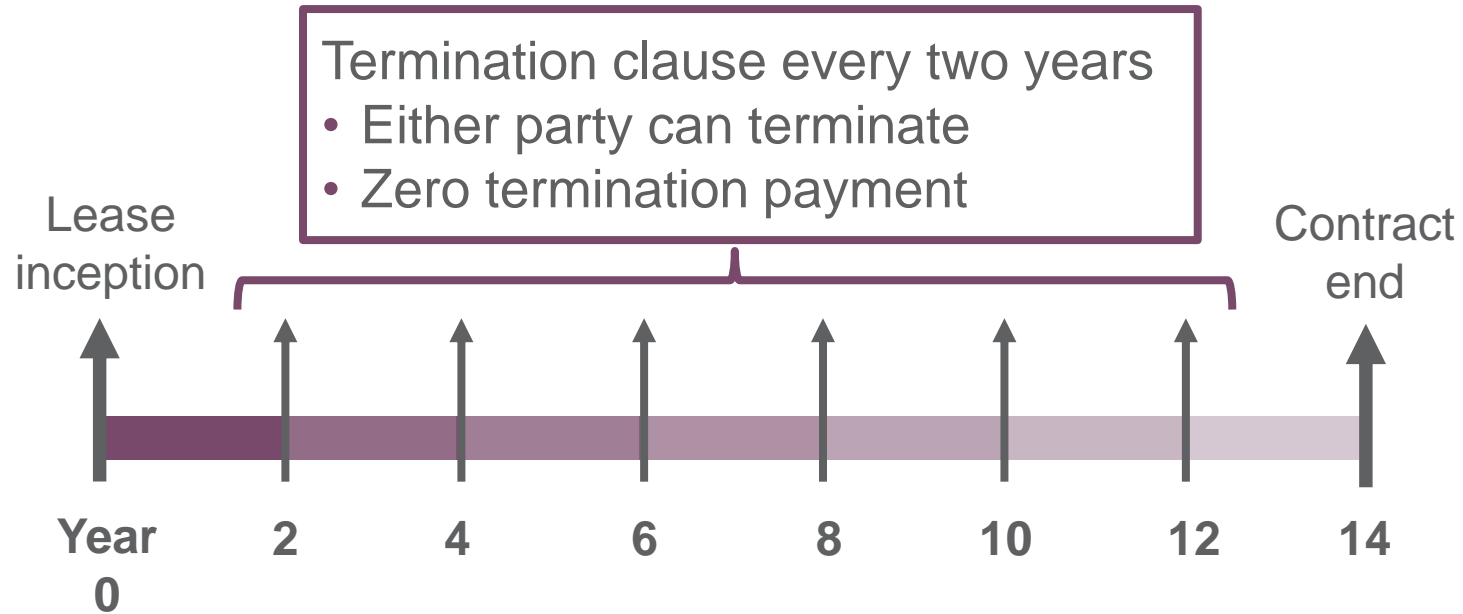
Zero penalty termination - lessee



Q: Is the lease enforceable after 2 years?
What is the lease term?

Example 2

Zero penalty termination – both parties

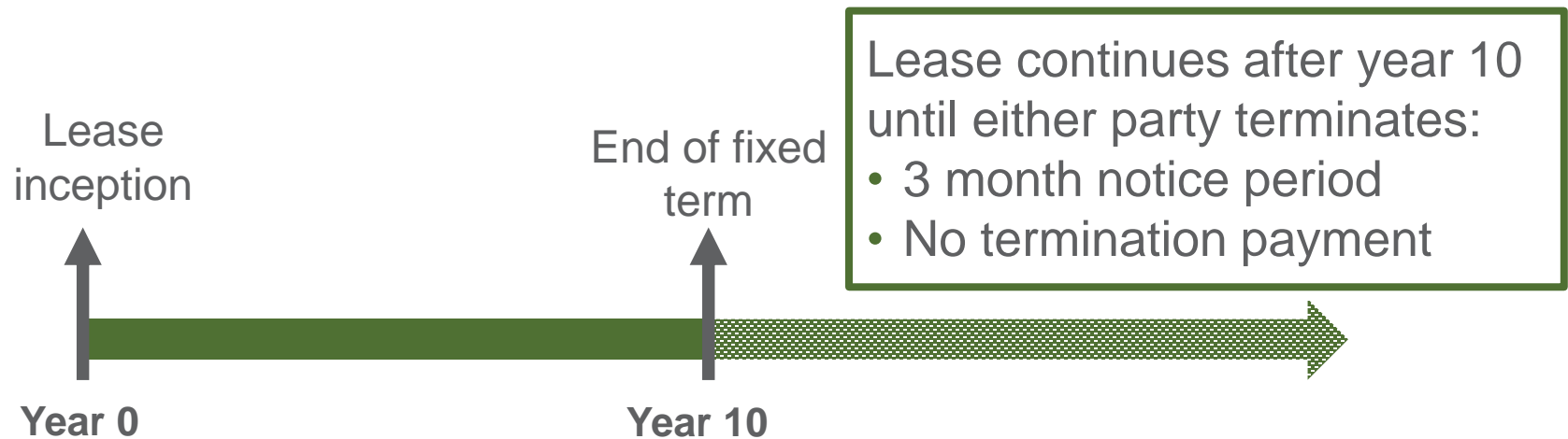


Q: Is the lease enforceable after 2 years?
What is the lease term?

Example 3

Lease continues until either party terminates

47

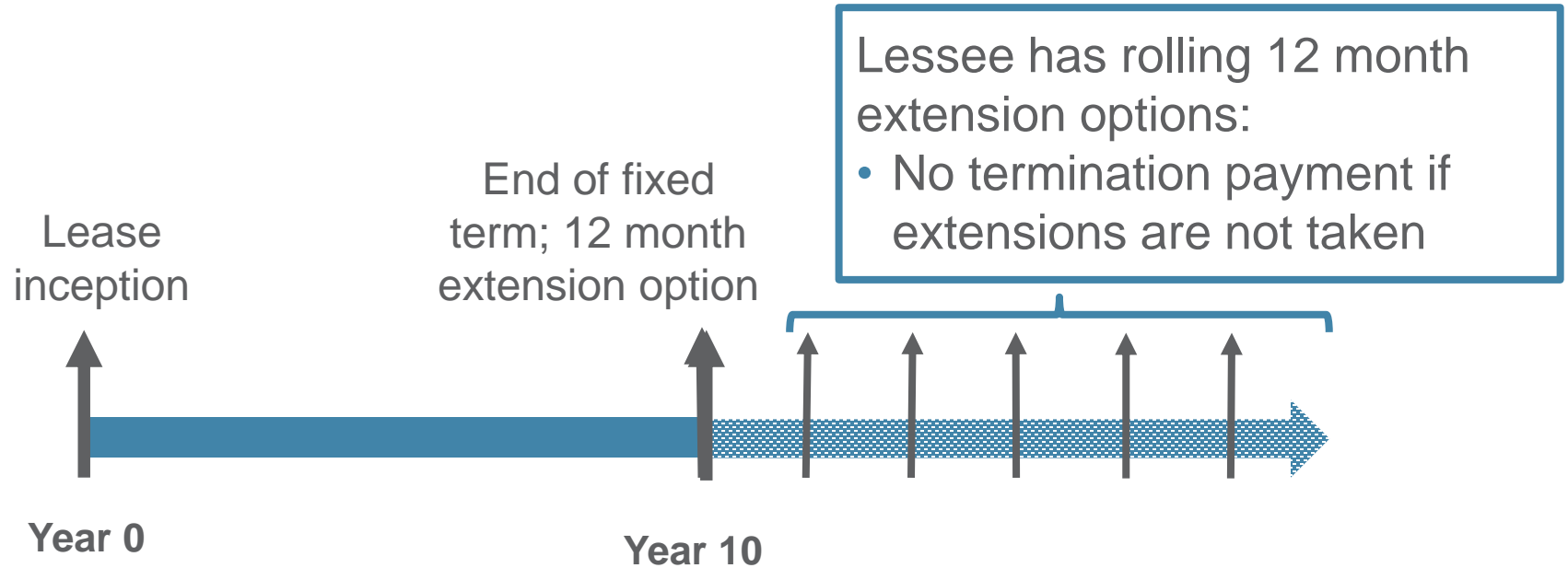


Q: Is the lease enforceable after 10 years?
What is the lease term?

Example 4

Lease continues until either party terminates

48



Q: If an extension option is taken at the end of year 10, is it a short-term lease?

Disclosures

- Two main elements to IFRS 16 disclosures:

**Mandatory
quantitative
information**



Information that users want to see for **all** material lease portfolios

**Additional
entity specific
information**



Companies **apply judgement** to determine whether and what further information is needed to meet the disclosure objectives

- To be disclosed whenever material:

Information about lease costs, cash flows and assets

- Breakdown of lease costs
- Total lease cash flows
- ROU assets by major class of leased asset
- Additions to ROU assets

Maturity analysis

- Maturity analysis of lease commitments
 - as for all other financial liabilities
 - apply judgement in determining time bands

- To be disclosed whenever material:

Information about lease costs, cash flows and assets

- Breakdown of lease costs
- Total lease cash flows
- ROU assets by major class of leased asset
- Additions to ROU assets

Maturity analysis

- Maturity analysis of lease commitments
 - as for all other financial liabilities
 - apply judgement in determining time bands

- Two main elements to IFRS 16 disclosures:

**Mandatory
quantitative
information**



Information that users want to see for **all** material lease portfolios

**Additional
entity specific
information**



Companies **apply judgement** to determine whether and what further information is needed to meet the disclosure objectives

Additional Entity-Specific Information

54

- Lessee to apply judgement about what is relevant:

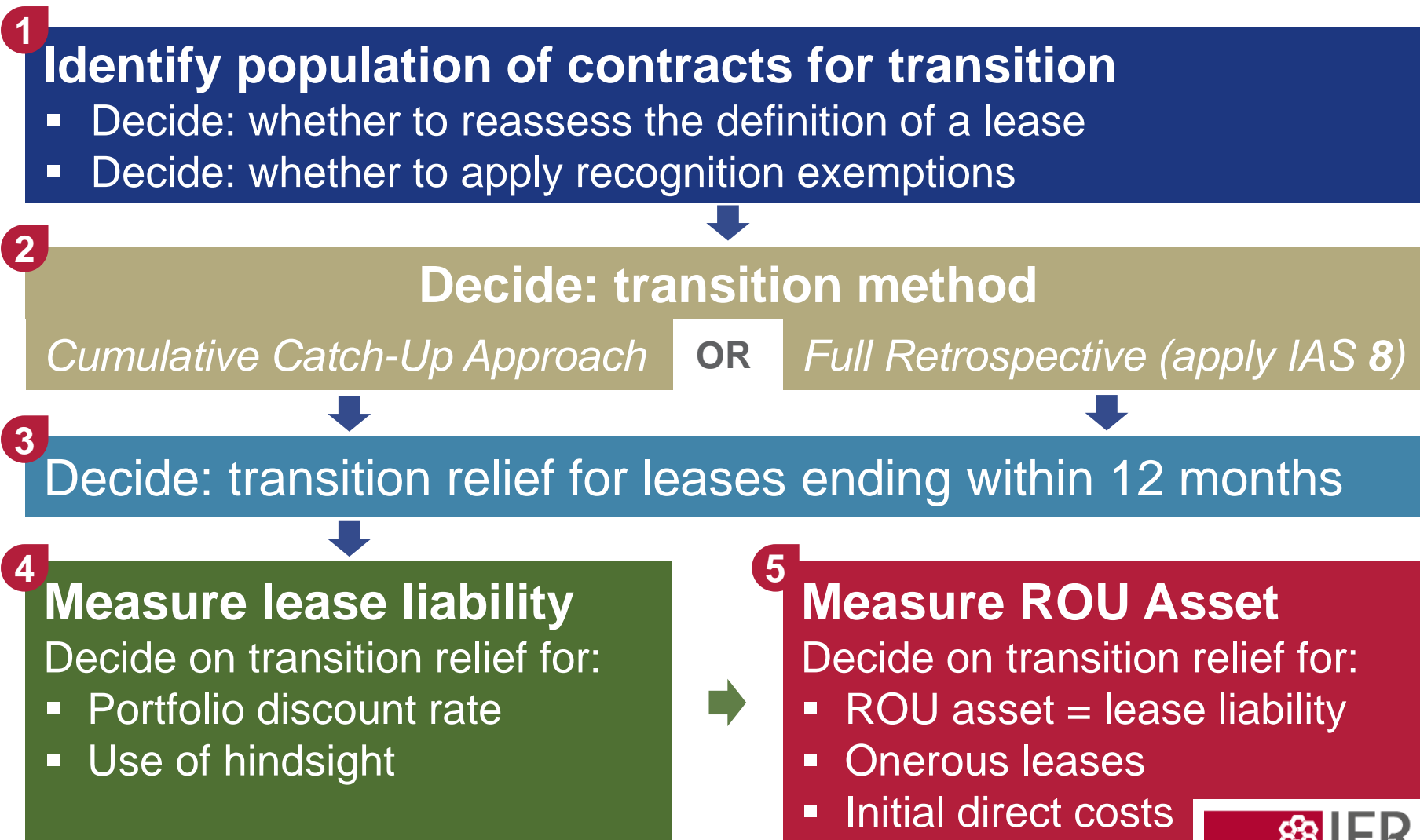
Extension and termination options	Variable lease payments	Residual value guarantees	Sale & leaseback transactions
<p>For example....</p> <ul style="list-style-type: none">• Why have them?• Prevalence within lease portfolio• Relative magnitude of optional payments vs committed payments• Exercise of options not recognised on balance sheet	<p>For example....</p> <ul style="list-style-type: none">• Why have them?• Prevalence within lease portfolio• Relative magnitude of variable payments vs fixed payments	<p>For example....</p> <ul style="list-style-type: none">• Why have them?• Nature of relevant assets• Prevalence within lease portfolio• Magnitude of exposure to residual value risk	<p>For example....</p> <ul style="list-style-type: none">• Why use them?• Prevalence• Key terms and conditions• Payments not recognised on balance sheet• Cash flow effect

- Key Considerations

What information
is **monitored**
and **reported**
internally?

What information
is used in
decision
making?

Transition



1 Identify population of contracts

58

Decision: reassess the definition of a lease?

Reassess

OR

Don' Reassess

How?

- Apply IFRS 16 definition of a lease requirements to all existing contracts

Benefits?

- Small number of IAS 17 leases might be services applying IFRS 16

How?

- Transition all existing operating leases
- Apply *definition of a lease* only to contracts entered after date of transition

Benefits?

- Cost relief on transition
- Change in outcome expected for very few contracts

1 Identify population of contracts

Decision: recognition exemptions for short-term leases and leases of low-value assets

Apply

OR

Don' Apply

How?

How?

Continue to account for these leases similarly to IAS 17 operating leases

Recognise ROU assets and lease liabilities for all leases

Benefits?

Benefits?

Cost relief on transition: smaller population of ROU assets and lease liabilities recognised on balance sheet

Ongoing simplicity: one accounting model applied to all leases

2 Decision: *Transition method*

60

Fully Retrospective

OR

Cumulative Catch up

How?

Apply IAS 8:

- As if IFRS 16 always applied
- Restate comparatives
- Disclose effect on each line item

Benefits?

Better quality of reported information in transition year

How?

- Cumulative effect of initial application in opening equity
- Do not restate comparatives
- Consider additional reliefs
- Disclose effect of applying cumulative catch-up method

Benefits?

Significant cost relief

3 Decision:

Relief for leases ending within 12 months

61

Apply

How?

- Do not recognise ROU assets and lease liabilities for these leases
- Account for an disclose similarly to short-term leases

Benefits?

Cost relief: smaller population of contracts to transition

OR

Don't Apply

How?

- Apply transition requirements in IFRS 16 to these leases
- ie recognise ROU asset and lease liability

Benefits?

Comparability benefits – transition year better reflects ongoing lease portfolio

4 Measure lease liability

62

Measure lease liability at present value of remaining lease payments

Fixed payments
(including inflation-linked
payments)

Optional payments
(if reasonably certain)

Residual value
guarantees

Discounted

At date of
transition, ie
no backward
looking
information
required

4 Measure lease liability

63

Decision: whether to apply transition relief for -

Portfolio discount rate

OR

Use of hindsight

How?

Apply single discount rate to leases with similar characteristics

Benefits?

Cost relief on transition, 'portfolios' of lease liabilities could be measured collectively in some circumstances

How?

Eg, use hindsight in determining lease term

Benefits?

- Better quality: extension and termination options accurately reflected
- Cost relief: no need for 'what if' consideration

5 Measure ROU Asset

64

Decision: *how to measure ROU asset on lease-by-lease basis*

ROU asset = lease liability

OR

Measure retrospectively

How?

Measure ROU asset = lease liability (adjusted for prepaid or accrued lease payments)

Consequence?

ROU asset 'too high' – higher depreciation expense

Benefits?

- Cost relief on transition
- Most benefit for high-volume/low-value leases

How?

Measure as if IFRS 16 always been applied. Calculate:

- Asset value at lease commencement
- Accumulated depreciation at date of transition

Benefits?

- Accurate asset measurement
- Most benefit for individually significant leases

5 Measure ROU Asset

65

Decision: whether to apply transition relief for:

Onerous leases

OR

Initial direct costs

How?

- Do not assess each asset for impairment at date of transition
- Adjust asset by amount of any previous onerous lease provision

Benefits?

Cost relief on transition: no need to perform ROU asset impairment reviews

How?

Exclude initial direct costs from ROU asset measurement

Benefits?

Cost relief on transition: no need to identify or account for historic initial direct costs

- Leases website

<http://www.ifrs.org/Current-Projects/IASB-Projects/Leases>

- Effects analysis

<http://go.ifrs.org/Leases/effects-analysis>

- Project summary and feedback statement

<http://go.ifrs.org/Leases/project-summary>

- Register for email alerts

<http://eifrs.ifrs.org/eifrs/Register>

IFRS 16 implementation page

go.ifrs.org/IFRS16-implementation

Webcasts and podcasts by IASB staff

IFRS 16 Leases: Implementation

IFRS 16 Leases was issued by the International Accounting Standards Board (the Board) on 13 January 2016 and has a mandatory effective date of 1 January 2019. The Board is currently undertaking a number of activities to support implementation of the Standard. This page will be updated throughout the implementation phase with information relating to these activities.

Educational and implementation materials






In addition to the materials provided with IFRS 16 itself, including the Illustrative Examples, various materials that support implementation of IFRS 16 have already been published or are planned. These are summarised below. Throughout the implementation phase, the Board will monitor implementation and will consider whether additional materials might be helpful.

Materials published alongside IFRS 16

<i>Video: IASB Chairman Hans Hoogervorst introduces the new Leases Standard</i>	January 2016
<i>Project Summary and Feedback Statement</i>	January 2016
<i>Effect Analysis</i>	January 2016

Webcasts and podcasts by IASB staff

<i>Introducing IFRS 16</i>	January 2016
<i>Transition to IFRS 16</i>	March 2016
<i>IFRS 16: Definition of a lease</i>	April 2016
<i>IFRS 16: Exemptions—Discussion with Board Member Sue Lloyd</i>	April 2016

Title	Slides	Date Live
<i>Introducing IFRS 16</i>		January 2016
<i>Transition to IFRS 16</i>		March 2016
<i>IFRS 16: Definition of a lease</i>		April 2016
<i>IFRS 16: Exemptions—Discussion with Board Member Sue Lloyd</i>		April 2016
<i>IFRS 16: Lessee Measurement</i>		June 2016



Contact us

68

Keep up to date



@IFRSFoundation



IFRS Foundation



www.ifrs.org



IFRS Foundation

Comment on our work



go.ifrs.org/comment