IFRS 16 - Leases

CPD Activity

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Presenter:

Mian Ahmad Farhan, FCA

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Disclaimer

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Hans Hoogervorst discusses the lease accounting Standard IFRS Foundation

https://youtu.be/gBQ6Z5j9Lko

NEWS

- **IFRS 16 will bring $2.8trn worth of lease commitments that are currently off balance sheet. These will be included in to the balance sheets of the world's listed companies as assets and liabilities**
- **The profession has hailed the new leasing standard as "one of the most significant developments to date in the world of international financial reporting"**
- **The new standard, which comes into operation on 1-1-2019, will affect around 50% of the world's listed companies, particularly those in the airline, retail and travel/leisure sectors. Currently, the IASB says, the value of the off balance sheet leases of some airlines is equivalent to more than 100% of the value of the airline's total assets.**
- **Under IAS 17 the understatement of long-term liabilities by the heaviest users of off balance sheet leases is as high as 45% in Latin America and 32% in Asia/Pacific. The lowest understatement is in North America (22%) and Europe (26%). Africa comes in at 27%.**

Why a new leasing standard?

- Currently analysts adjust financial statements for off-balance sheet leases

- Under IFRS 16, companies will bring these leases on balance sheet, using a common methodology

IFRS 16 – Main Features

LESSEE ACCOUNTING

- IFRS 16 introduces a **<u>single lessee accounting model</u>** and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.
- A lessee is required to recognise a **<u>right-of-use asset</u>** representing its right to use the underlying leased asset and a **<u>lease liability</u>** representing its obligation to make lease payments.

Main Features

- A lessee measures right-of-use assets similarly to other **non-financial assets** (such as property, plant and equipment) and lease liabilities similarly to other **financial liabilities**.
- As a consequence, a lessee recognises **depreciation** of the right-of-use asset and **interest** on the lease liability, and also classifies cash repayments of the lease liability into a **principal portion and an interest portion** and presents them in the statement of cash flows applying IAS 7 *Statement of Cash Flows.*

Main Features

- Assets and liabilities arising from a lease are initially measured on a **present value basis**.
- The measurement includes **non-cancellable lease payments** (including inflation-linked payments), and also includes payments to be made in **optional periods** if the lessee is reasonably certain **to exercise an option** to extend the lease, or **not to exercise an option** to terminate the lease.

Main Features

- IFRS 16 contains disclosure requirements for lessees.
- Lessees will need to apply **judgement** in deciding upon the information **to disclose** to meet the objective of providing a basis for **users** of financial statements **to assess the effect** that leases have on the financial position, financial performance and cash flows of the lessee.

Main Features

LESSOR ACCOUNTING

- IFRS 16 substantially carries forward the lessor accounting **requirements in IAS 17**.
- Accordingly, a lessor continues to classify its leases as **operating leases or finance leases**, and to account for those two types of leases differently.

Main Features

- IFRS 16 also requires **enhanced disclosures** to be provided by lessors that will improve information disclosed about a lessor's risk exposure, particularly to **residual value risk**.

Definitions

As defined in the Appendix A of the standard

Scope

As described in the standard

Effective date

The big change for lessees

The end of the road for operating leases!

The new IFRS 16 Leases introduces **a single lessee accounting model** where all leases will be accounted for in a similar manner to the way in which finance leases are currently accounted for.

Example

- Background information

  Entity A entered into a **3 year lease** of an administration building with the following lease payments, **payable at the end of each year**:
  - Rs. 50,000 per month for the first year;
  - Rs. 60,000 per month for the second year; and
  - Rs. 70,000 per month for the third year.

Example

- Accounting Treatment in terms of the Current IAS 17
  - Operating lease
  - Why?
    - The lease does not transfer substantially all the risks ad rewards incidental to ownership of the building to the lease

Example

- Accounting Treatment in terms of the **current IAS 17**
- The even operating lease expense over the 3 years of the operating lease can be calculated as follows:

	Rs.
– Lease payments in year 1 (50,000x12)	600,000
– Lease payments in year 2 (60,000x12)	720,000
– Lease payments in year 3 (70,000x12)	840,000
Total Lease payments over the lease term	**2 ,160,000**

Even operating lease expense for the year 1 – 3

(2,160,000 / 3 years) = 720,000

Example

- Accounting Treatment in terms of the **Current IAS 17**
- Journal entries for year 1

		AED	AED
Operating lease expense	**Dr.**	720,000	
Bank	**Cr.**		600,000
Accrual Liability	**Cr.**		120,000

Example

- Accounting Treatment in terms of the **Current IAS 17**
- Journal entries for year 2

		AED	AED
Operating lease expense	**Dr.**	720,000	
Bank	**Cr.**		720,000

Example

- Accounting Treatment in terms of the **Current IAS 17**
- Journal entries for year 3

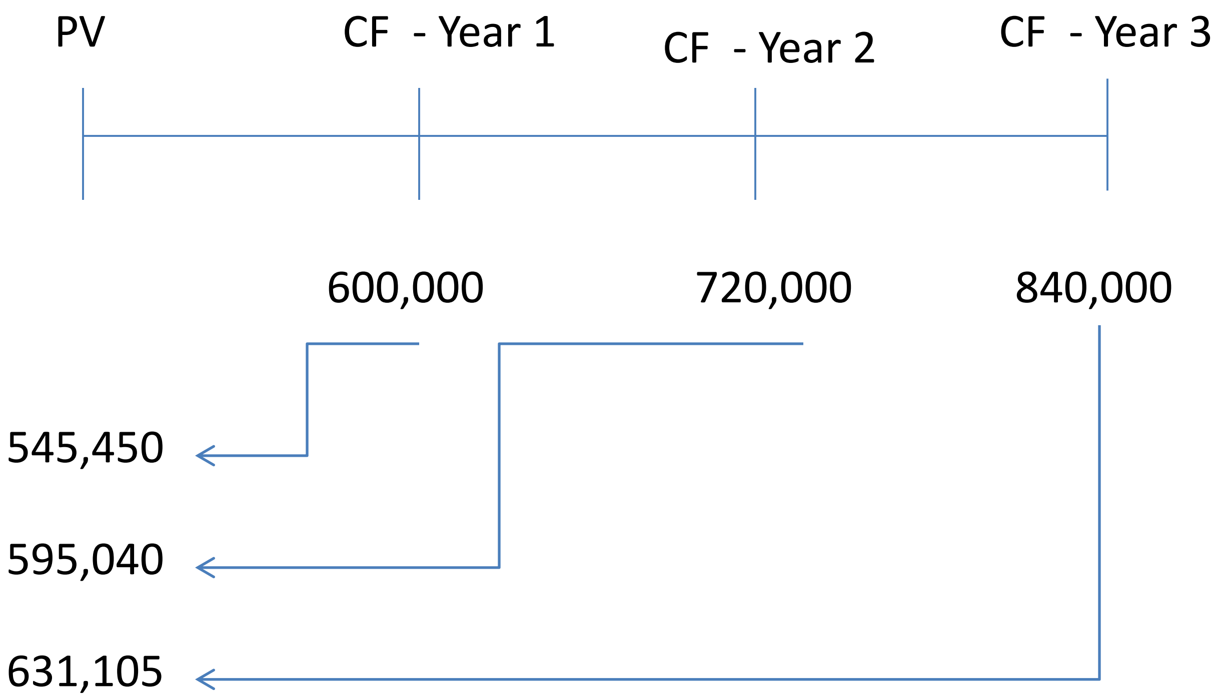
		AED	AED
Operating lease expense	**Dr.**	720,000	
Accrual Liability	**Dr.**	120,000	
Bank	**Cr.**		840,000

Example

Accounting Treatment in terms of the **<u>New IFRS 16</u>**

Time Line

@ 10%



PV of Future Cash Flows = 1,771,595

Example

- Accounting Treatment in terms of the **<u>New IFRS 16</u>**
- **<u>Amortization Table</u>**

Year	Cash lease payments	Interest expense	Principal repaid	Closing Balance
0	-	-	-	1,771,595
1	600,000	177,160	422,840	1,348,755
2	720,000	134,875	585,125	763,630
3	840,000	76,370	763,630	-
Total	2,160,000	388,405	1,771,595	-

Example

Accounting Treatment in terms of the **New IFRS 16**

Journal entry of day 1 of the lease

	AED	AED
Right-of-use asset **Dr.**	1,771,595	
Lease liability **Cr.**		1,771,595

Example

Accounting Treatment in terms of the **New IFRS 16**

Journal entry for the year 1 of lease

		AED	AED
Interest expense	**Dr.**	177,160	
Lease liability	**Dr.**	422,840	
Bank	**Cr.**		600,000

Amortization expense Dr.	590,532	
Accumulated amrt exp Cr.		590,532

(1,771,595 / 3 years = 590,532)

Example

Accounting Treatment in terms of the **New IFRS 16**

Journal entry for the year 2 of lease

		AED	AED
Interest expense	**Dr.**	134,875	
Lease liability	**Dr.**	585,125	
Bank	**Cr.**		720,000
Amortization expense	**Dr**	590,532	
Accumulated amrt exp	**Cr**		590,532

(1,771,595 / 3 years = 590,532)

Example

Accounting Treatment in terms of the **<u>New IFRS 16</u>**

Journal entry for the year 3 of lease

		AED	AED
Interest expense	**Dr.**	76,370	
Lease liability	**Dr.**	763,630	
Bank **Cr.**			840,000

Amortization expense	**Dr**	590,531	
Accumulated amrt exp	**Cr**		590,531

(1,771,595 / 3 years = 590,531.66)

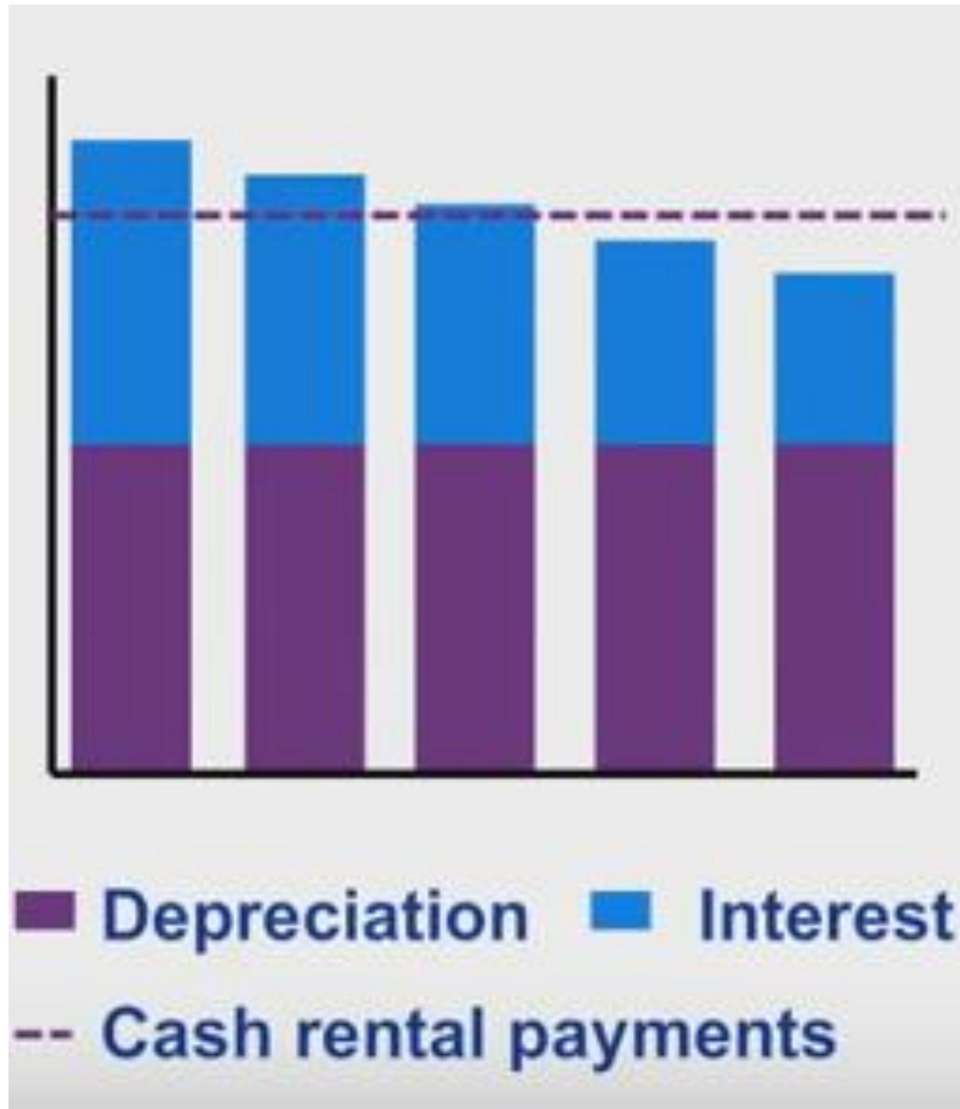
Example

Impact on the **Statement of Profit or Loss**

SOPL	Year 1		Year 2		Year 3	
	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16
Operating lease exp	720,000		720,000		720,000	
Interest expense		177,160		134,875		76,370
Amortization expense		590.532		590,532		590,532
Total expense	**720,000**	**767,692**	**720,000**	**725,407**	**720,000**	**666,902**

Impact on SoPL

Total lease expense will now be **<u>front-loaded</u>** even when cash rentals are constant



Example

Impact on the **Statement of Financial Position**

SOFP	Year 1		Year 2		Year 3	
	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16
Right-of-use asset	0	1,181,063	0	590,532	0	0
Lease liability	0	1,348,755	0	763,630	0	0
Net Asset or Net Liability		(167,692)		(173,098)	0	0

Impact on SoFP

Companies with operating leases will now appear to be **more asset-rich**, but also more **heavily indebted**

Example

Impact on the **Statement of Cash Flows**

SOCF	Year 1		Year 2		Year 3	
	IAS 17	IFRS 16	IAS 17	IFRS 16	IAS 17	IFRS 16
Operating cash flows	(600,000)	(177,160)	(720,000)	(134,875)	(840,000)	(76,370)
Financing cash flows	0	(422,840)	0	(585,125)	0	(763,630)
Total impact	(600,000)	(600,000)	(720,000)	(720,000)	(840,000)	(840,000)

Reasons for issuing IFRS 16

- **Greater transparency** of the lessee's
  - Financial leverage, and
  - Capital employed
- **Complete and understandable picture** of an entity's leasing activities
- Address concerns around "**off-balance sheet**" finance through the use of operating leases

Financial impacts - Lessee

	Profit/loss	Balance sheet	Ratios
↑	EBITDA	Total assets	Gearing
↓	EPS (in early years)	Net assets	Interest cover Asset turnover

Financial impacts - Lessee

Capitalization of former operating leases

- Some financial ratios and measures will change for the worse
- But all companies will be impacted to some degree

Key Ratios/Measures	Effect of IFRS 16
EBITDA	+
Gross Margin	None
Operating Efficiency Ratio	+
Current Ratio	- (more liabilities)
Quick Ratio	- (more liabilities)
Net Worth	None
Debt/Equity Ratio	- (more debt plus less equity)
Return on Assets (RoA)	- (more assets plus front ended costs)
Return on Equity (RoE)	+/- (?) (less equity but front ended costs)

Determine When to Apply IFRS 16

- Step 1

  Identify a lease

- Step 2

  Chose whether to apply the practical expedients

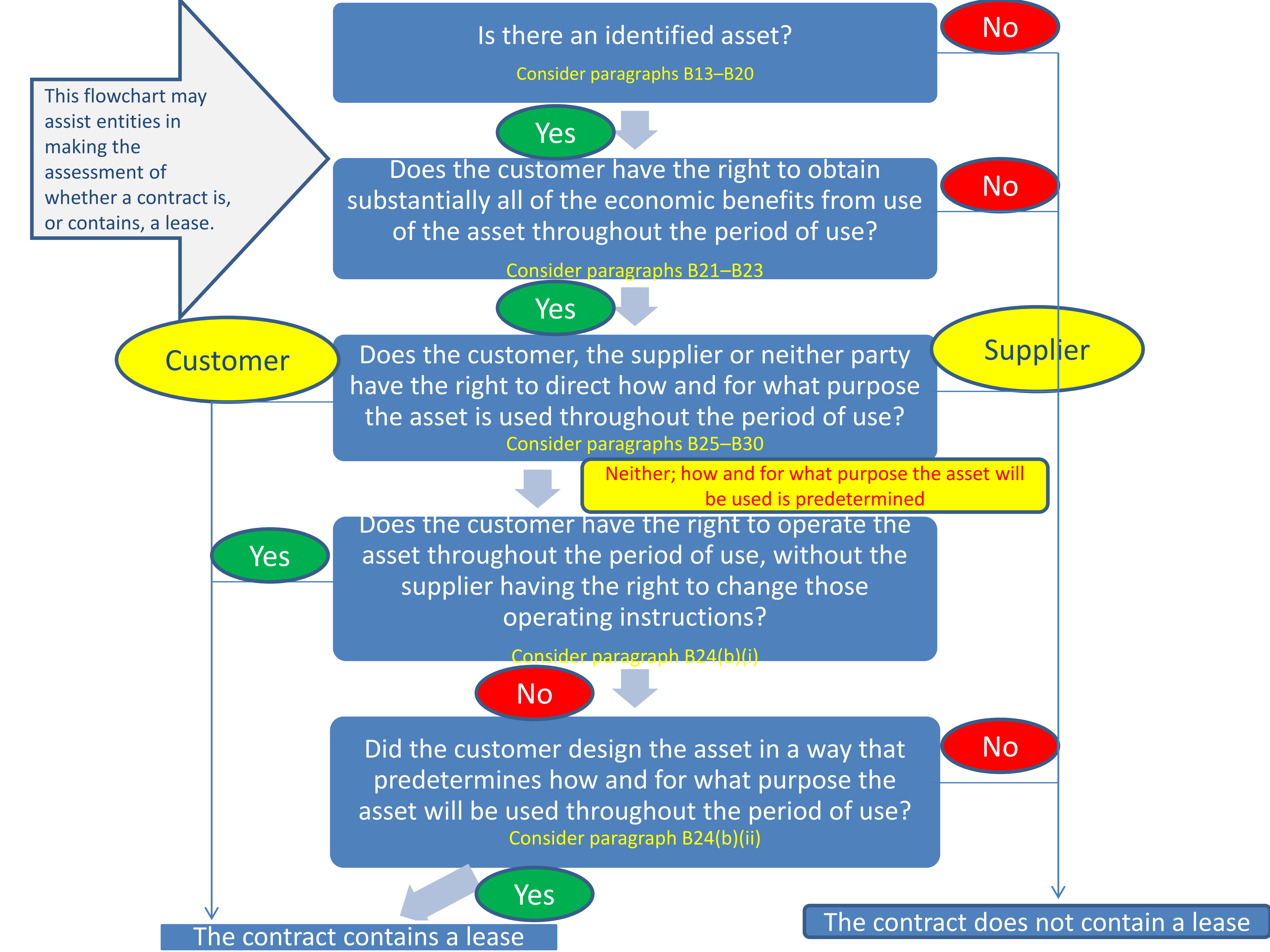
- Step 3

  Separate Lease and Non-lease Components

Step 1 - Identify a Lease

- At inception of a contract, an entity shall assess whether the **contract is**, or **contains**, a lease

- A contract is an agreement between two or more parties that creates **enforceable** rights and obligations


This flowchart may assist entities in making the assessment of whether a contract is, or contains, a lease.
Is there an identified asset?
Consider paragraphs B13–B20
No
Yes
Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?
Consider paragraphs B21–B23
No
Yes
Customer
Does the customer, the supplier or neither party have the right to direct how and for what purpose the asset is used throughout the period of use?
Consider paragraphs B25–B30
Supplier
Neither; how and for what purpose the asset will be used is predetermined
Yes
Does the customer have the right to operate the asset throughout the period of use, without the supplier having the right to change those operating instructions?
Consider paragraph B24(b)(i)
No
Did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use?
Consider paragraph B24(b)(ii)
No
Yes
The contract contains a lease
The contract does not contain a lease

Identified Asset

- **Explicitly** specified in a contract
- **Implicitly** specified at the time that the asset is made available for use by the customer
  - Even if an asset is specified, a customer does not have the right to use an identified asset if the **supplier has the substantive right to substitute** the asset throughout the period of use

Identified Asset

- A supplier's right to substitute an asset is **substantive** only if both of the following conditions exist:
  - The supplier has the **practical ability to substitute** alternative assets **throughout the period** of use; and
  - The **supplier would benefit economically** from the exercise of its right to substitute the asset

Rights to Obtain Economic Benefits from Use

- Directly or indirectly, such as **by using, holding or subleasing the asset**
  - Example, exclusive use of the asset throughout that period
- The **economic benefits** from use of an asset include:
  - Its primary output;
  - By-products (including potential cash flows derived from these items); and
  - Other economic benefits from using the asset that could be realized from a commercial transaction with a third party

Step 2 - Chose whether to apply the practical expedients

Two Practical Expedients

A lessee may elect to **not apply the single lessee accounting model** to

1. **Short-term** leases; and
2. Leases for which the underlying asset is of **low value**

Short Term leases

- A lease that at the commencement date, has a lease term of **12 months or less**.
- A lease that contains a **purchase option** is not a short-term lease
- Election is made **by class of underlying asset**

Underlying Asset is of Low Value

- Value of an underlying asset based on the value of the asset **when it is new**, regardless of the age of the asset being leased
- The assessment of whether an underlying asset is of low value is performed on an **absolute basis**
- Leases of low-value assets qualify for the accounting treatment as operating lease **regardless of whether those leases are material to the lessee**
- The assessment is **not affected by the size, nature** or circumstances of the lessee
- **Different lessees are expected to reach the same** conclusions about whether a particular underlying asset is of low value

Underlying Asset is of Low Value

- If a lessee **subleases an asset**, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset

- **Examples** of low-value underlying assets can include:
  - Tablet and personal computers,
  - Small items of office furniture, and
  - Telephones

Step 3 - Separating Components of a Contract

- Account for each lease component within the <u>**contract as a lease separately from non-lease components**</u> of the contract, unless the entity applies the practical expedient
- Practical expedient
  - A lessee may elect, by class of underlying asset not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component

Clear Division

- IFRS 16 introduces a clear dividing line between **leases and service contracts**
  - Leases will be brought **on-balance sheet**
  - Service contracts will remain **off-balance sheet**

Accounting treatment in the records of lessees

- Recognition
  - At the commencement date, a lessee shall recognize:
    - A **right-of-use asset**, and
    - A **lease liability**

Initial measurement of right-of-use asset

- At the commencement date a lessee shall measure the right-of-use asset **at cost**
- The cost of the right-of-use asset shall comprise:
  - The amount of the initial measurement of the **lease liability**
  - Any **lease payments made** at or before the commencement date, less any lease incentives received;
  - Any **initial direct costs** incurred by the lessee; and
  - An estimate of costs to be incurred by the lessee in **dismantling and removing** the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

Initial measurement of the lease liability

- At the commencement date, a lessee shall measure the lease liability at the **present value** of the lease payments that are not paid at the date
- The lease payments shall be discounted using the **interest rate implicit in the lease**, if that rate can be readily determined
- If the rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate

Subsequent measurement of the right-of-use asset

- Subsequent measurement of the right-of-use asset
  - Cost model – IAS 16
  - Investment property at fair value - IAS 40
  - Revaluation model IAS 16

Subsequent measurement of the lease liability

- After the commencement date, a lessee shall measure the lease liability by:
  - Increasing the carrying amount to reflect **interest on the lease liability**;
  - Reducing the carrying amount to reflect the **lease payments made**; and
  - Re-measuring the carrying amount to reflect any **reassessment or lease modifications** or to reflect revised in-substance fixed lease payments

Presentation

- A lessee shall either present in the statement of financial position, or disclose in the notes:
  - Right-of-use assets **separately from other assets**. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
    - Include right-of-use assets within the **same line item** as that within which the corresponding underlying assets would be presented if they were owned; and
    - **Disclose which line items** in the statement of financial position include those right-of-use assets
  - Lease liabilities **separately from other liabilities**, if the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall:
    - **Disclose which line items** in the statement of financial position include those liabilities

Disclosure

- **Depreciation charge** for right-of-use assets by class of underlying asset
- **Interest expense** on lease liabilities
- **The expense relating to short-term leases** accounted for applying the practical expedient. This expense need not include the expense relating to leases with a lease term of one month or less
- **The expense relating to leases of low-value assets** accounted for applying the practical expedient

Disclosure

- **The expense relating to variable lease payments** not included in the measurement of lease liabilities
- **Income from subleasing right-of-use assets**
- **Total cash outflow** for leases
- **Additions** to right-of-use assets
- **Gains or losses arising from sale and leaseback** transactions
- The **carrying amount of right-of-use assets** at the end of the reporting period by class of underlying asset

Accounting Treatment in the Records of Lessors

Status Quo

- IFRS 16 **substantially carries forward** the lessor accounting requirements in the IAS 17
- Accordingly, a lessor continues to classify its leases as **operating leases or finance leases**, and to account for those two types of leases differently
- IFRS 16 also requires **enhanced disclosures** to be provided by lessors that will improve information disclosed about a lessor's **risk exposure**, particularly to residual value risk

Overview

Key Changes

- A single lessee accounting model
  - A lessee accounts for all leases in the same way
  - No distinction between operating and finance leases
  - Recognize assets and liabilities for all leases (with limited exceptions)
  - All leases (with limited exceptions) will be accounted for in the same way as we currently account for finance leases
- No substantial changes to lessor accounting

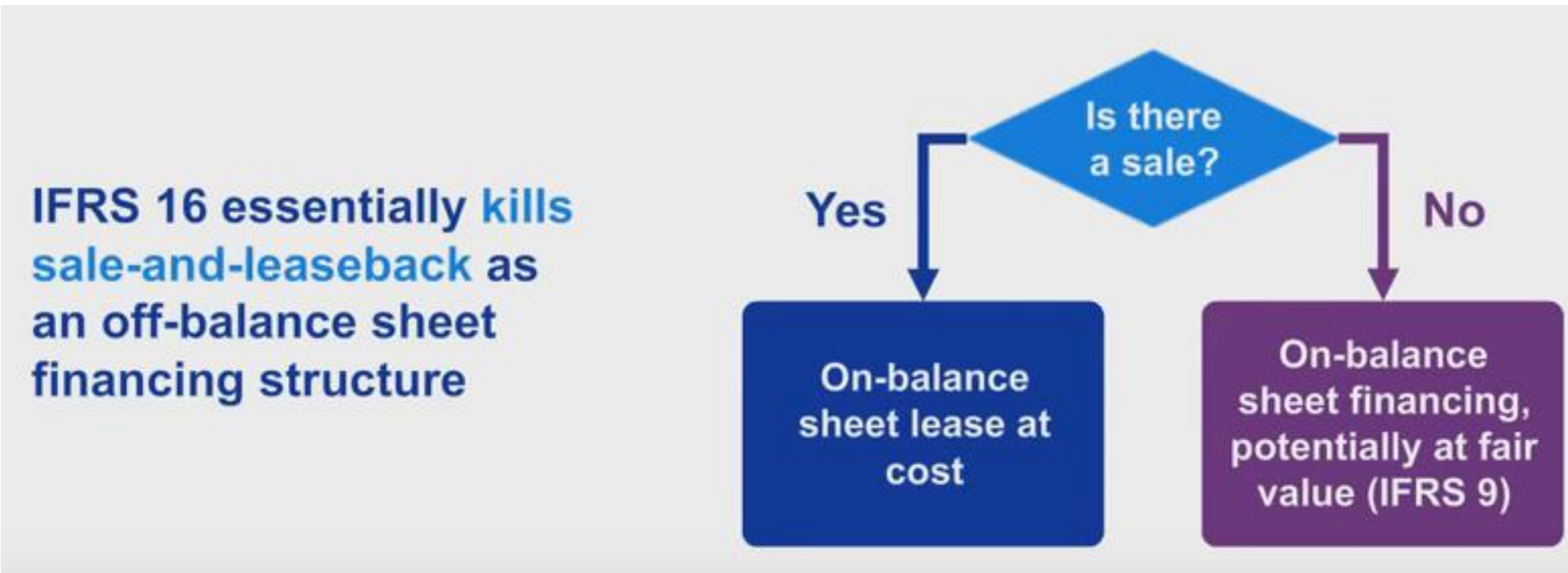
Overview

- Issued in January 2016
- Effective for annual periods beginning on or after 1 January 2019
- Earlier adoption is permitted if IFRS 15 *Revenue from Contracts with Customers* is applied at or before the date of initial application of IFRS 16

Overview

- IFRS 16 supersedes:
  - IAS 17
  - SIC ? Determining whether an arrangement contains a lease
  - SIC/IFRIC ? Operating Leases - Incentives

Sales-and-leaseback



Engaging the Customer

Objection # 1

My compensation is based o n ROA and now that leases will be an on-balance sheet asset my ROA will be worse. I might as well just buy the asset and borrow to pay for it.

Talking points:

- The operating lease asset will be on balance sheet BUT only to the extent of the present value of the rents (much less than cost) and the P&L lease cost is straight lined.
- Assume you are leasing construction equipment under a three year FMV lease. The capitalized amount is 52% of the asset cost (48% better than borrowing to buy) & the first year's cost 7% less than the first year's cost of a capital lease/loan. The ROA savings on that leased asset versus buying the asset including the cost to fund it in year one is about 55% (48% balance sheet savings + 7% lower lease cost).
- What is your alternative? Is it borrow to buy? In addition to the financial factors above, al of the traditional benefits of leasing remain.

Engaging the Customer

Objection # 2

The debt limit covenants in my borrowing agreements will be broken if the operating lease liability is on balance sheet.

Talking Points:

- The FASB listened to feedback that pointed out that executor contract (operating lease) liabilities are not debt per the UCC definition of debt.
- The FASB specifically said the capitalized operating lease obligation is to be reported on the balance sheet as a “non-debt”, “other”, “operating” liability.
- As a result the capitalized liability should not result in a technical default under your debt limit covenants nor is it reported as debt, but you will need to check the defined terms in your agreement.

Engaging the Customer

Objection # 3

Capitalizing operating leases on balance sheet will ruin my credit rating.

Talking points:

- Your credit should not change just because the FASB changes the accounting and reporting of operating leases.
- Bank lenders and credit analysts already factor in the operating lease obligations reported in your footnotes.
- The proposed formula to capitalize operating leases is substantially the same as what the major rating agencies use. In some cases the estimates they use are higher than what the proposed rules require.
- If you borrow to buy equipment, the loan is debt, it is for the full amount of the asset and it will impact your ability to borrow as it eats into your credit capacity
- Accounting does not alter cash flows.

Engaging the Customer

Objection # 4

I lease lots of PCs and the new accounting is too complex and will be too much work for my staff. I may as well just buy the PCs.

Talking points:

The FASB has accepted simple accounting method for capitalizing operating leases.

- To account for operating lease costs under current IAS 17 you accrue the average rent & pay the actual rent – that will not change.
- Now you may be using an Excel spreadsheet for footnoting the future operating lease rents. If you add the discount rate and a PV calculation you have the amount to capitalize, BUT Excel spreadsheet applications have internal control issues. You should consider buying/creating systems application.
- You should also consider asset capitalization thresholds to minimize the burden.
- Don't forget that the other benefits or leasing a PC such as:
  - The capitalized amount < than the asset cost = still a partial off balance sheet benefit.
  - An op lease straight line P&L cost pattern is better than the front ended cost of a financed purchase.
  - The lessor is assuming residual risk so you can return the PC & lease a newer, better model every 3 years or so as technology improves
  - The lessor has to deal with the environmental regs. Re disposing of computers.

Illustrative Example
Identifying a lease – paragraph 9-11

Example 1A: a contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail cars of a particular type for five years. The contract specifies the rail cars; the cars are owned by Supplier. Customer determines when, where and which goods are to be transported using the cars. When the cars are not in use, they are kept at Customer's premises. Customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that Customer cannot transport particular types of cargo (for example, explosives). If a particular car needs to be serviced or repaired, Supplier is required to substitute a car of the same type. Otherwise, and other than on default by Customer, Supplier cannot retrieve the cars during the five-year period.

The contract also requires Supplier to provide an engine and a driver when requested by Customer. Supplier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers (ie if other customers require the transportation of goods to destinations close to the destination requested by Customer and within a similar timeframe, Supplier can choose to attach up to 100 rail cars to the engine).

Illustrative Example
Identifying a lease – paragraph 9-11

Example 1B: the contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for five years. Supplier provides the rail cars, driver and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods). Supplier has a large pool of similar cars that can be used to fulfil the requirements of the contract. Similarly, Supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored at Supplier's premises when not being used to transport goods.

Key points to remember

- New leases standard will impact most companies
- Process of assessing impact should start now
- Additional training and guidance on its way