IFRS 16 - Lease

Deloitte Hungary issues its monthly newsletter to inform its clients about the most recent developments involving International Financial Reporting Standards (IFRSs) and the most critical issues surrounding their adoption. This edition of our newsletter deals with the introduction of IFRS16 - leases.

IFRS 16 is the result of the joint project initiated by the IASB together with the U.S. national standard-setter, the Financial Accounting Standards Board (FAS8), to address concerns raised by users of financial statements in respect of reduced comparability between financial statements due to the very different accounting applied to operating and finance leases and limitations in the information provided on operating leases and on entities' exposure to risks arising from lease arrangements.

To address those concerns, the two boards decided to develop a new approach to lessee accounting that requires a lessee to recognize assets and liabilities for the rights and obligations created by leases (with some limited exceptions) and to enhance the required disclosures on leases.

Scope

The new Lease Standard applies to all leases, including leases of right of use assets in a sublease, with the exception of specific items covered by other standards, namely:

- **leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;**
- **contracts within the scope of IFRIC 12 Service Concession Arrangements;**
- **for lessors, licenses of intellectual property within the scope of IFRS 15 Revenue from Contracts with Customers; and**
- **for lessees, leases of biological assets within the scope of IAS 41 Agriculture and rights held under licensing agreements within the scope of IAS 38 Intangible Assets for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.**

Lessees are permitted, but not required, to apply IFRS 16 lo leases of other intangible assets.

Short-term leases and leases of low value assets

In response to concerns raised over the cost of applying the requirements of the new Standard, the IASB decided to provide a recognition exemption for preparers by allowing short-term leases and leases of low value assets to be accounted for by simply recognising an expense, typically straight-line, over the lease term (so, in a manner consistent with the current accounting for operating leases).

A 'short-term lease' is defined as one that does not include a purchase option and has a lease term at commencement date of 12 months or less. Lessees must apply, or not apply, the exception for short-term leases consistently for each class of underlying leased asset.

Effective date and transition

The Standard is applicable 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 at or before the date of initial application of this Standard.

The Standard provides specific transition requirements to:

- the definition of a lease (permitting the conclusion reached under IAS 17 and WR\C 4 Determining whether an Arrangement contains a Lease to be carried forward in respect of contracts entered into prior to the date of initial application of IFRS 16);
- the measurement of right-of-use assets and lease liabilities (providing relief from full retrospective calculation of these balances);
- sale and leaseback transactions before the date of the initial application (requiring accounting based on the conclusion on whether the transaction was a sate and operating leaseback or a sale and finance leaseback reached under IAS 17); and
- amounts previously recognised In relation to business combinations {requiring any asset or liability in relation to favourable or unfavourable terms of operating leases to be derecognised and the carrying amount of the associated right-of-use asset adjusted by a corresponding amount).

A lessee can apply this Standard either by a full retrospective approach or a modified retrospective approach. If the latter approach is selected, an entity is not required to restate the comparative information and the cumulative effect of Initially applying this Standard must be presented as an adjustment to the opening balance of retained earnings (or other component of equity as appropriate).

Implementing the new Lease Standard

The IASB set the effective date on 1 January 2019 with the consideration of the time and cost that will be involved in implementing the new Standard. This time allows entities to consider the effects of IFRS 16 for example in respect of:

- changes needed to its systems and processes; for example to track leases individually or at portfolio level and to perform calculations;
- judgements required particularly in respect of the definition of a lease and in the assessment of the lease term;
- any potential tax impacts if the treatment of a lease for tax purposes is based on its treatment in financial statements;
- the impact of the Standard on key metrics, debt covenants and management compensation; and
- additional information that entities may need to gather to make the required disclosures.

Lease term

The lease term is defined as the non-cancellable period of the lease, including:

a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option;

b) periods covered by an option to terminate the lease if the lessee Is reasonably certain not to exercise that option.

An entity is required to revise the lease term if there is a change in the non-cancellable period of a lease.

The exception for leases of low value assets can, on the other hand, be applied on a lease by lease basis.

Definition of a lease

The Standard aims to distinguish a lease from a service contract on the basis of whether a customer is able to control the asset being leased.

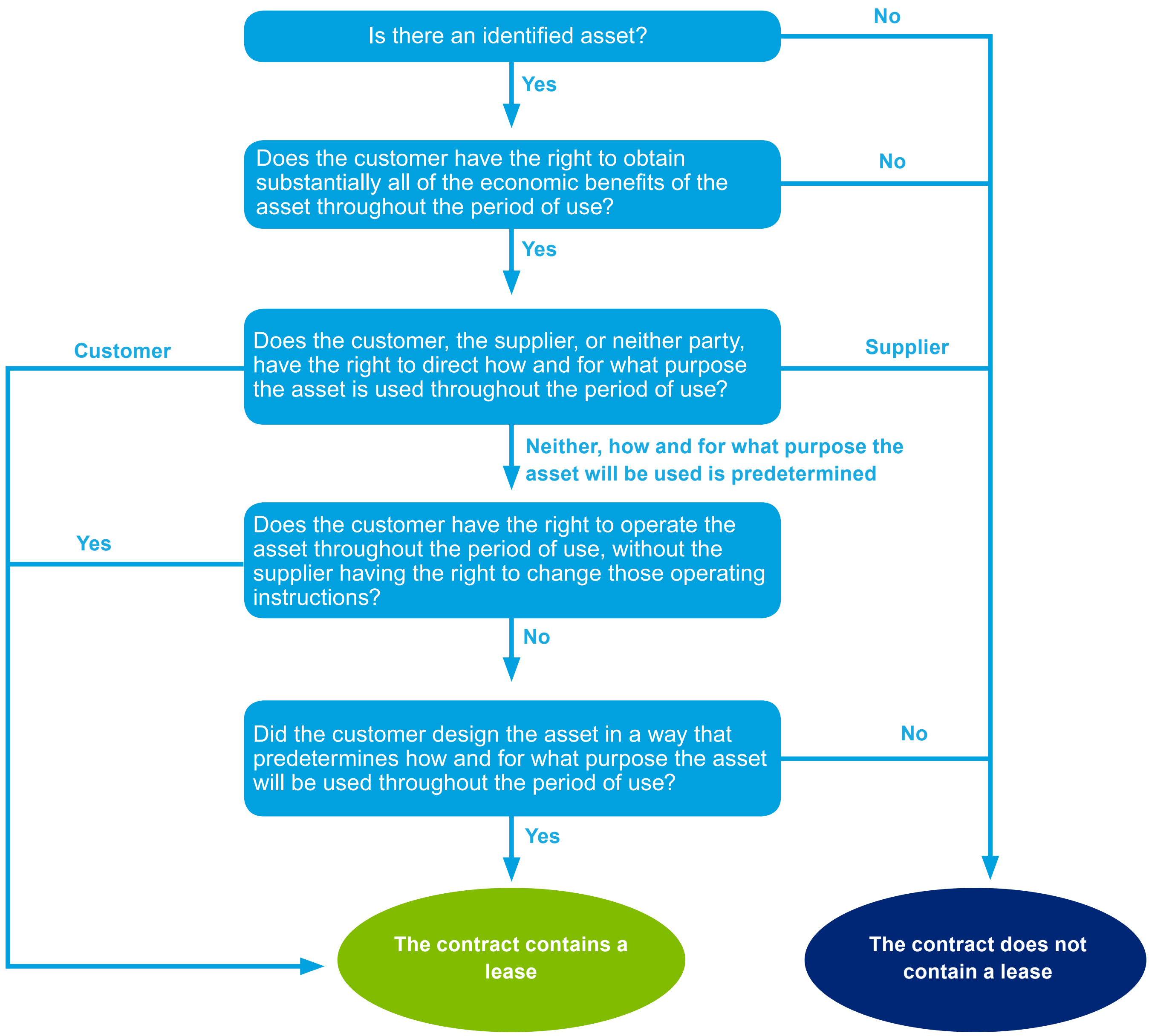
A contract is, or contains, a lease if the contract provides a customer with the right to control the use of the identified asset for a period of time in exchange for consideration. Control is considered to exist if the customer has:

(a) the right to obtain substantially all of the economic benefits from use of an identified asset; and

(b) the right to direct the use of that asset.

An entity is required to identify whether a contract is, or contains, a lease at inception and it will only reassess whether the contract is or contains a lease in case of a modification to the terms and conditions of the contract. The inception of a lease is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

To help entities determine whether a contract is, or contains, a lease, the Standard provides the following flowchart:



Recognition

A lessee will recognise at lease commencement a right-of-use asset and a lease liability. The commencement date of a lease is defined in the Standard as the date on which a lessor makes an underlying asset available for use by a lessee.

Measurement

Right-of-use asset

A lessee is required to include the following items as part of the costs of the right-of-use assets:

- the amount of the initial measurement of the lease liability (see below);
- any lease payments made to the lessor at or before the commencement date, less any lease incentives;
- 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. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

Subsequently, an entity will measure the right-of-use asset using either the cost or revaluation model of IAS 16 Property, Plant and Equipment (thus, recognising depreciation and impairment expenses in profit or loss and, if that model is applied, revaluations in other comprehensive income). However, the Standard requires the right-of-use asset of leased investment property to be measured at fair value if the entity uses the fair value model under IAS 40 Investment Property to its other investment properties.

As noted below, right-of-use assets are also adjusted as a result of certain changes in the lease liability subsequent to commencement of the lease.

Lease liability

An entity will measure the lease liability at the present value of lease payments discounted using the rate implicit in the lease if that rate can be readily determined, if an entity is unable to estimate the rate implicit in the lease, then the lessee should use its incremental borrowing rate.

The lease payments should include the following items:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable from the lessor;
- variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a benchmark interest rate), using the index or rate as at the commencement date;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Subsequently, a lessee will increase the lease liability to reflect interest accrued (and recognised in profit or loss), deduct lease payments made from the liability and remeasure the carrying amount to reflect any reassessment, lease modification, or revision to in-substance fixed payments.

Reassessment of the lease liability

A lessee Is required to remeasure the lease liability in the following circumstances:

- a change in the amount expected to be payable under a residual value guarantee;
- a change in future lease payments to reflect a change in an index or rate used to determine those payments (including, for example, a market rent review);
- a change in the lease term resulting from a change in the non-cancellable period of the lease (for example, the lessee not exercising an option previously included in the determination of the lease term); of
- a change in the assessment of an option to purchase the underlying asset.

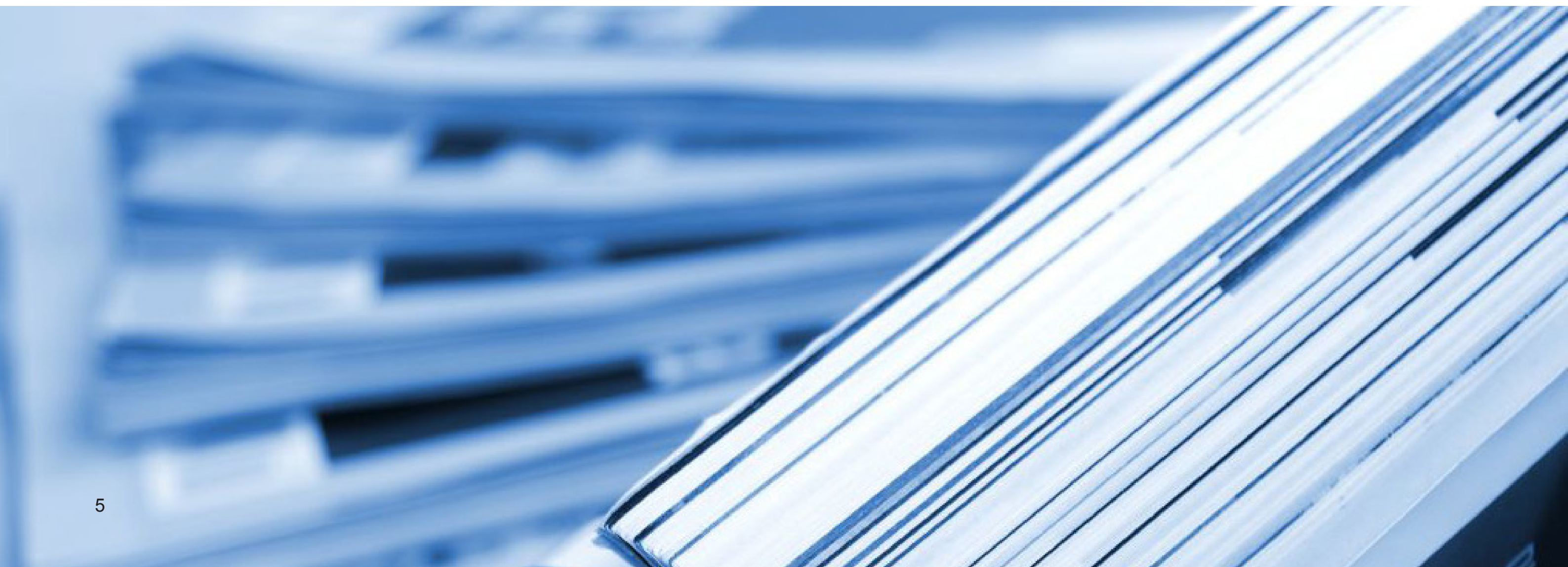
Changes resulting from revisions to residual value guarantees and changes in an index or rate are calculated using the interest rate determined at commencement of the lease, whilst changes to the lease term or in the assessment of a purchase option require calculation of a revised interest rate at the date of the change.

A lessee is required to recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset unless the carrying amount of the right-of-use asset is reduced to zero, in that situation, a lessee will recognize any remaining amount in profit or loss.

Presentation

The main presentation requirements are summarised below:

Statement of financial position	Statement of profit or loss and other comprehensive income	Statement of cash flows
• Right-of-use assets • Lease liabilities	Interest expense on the lease liability (a component of finance costs)	Cash payments for the principal portion of the lease liability within financing activities.
Distinguished from other assets and liabilities either by separate presentation in the statement of financial position or by disclosure of the line item that they are included in.	Depreciation charge from the right-of-use asset	Cash payments for the interest portion of the lease liability presented consistently with other interest payments.
		Short-term lease payments, payments for leases of low-value assets and variable lease payments not included In the measurement of the lease liability within operating activities.



Disclosure

The disclosure objective of the Standard is that m entity is required to provide information to enable users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

The Standard significantly expands the current disclosure requirements about leases. The required quantitative disclosure requirements include:

- depreciation charge for right-of-use assets by class of underlying asset;
- interest expense on lease liabilities;
- the expense relating to short-term leases;
- the expense relating to leases of low-value assets;
- 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; and
- the carrying amount of right-of-use assets at the end of the reporting period, by class of underlying asset,

In addition, a lessee is required to disclose a maturity analysis of lease liabilities (separately from other financial liabilities) in accordance with IFRS 7 Financial Instruments: Disclosures.

Accounting for leases in the financial statements of lessors

The Standard maintains substantially the lessor accounting requirements in IAS 17 Leases.

Classification

The Standard requires a lessor to classify a lease either as an operating lease or a finance lease.

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership. The Standard includes examples of situations that will lead a lease to be considered a finance lease.

Finance leases

Recognition

A lessor is required to recognise at the commencement date assets held under a finance lease in its Statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

Measurement

The net investment in the lease will be measured as the sum of both of the following;

a) the lease receivable measured at the present value of the lease payments; and

b) the residual asset, measured at the present value of any residual value accruing to the lessor.

Subsequently, a lessor is required to recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor’s net investment in the lease.

Operating Leases

Recognition and measurement

A lessor is required to recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. Another systematic basis should be applied if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

Presentation

A lessor is required to present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

Disclosure

Similarly to the requirements for lessees, the Standard includes a disclosure objective for lessors. The objective is to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives 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 lessor.

Sale and leaseback transactions

The Standard includes guidance on sale and leaseback transactions applicable to both the seller-lessee and buyer-lessor. The treatment of such transactions depends on whether the transfer of the asset in question meets the criteria of IFRS 15 Revenue from Contracts with Customers for recognition as a sale.

If these criteria are met:

- the seller-lessee recognises a right-of-use asset calculated as the proportion of the asset's previous carrying amount relating to the right-of-use it has retained (as a result, a gain or loss on disposal is recognised only to the extent that rights of use have transferred to the buyer-lessor); and
- the buyer-lessor accounts for the purchase of the underlying asset under applicable Standards (for example, IAS 16 for a purchase of property, plant and equipment) and the lease under IFRS 16's lessor accounting model.

If the sale proceeds do not reflect the fair value of the asset, or if the lease payments are not at a market rate, adjustments are made to reflect a prepayment of lease payments or additional financing provided by the buyer-lessor.

If the criteria are not met:

- the seller-lessee continues to recognise the underlying asset and recognises a financial liability in respect of the sales proceeds received; and
- the buyer-lessor recognises a financial asset in respect of the payment made.

Both parties then account for the financial instrument in accordance with IFRS 9 Financial Instruments (or, if that standard has not yet been applied, IAS 39 Financial Instruments: Recognition and Measurement).

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For further information on IFRS, please visit the following website:

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