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Need to know
IASB issues IFRS 16 – Leases

In a nutshell

- The new Standard provides a comprehensive model for the identification of lease arrangements and their treatment in the financial statements of both lessees and lessors. It supersedes IAS 17 Leases and its associated interpretative guidance.
- IFRS 16 applies a control model to the identification of leases, distinguishing between leases and service contracts on the basis of whether there is an identified asset controlled by the customer.
- Significant changes to lessee accounting are introduced, with the distinction between operating and finance leases removed and assets and liabilities recognised in respect of all leases (subject to limited exceptions for short-term leases and leases of low value assets).
- In contrast, the Standard does not include significant changes to the requirements for accounting by lessors.
- Entities will need to consider the impact of the changes introduced by the Standard on, for example, IT systems and internal controls.
- Subject to EU endorsement, the Standard is effective for annual periods beginning on or after 1 January 2019 with earlier application permitted for entities that have also adopted IFRS 15 *Revenue from Contracts with Customers*.

Introduction

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 (FASB), 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 recognise assets and liabilities for the rights and obligations created by leases (with some limited exceptions) and to enhance the required disclosures on leases.

The latest Project Insight Leases provides further background on the history of the project.

Observation

The project's original aim was the production of a converged IFRS and U.S. GAAP standard. However, the IASB and FASB reached different conclusions on a number of issues including the recognition and presentation of expenses by lessees. As a result, the FASB's leasing standard (due for publication early in 2016) will differ from IFRS 16 in several respects.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

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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, licences 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 to 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.

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; and

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.

Observation

The 'low value' exception is unusual in that it applies in absolute terms rather than by reference to the size of the reporting entity (i.e. it is not a measure of the lease's materiality).

The Standard does not provide a monetary value that should be considered 'low' for these purposes, but does state that the assessment should be made based on the asset's value when new (even if a used asset is leased) and the Basis for Conclusions notes that, at the time of reaching its decision to provide an exception, the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US$5,000 or less.

It should also be noted that the 'low value' exception only applies to leased assets that are not highly dependent on, or highly interrelated with, other assets.

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.

Observation

The definition emphasises the notion of control because the IASB decided that to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a 'benefits' element) but also the ability to direct the use of that asset (a 'power' element). This guidance is consistent with the concept of control in IFRS 10 *Consolidated Financial Statements* and IFRS 15 *Revenue from Contracts with Customers,* and with the IASB's proposals regarding control in the Conceptual Framework Exposure Draft.

The Standard provides detailed guidance to determine whether those conditions are met. It is expected that significant judgement will be required to make this assessment in some cases. A summary of the detailed guidance is provided below.

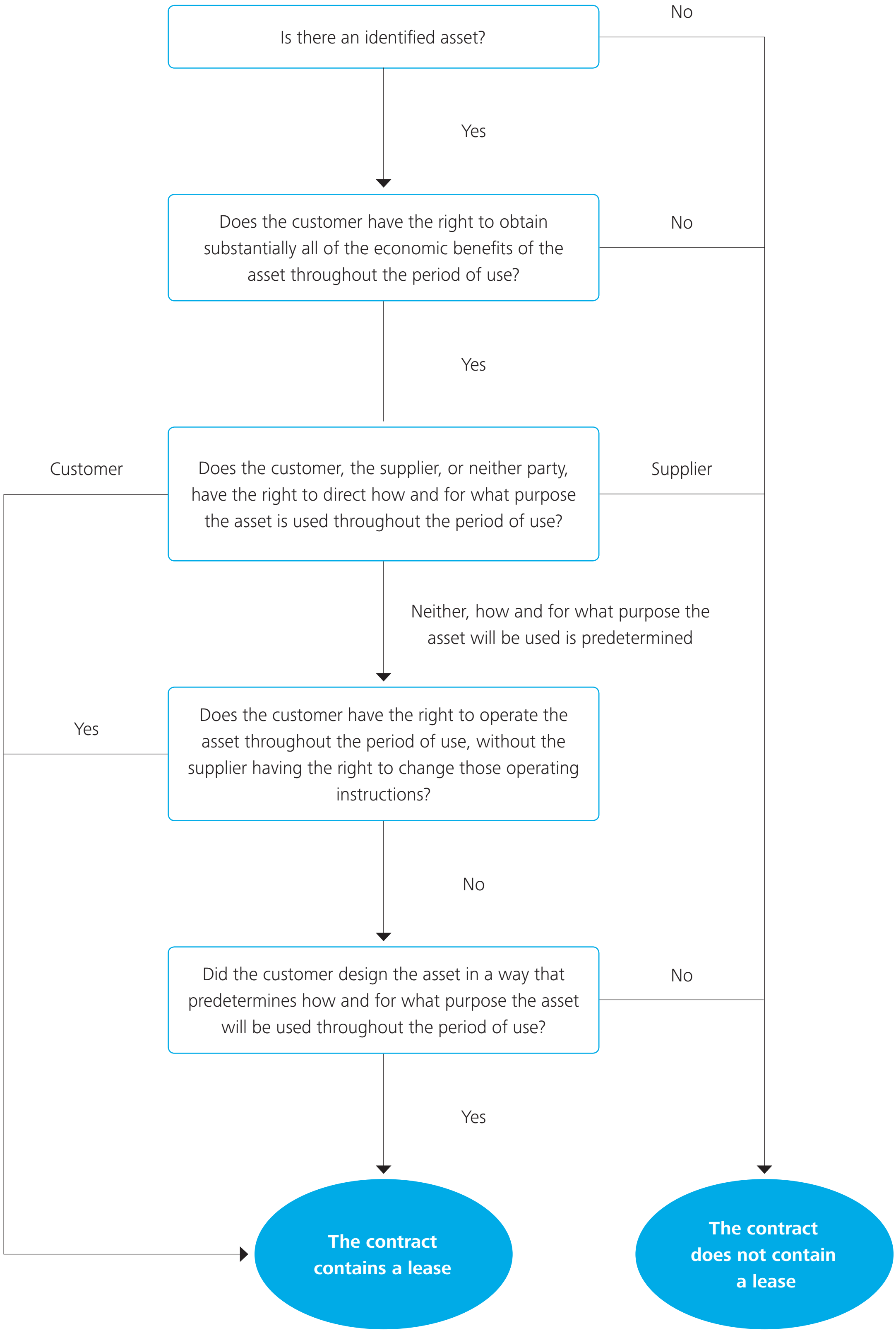
Concept	Definition	Observation
Use of an identified asset	An asset is typically identified if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has **substantive rights to substitute the asset** throughout the period of use then the asset is not considered to be 'identified'.	The requirement is similar to the guidance set out in IFRIC 4 *Determining whether an Arrangement contains a Lease*. An entity does not need to be able to identify the particular asset (for example, a specific serial number). Instead, an entity needs to determine whether an identified asset is needed to fulfil the contract. One area that will involve significant judgement will be the distinction between a lease and a capacity contract. The Standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). By way of illustrating this concept, the Standard contrasts a contract for exclusive use of specific fibres within a larger cable used to transmit data with one for use of an equivalent portion of the capacity of the cable as a whole – concluding that the former contract includes the right to use an identified asset but the latter does not.
Substantive substitution rights	A supplier's right to substitute an asset is substantive only if both of the following conditions exist: (a) the supplier has the practical ability to substitute alternative assets throughout the period of use; and (b) the supplier would benefit economically from the exercise of its right to substitute the asset.	The IASB decided to include this requirement because it considered that if a supplier has a substantive right to substitute the asset throughout the period of use, then it is the supplier who controls the use of the asset and not the customer. The concept of economic benefit from substitution rights is illustrated by an example of a contract to use a specified type of rail car to transport goods. In this example, the supplier is deemed to benefit from exercise of its right to substitute as this allows them to utilise its pool of available rolling stock in the most efficient manner.

Concept	Definition	Observation
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use. The economic benefits from use of an asset include its primary output and by-products, and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.	This assessment is made within the boundaries of the scope of the contract. For example in a lease of a motor vehicle which includes a limit for mileage use, that limit is the scope of the contract and the customer will assess the economic benefits obtained within this limit.
Right to direct the use of the identified asset	A customer has the right to direct the use of an identified asset throughout the period of use only if either: (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or (b) the relevant decisions about how and for what purpose the asset is used are predetermined and: (i) the customer has the right to operate the asset throughout the period of use; or (ii) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.	The relevant decision rights to be considered are those that affect the economic benefits derived from the use of the asset. Some examples of customer's rights that meet the definition are: (i) rights to change the type of output produced by the asset; (ii) rights to change when the output is produced; or (iii) rights to change where the output is produced. On the other hand, rights that are limited to maintaining or operating the asset do not grant on its own a right to direct how and for what purpose the asset is used. The concept of directing use through design of the asset is explored in an example of a contract to purchase all of the output of a solar farm, concluding that although the customer makes no decisions during the life of the farm it has the right to direct its use as a result of having designed the asset before it was constructed.

Observation

The Standard does not provide a definition of services; however, the Basis for Conclusions provides some considerations made by the IASB to distinguish leases from services. For example, it indicates that leases create rights and obligations that are different from those that arise from service contracts. This is because the lessee obtains and controls the right-of-use asset at the time that the underlying asset is made available for use by the lessee, on the other hand, in a service contract, the customer does not obtain an asset that it controls at commencement of the contract.

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



Accounting for leases in the financial statements of lessees

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.

> **Observation**
>
> The IASB decided to require a single accounting model for leases in which a lease will be recognised in the statement of financial position (unless any of IFRS 16's scope exceptions are available). The IASB concluded that a lessee's right to use an underlying asset meets the definition of an asset for the following reasons:
>
> (i) the lessee controls the right to use the underlying asset throughout the lease term;
>
> (ii) the lessee has the ability to determine how to use the underlying asset and, thus, how it generates future economic benefits from that right of use; and
>
> (iii) the right to control and use the asset exists even when a lessee's right to use an asset includes some restrictions on its use; and the lessee's control of the right of use arises from past events – not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee for the duration of the non-cancellable period of the lease.

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.

> **Observation**
>
> The rate implicit in the lease is defined in the Standard as the rate of interest that at commencement date causes the aggregate present value of lease payments and the residual value of the asset at the end of the lease term to equal the sum of the fair value of the underlying asset and any initial direct cost of the lessor.
>
> The IASB indicates that the interest rate implicit in the lease is likely to be similar to the lessee's incremental borrowing rate in many cases. This is because both rates take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs.

The lease payments should include the following items:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable from the lessor;

> **Observation**
> Lease payments should include fixed payments regardless of the form in which they were structured in the contract. For this reason, the IASB included the concept of 'in-substance fixed payments' which intend to capture payments that could, according to the contract, be variable but are in reality unavoidable.

- 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;

> **Observation**
> A lease may include variable payments related to future performance. The Standard requires that any variable lease payment not related to an index or a rate will be recognised in profit or loss as incurred.
>
> The IASB decided to exclude those variable payments from the initial measurement of the lease liability primarily for cost and benefits reasons. There was no specific conclusion as to whether variable payments related to future performance meet the definition of a liability.

- 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.

> **Observation**
> The differing treatment of the right-of-use asset (depreciation typically recognised on a straight-line basis) and the lease liability (interest calculated using a constant rate of return method) results in probably the most significant impact of the new Standard on a lessee's net profit as the total expense recognised will be weighted towards the start of the lease term (due to the higher interest cost arising at that time) whereas under IAS 17 the cost of an operating lease is usually recognised on a straight-line basis across the lease term.

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); or

- 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 recognise 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 recognise 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 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.	• Interest expense on the lease liability (a component of finance costs) • Depreciation charge from the right-of-use asset	• Cash payments for the principal portion of the lease liability within financing activities. • 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 an 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.

Observation

Consistently with the requirements being discussed under the IASB's Disclosure Initiative, the Standard indicates that a lessee should provide additional quantitative and qualitative information if it is necessary to meet the disclosure objective.

The Standard indicates that the information provided must be relevant for the users of the entity's financial statements and should help users to understand the most relevant implications derived from its leases, including for example, the flexibility provided by leases; restrictions imposed by leases; sensitivity on key variables; exposure to additional risks and deviations from industry practices.

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*).

Effective date and transition

Subject to EU endorsement, 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 IFRIC 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 sale 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.

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