IFRS UPDATE AND IFRS 16 TRAINING

Presentation slides

TUESDAY 3RD DECEMBER 2019

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Overview of the IFRS Update

- Introduction and IFRS Round up
- Changes effective in 2018
- Changes effective from 1 January 2019
- Changes effective on or after 1 January 2020
- IASB’s work-in-progress

SESSION 1: INTRODUCTION AND IFRS ROUND-UP

IFRS Round up - Background

From 2001: “knock everything into shape before adoption by European Union in 2005”. Work commenced on an Insurance Standard

2008: just as the dust settled on EU adoption, along came the global financial crisis

2009 to 2017: responding to the financial crisis – mainly IFRS 9 – with attempts at convergence with US GAAP

2009: IFRS for SMEs issued (revised in 2015)

2018: Application of IFRS 9 and IFRS 15. Review of the conceptual framework completed

IFRS Round up – where we are now

- Major change from 1 January 2019 – IFRS 16, Leases
- IFRS 17 now issued, after some 20 years in the making, effective date likely to be put back to 1 January 2022
- No other major changes on the horizon
- No changes to the IFRS for SMEs since 2015

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Changes that became effective 1 January 2018

Change	Issued
IFRS 9 – *Financial Instruments*	7/14
IFRS 15 – *Revenue from Contracts with Customers*	5/14
Amendments to IFRS 2 - Classification and Measurement of Share-based Payment Transactions	6/16
Amendments to IFRS 4 – Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*	9/16
Amendments to IAS 40 – Transfers of investment property	12/16
IFRIC 22 – Foreign Currency Transactions and Advance Consideration	12/16

Changes that became effective 1 January 2019

Change	Issued
IFRS 16 – *Leases*	1/16
IFRIC 23 – *Uncertainty over Income Tax Treatments*	6/17
Amendments to IFRS 9 - Prepayment Features with Negative Compensation	10/17
Amendments to IAS 28 - Long-term Interests in Associates and Joint Ventures	10/17
Annual Improvements to IFRSs 2015–2017 Cycle – minor amendments to IFRS 3, IFRS 11, IAS 12, and IAS 23	12/17
Amendments to IAS 19 - Plan Amendment, Curtailment or Settlement	2/18

Changes that become effective 1 January 2020

Change	Issued
Amendments to IFRS 3 - Definition of a Business	10/18
Amendments to IAS 1 and IAS 8 - Definition of Material	10/18
Interest Rate Benchmark Reform – amendments to IFRS 9, IAS 39 and IFRS 7	9/19

Changes that become effective 1 January 2022 (?)

Change	Issued
IFRS 17 – *Insurance Contracts*	5/17

Change at an effective date to be determined	Issued
Amendments to IAS 10 and IAS 28 - Sale or Contribution of Assets between an Investor and its Associate or Joint Venture	9/14

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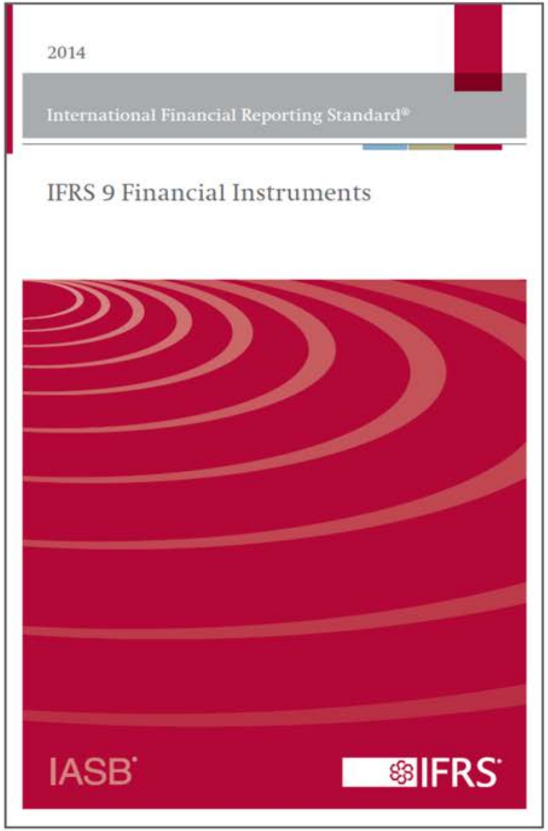
IFRS 9 - a comprehensive Standard to replace IAS 39



Classification and measurement

- A logical, single classification approach for financial assets driven by cash flow characteristics and business model
- Improvements to "own credit" for financial liabilities

Impairment

- A much needed and strongly supported forward-looking 'expected loss' model

Hedge accounting

- An improved and widely welcomed model that better aligns accounting with risk management

IFRS 9 – Implementation experience

- No great difficulties with classification and measurement, but need to be careful over terminology – “available for sale” and “held to maturity” no longer exist
- ‘Expected credit losses’ much more challenging, especially for banks. Difficulty in getting management/directors to accept responsibility for the estimates and to ‘mine’ their data appropriately
- No increase in volatility (e.g. quarter by quarter) but this is thought to result from the current “very benign” climate globally
- Some evidence (in Kenya) of abuse of transition – overstating adjustment to retained earnings at 1/1/18
- For non-banks the main impact has been to make provision for expected credit losses for trade receivables that are not yet past due.

IASB's analysis – IFRS 9

Benefits

- Aligns accounting with credit risk management
- Addresses 'too little too late'
- No more diversity re 'significant or prolonged impairment'

Concerns

- Comparability, given increased judgement
- No recycling of FVOCI for equities
- More earnings volatility because more FVPL

IFRS 15 Revenue - Core principle & 5-steps

The 5 step model:

Principle: Recognise revenue to depict transfer of goods or services in an amount of consideration to which the entity expects to be entitled

1. Identify the contract(s) with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when (as) a performance obligation is satisfied

IFRS 15 – Implementation experience

- Impact on timing of recognition of revenue has been minimal. Cases of adjustments to opening retained earnings have been rare

- Primary impact has been (or should have been) on greater disclosure, including disaggregation, revenue recognition accounting policies that are more entity-specific, and better understanding of contractual arrangements

- Challenges (globally) have been in the areas of licences and variable consideration.

IFRS 16 Leases – At a glance

IFRS 16 *Leases* was issued on 13 January 2016

- It has replaced IAS 17 *Leases*, effective 1 January 2019
- Biggest change introduced: nearly all leases will be brought onto the balance sheet of lessees, increasing the visibility of their assets and liabilities
- Voted as "Favorite Standard" of the Big Four – IFRSs 9, 15, 16, 17 - probably due to relatively less judgement required. Preparers already know how to account for finance leases, so treating operating leases as finance leases should not be that difficult.

IFRS 16 Leases – Implementation challenges

- Note that IFRS 16 applies from 1 January 2019. You should already be making entries in your ledgers

- Challenge should have been (/will be?) for you to:
  - Decide on approach to transition
  - Identify all contracts containing a lease
  - Determine the lease term and expected cash flows
  - Determine the discount rate if not implicit in the lease

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IFRIC 23 – UNCERTAINTY OVER INCOME TAX TREATMENT Effective 1 January 2019

Examination by tax authorities

Assume that the tax authority will examine amounts it has a right to examine and have full knowledge of all related information:

Is it probable that the tax authority will accept the treatment in the tax return?

Probable

Amount in financial statements is the same as in the tax return

Not probable

Amount in financial statements is NOT the same as in the tax return

Determination of amounts

For each uncertain tax treatment determine either:

- The **most likely amount** (the single most likely amount from a range of possible outcomes); or
- The **expected value** (the sum of the probability weighted amounts in a range of possible outcomes)

depending on which method the entity expects to better predict the resolution of the uncertainty.

DEFINITION OF MATERIAL

Issued in October 2018 – effective 1 January 2020

Definition of Material

The definition of material (in IAS 1) now reads:

“Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.”*

*IAS 1 goes on to say that information is obscured if it is communicated in a way that would have a similar effect to omitting or misstating that information.

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Definition of Material

It still presents the challenge (particularly as regards disclosure) of assessing:

- Who are the primary users?
- What decisions, if any, might they make on the basis of the financial statements?
- What information do they need within the financial statements to be able to make those decisions?

Definition of Material

The IASB wants to discourage a ‘checklist approach’, which results in information being disclosed simply because the checklist says it should, rather than a consideration of whether each disclosure is material.

And of course there could be information that is not mentioned in a disclosure checklist that is nevertheless needed by the primary users of the financial statements.

IFRS 17 – INSURANCE CONTRACTS

Issued in May 2017 – likely to be effective 1 January 2022

IFRS Update – December 2019

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IFRS 17 – Insurance contracts

It establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts:

- Groups of contracts will be measured at a risk-adjusted present value of the future cash flows plus/minus an amount representing the unearned profit/loss in the group of contracts
- Profit from a group of contracts should be recognised over the period of cover, and as the entity is released from risk
- Embedded derivatives, direct investment components and distinct performance obligations should be separated

An exposure draft ‘Amendments to IFRS 17’ has been issued in June 2019

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IFRS 17 – Exemption from IFRS 9

Under IFRS 4, insurance companies can opt to defer implementation of IFRS 9 until they implement IFRS 17.

Insurance Regulator is considering whether to make adoption of IFRS 9 mandatory.

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CURRENT IASB WORK-IN-PROGRESS

IFRS Amendments expected early 2020

- **Classification of liabilities as current or non-current**
  - Main proposal is to delete the word “unconditional” from the requirement in IAS 1p69 that the entity “does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period”

Current major projects

- Better communication in financial reporting
- Goodwill and impairment
- Business combinations under common control

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Why better communication?

Issue	Response
Statements of financial performance are not sufficiently comparable between companies	Primary Financial Statements
Poor communication *Too much irrelevant and not enough relevant information*	Disclosure initiatives
More information on intangibles, ESG, matters that underpin long-term success and linkage to strategy	Management commentary
Electronic consumption	IFRS Taxonomy

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Primary financial statements

- Focus now on the income statement
- Operating profit will be defined (will exclude investment income, financing activities and income tax) (will not apply to financial institutions)
- Management performance measures (MPM) will have to be defined and reconciled to the most directly comparable sub-total specified by IFRS, with an explanation of why management consider them appropriate
- More guidance on aggregation and disaggregation with the aim of eliminating large ‘other’ balances (“other has become a dirty word”)
- ‘unusual items’ to be defined, with additional disclosure requirements

ED to be issued by end of 2019

Statement of profit or loss – proposed structure

Revenue	X
Expenses - by nature or by function	X
Operating profit	X
Share of profit of integral associates and JVs	X
Operating profit and share of profit of integral associates and JVs	X
Investment income	X
Share of profit of non-integral associates and JVs	X
Profit before financing and income tax	X
Interest income from cash and cash equivalents	X
Expenses from financing activities	X
Profit before tax	X

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Statement of cash flows

Proposed changes

- Starting point will always be ‘operating profit’
- Classification options for interest and dividends will be eliminated
- Separate presentation of integral and non-integral associates and JVs

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Disclosure initiatives

- Board is carrying out a review of disclosures requirements in targeted Standards (IFRS 13 and IAS 19). ED planned for 2020

- Review of disclosure of accounting policies has also been carried out (90% of accounting policies are estimated to be extracts from the Standards). ED issued in August 2019 – “significant accounting policies” will change to “material accounting policies”

Management commentary

There is already non-mandatory guidance on management commentary.

Project aims at providing additional guidance, with particular emphasis on:

- Matters specific to the entity
- Matters that underpin the entity’s long term success
- Coherent discussion of financial and operational performance in the context of an entity’s strategy

IFRS Taxonomy

What is it?

- The IFRS Taxonomy lists and defines the specific codes that preparers can use to identify (tag) the information disclosed in IFRS financial statements (there are currently about 5,000 tags)

- The IFRS Taxonomy transforms information prepared in accordance with IFRS into a machine readable format. This format facilitates efficient, timely analysis by investors and analysts

Quotes:

- “Paper reports have served us well for 525 years” but the world is changing. “XBRL is not going away”

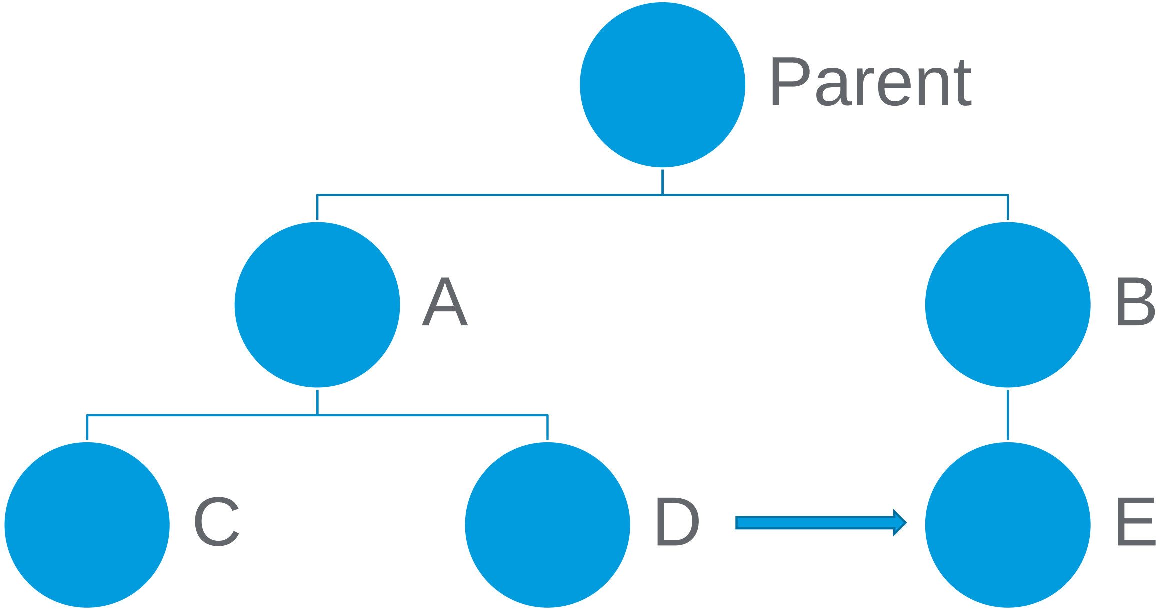
Goodwill and impairment

Issue	Response
Impairment test costly	• Permit relief from annual quantitative test • Simplify impairment test process
Impairments not timely	• Reintroduce amortisation of goodwill?
Users need information to assess subsequent performance	• Improve disclosures to explain key objectives for acquisition and whether key objectives are being achieved

Discussion paper expected February 2020

Business combinations under common control

Example: Parent wants E to buy the business of D



Business combinations under common control

- Currently outside the scope of IFRS 3 – reducing comparability and understandability of financial information

- In practice, ‘predecessor approach’ (retaining current carrying amounts) is often used unless IFRS 3 is applied (current value approach)

- Needs of non-controlling shareholders should be considered – Board may propose a dual approach: current value for all or some transactions involving non-controlling shareholders and a predecessor approach for transactions between wholly-owned entities

- Discussion paper to be issued in 2020

Annual improvements to IFRS 2018-2020

Standard being amended	Subject of amendment
IFRS 1, First time adoption	Subsidiary as a first time adopter
IFRS 9, Financial Instruments	Fees included in the ’10%’ test for derecognition of financial liabilities
IFRS 16, Leases – Illustrative examples	Lease incentives
IAS 41, Agriculture	Taxation in fair value measurements

ED issued on 21 May 2019

Amendments to be issued in 2020

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Other IASB projects

- Amendments to IAS 12 – Deferred Tax Related to Assets and Liabilities Arising from a Single Transaction – Exposure draft issued in July 2019

- IAS 16 – proceeds before intended use. Amendment to be issued in 2020

The IFRS for SMEs

- None of the foregoing presentation relates to entities using the IFRS for SMEs
- The IFRS for SMEs was last revised in 2015, effective 1 January 2017
- The next ‘comprehensive review’ has commenced – a Request for Information will be issued early next year
- Revised Standard unlikely to be issued before 2021, possibly effective from 1 January 2023

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IFRS 16 - LEASES

IFRS 16 – At a glance

- Issued in January 2016, it replaced IAS 17, *Leases*, effective 1 January 2019

- Biggest change introduced: most leases will be brought onto the balance sheet of lessees (i.e. no operating leases), increasing the visibility of their assets and liabilities

- Short-term leases (less than 12 months) and leases of low-value assets (such as personal computers) are exempt from the requirements

- Little change for lessors

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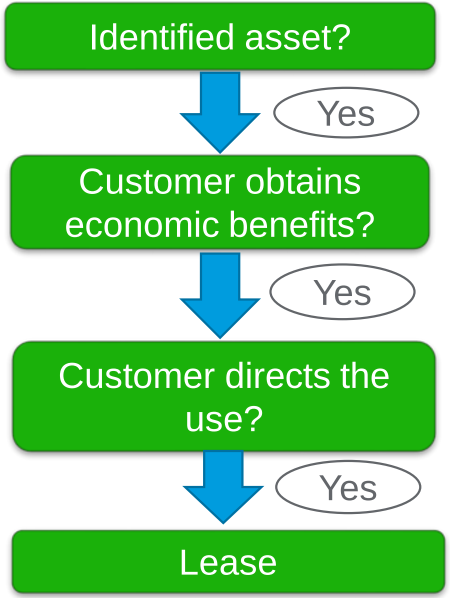
Definition of a lease

A contract, or part of a contract, that conveys the right to use an asset for a period of time in exchange for consideration.



Right-of-use model

A lease conveys the right to use an asset for a period of time in exchange for consideration

Customer (Lessee)	← **Right to use an asset**	**Supplier** (Lessor)
	Cash payments →	

- Lessee reports lease assets and liabilities on balance sheet at present value of future lease payments
- Discount rate: the rate implicit in the lease, or, if none, the lessee's incremental borrowing rate
- Exclude variable payments linked to sales or usage and optional payments where lessee is not reasonably certain to exercise the option

Initial measurement of right-of-use asset

At the date of commencement, measure at cost comprising:

- The lease liability
- Plus:
  - prepaid lease payments
  - initial direct costs
  - estimated dismantling, removal and restoration costs measured in accordance with IAS 37
- Less:
  - lease incentives received

IFRS 16 Leases

Recognition exemptions for lessees

- A lessee may elect to recognise lease payments as an expense on a straight-line basis over the lease term or another systematic basis for two types of leases:
  - Short-term leases with a lease term of 12 months or less at the commencement date (the election is by class of underlying assets)
  - Leases for which the underlying asset is of low value, for example, a tablet or personal computer, a small item of office furniture or a telephone with a value of US$5,000 or less when new (the election is on a lease-by-lease basis)

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IFRS 16 Leases

Impact of new lessee accounting model

Balance sheet	Profit or loss	Cash flows
Asset: Right-of-use of underlying asset	Depreciation and impairment of right-of-use asset	Lease payments under what was previously an operating lease no longer appear under operating activities
Liability: Obligation to make lease payments	Interest expense on lease liability	Principal repayments are included in financing activities and interest repayments are included, based on a policy choice, in operating or financing activities

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Lessee - Presentation

Balance sheet

- ROU assets together with PPE or as own line item
- Lease liabilities in accordance with IAS 1 (current and non-current)

Cash flow statement

- Principal within financing activities
- Interest within either operating or financing activities (IAS 7 policy choice)

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Lessee - Disclosure

Changed to focus on the most relevant information

- Breakdown of lease costs
- Information about lease cash flows
- Maturity analysis of undiscounted commitments
- Information about RoU assets by major class of underlying asset

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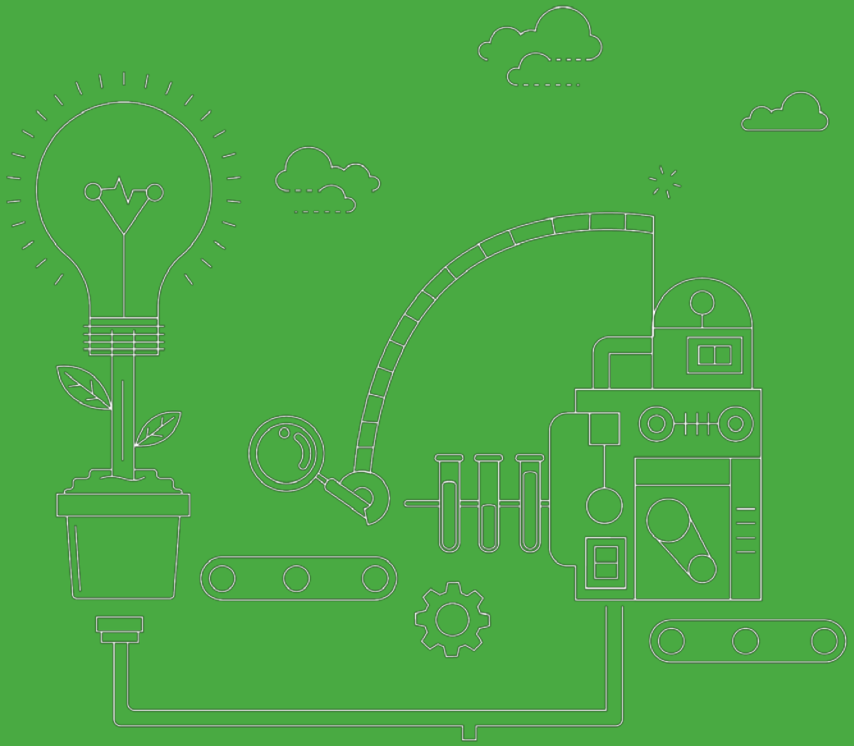
IMPLEMENTATION CHALLENGES

Implementation challenges

- Identification of right of use asset
- Non cancellable/enforceable lease period
- Determining the discount rate
- Determining the fixed and variable lease payment
- Intercompany leasing arrangements
- Current and deferred tax

Identification of right-of-use asset



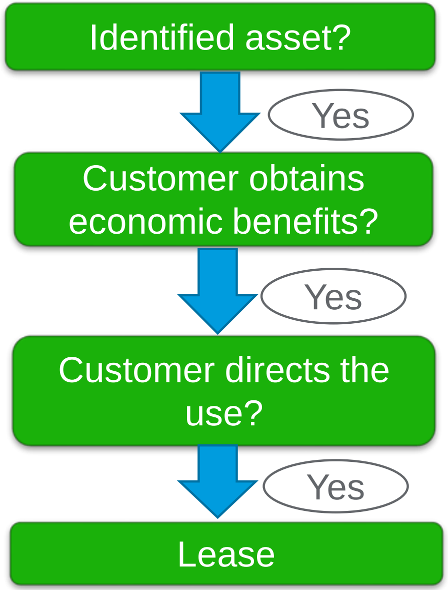
IFRS 16—Is it a lease?

Reminder

- IFRS 16, paragraph 9
  - 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.
- IFRS 16, paragraph B9 provides guidance on assessing control. Does customer have both:
  - The right to obtain substantially all of the economic benefits of an identified asset
  - The right to direct the use of the identified asset (how and for what purpose)

IFRS 16 Leases

Definition of a lease



Identified asset

Identified asset

- An asset can be identified either explicitly or implicitly
- No identified asset if the supplier has substantive rights to substitute the asset for an alternative asset throughout the period of use

Substantive substitution rights

- The supplier has the practical ability to substitute an alternative asset throughout the period of use; and
- The supplier can benefit from substituting the asset

Lease or service contract?

Which party controls the use of the identified asset?

- Customer: lease
- Supplier: service contract

Customer controls the use of the identified asset if

- Customer has the right to obtain substantially all of the economic benefits from use of the identified asset, for example, by having exclusive use of the asset; and
- Customer has the right to direct the use of the identified asset

Lease vs service contract

Illustration

Customer A enters into a 5-year contract with Company B, a ship owner, for the use of a ship. The ship is explicitly specified in the contract. B has no substitution rights. A decides what cargo will be transported and whether, when and where the ship will sail during the contract term. The contract includes restrictions which prevent A from carrying hazardous materials and sailing in waters with high risk of piracy. B operates and maintains the ship. A cannot hire another operator or operate the ship itself during the contract term.

Does the contract contain a lease?

Lease vs service contract

Illustration (cont'd)

The contract contains a lease. There is an identified asset. The ship is explicitly specified in the contract. B has no substitution rights.

A has the rights to substantially all of the economic benefits from use of the ship during the contract term as A has exclusive use of the ship.

A has the right to direct the use of the ship. A makes all the relevant decisions about how and for what purpose the ship will be used during the contract term. The contractual restrictions are protective rights that protect B's investment in the ship and B's personnel. B can make decisions about the operation and maintenance of the ship but these decisions are dependent on A's decisions about how and for what purpose the ship is used.

The contract also involves the provision of services, which could be separated.

IFRS 16 Leases

Directing the use of the identified asset

Which party determines how and for what purpose the asset is used?

- Customer: lease
- Supplier: service contract
- Predetermined: Consider whether customer is able to determine how the asset is operated or designed

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Decision making rights

Relevant rights may include

- Rights to change the type of output produced e.g. to determine the mix of products sold from a retail space
- Rights to change when output is produced e.g. to determine when an item of machinery is used
- Rights to change where output is produced e.g. to determine the destination of a truck or ship
- Rights to change whether output is produced and the quantity of output produced e.g. to determine whether to produce energy from a power plant and how much energy to produce from a power plant

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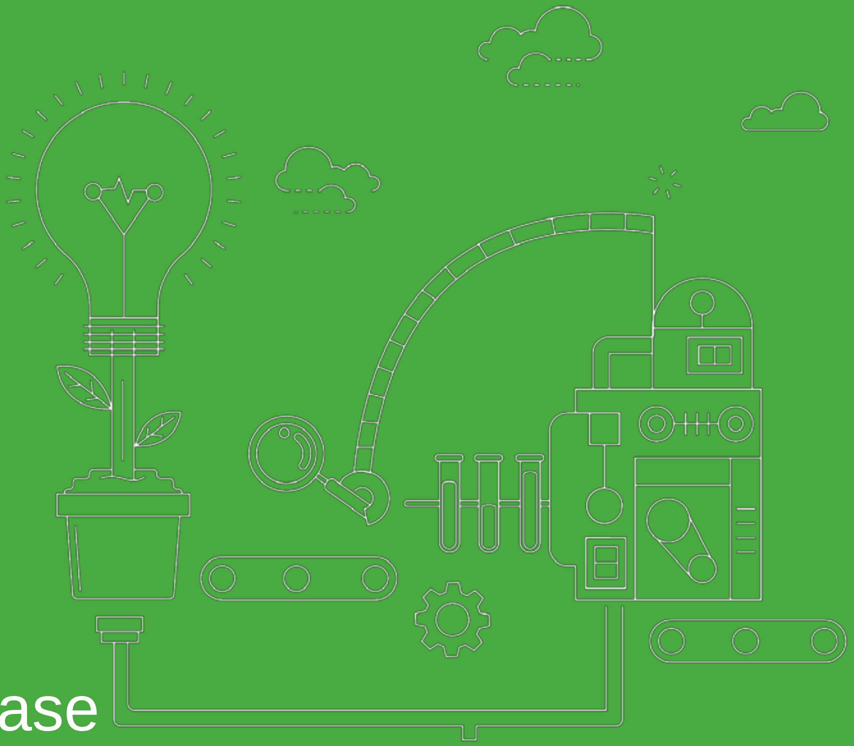
IFRS 16 Leases

Decision making rights

Non-relevant rights include

- Rights limited to operating (unless how and for what purpose the asset is used is predetermined) or maintaining the asset
- Protective rights



Non cancellable/enforceable lease period

IFRS 16 Leases – determining the lease term

Lease term

- Non-cancellable period of the lease together with
  - Periods covered by an extension option if the lessee is reasonably certain to exercise the option
  - Periods covered by a termination option if the lessee is reasonably certain not to exercise the option
- Consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise or not to exercise the option

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What is reasonably certain?

Examples of factors that may create a financial/economic incentive for the lessee to exercise an option to extend the lease or not to exercise an option to terminate:

- Leasehold improvements made to a rental property;
- prohibitive costs to exit the lease (such as exit fees, relocation costs, costs of sourcing a replacement asset etc);
- favourable costs, including rental payments, of extending the lease compared to equivalent anticipated market rates if entering a new lease;

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What is reasonably certain?(continued)

- asset is significant to your operations;
- lack of availability (and convenience of) an equivalent or replacement asset; and
- conditions attaching to the options are likely to be fulfilled

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Calculating the lease term

Non-cancellable period of the lease	X
Period covered by an option to extend the lease (if reasonably certain)	X
Period covered by an option to terminate the lease (if reasonably certain not to exercise the option)	X
Lease Term	X

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Lease term - illustration

Tenant A enters into a lease with Landlord B at the CBD for a period of six (6) years (renewable at negotiated terms) with effect from 1 January 2020.

The lease is for CU 8 per square foot totaling to CU 21,000 per month. Rental escalation will be 6.25% per annum, payable every two years (which translates to 12.5% every two years).

The lease agreement may be terminated at the instance of either the landlord or tenant by giving 3 months notice or 3 months rent in lieu of notice.

What is the lease term?

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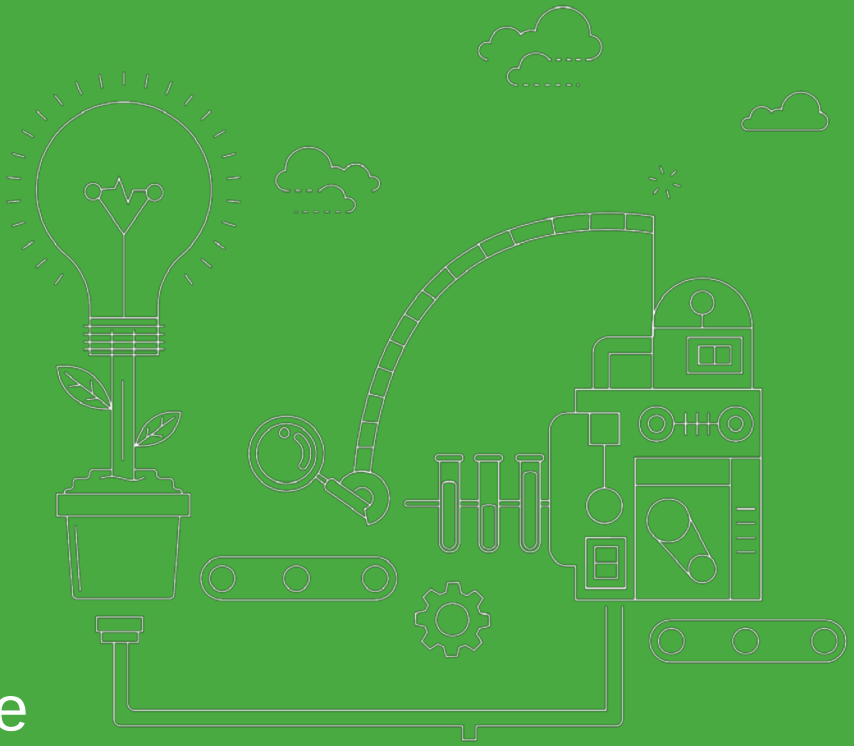
Determining the discount rate



Determining the discount rate

- Interest rate implicit in the lease, or
- Lessees incremental borrowing rate (IBR)

How is the rate implicit in the lease determined?

- Rate implicit in the lease is the discount rate at which:
  - The sum of present values of (i) lease payment and (ii) unguaranteed residual value, **equals**
  - The sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor
- Rate is company specific to the **lessor**

Determining the discount rate

Lessees incremental borrowing rate (IBR)

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***.

The definition highlights the rate is specific to:

- credit worthiness of the lessee
- term of the arrangement
- security i.e. nature and quality of the underlying asset
- the amount of funds 'borrowed'
- economic environment

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Determining the discount rate

IFRS 16 Basis for conclusions

- "…..depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is **readily observable as a starting point** when determining its incremental borrowing rate for a lease (for example, the **rate that a lessee has paid**, or would pay, **to borrow money** to purchase the type of asset being leased, or the **property yield** when determining the discount rate to apply to property leases). Nonetheless, a lessee should **adjust** such **observable rates** as is needed to determine its incremental borrowing rate as defined in IFRS16." (BC162)

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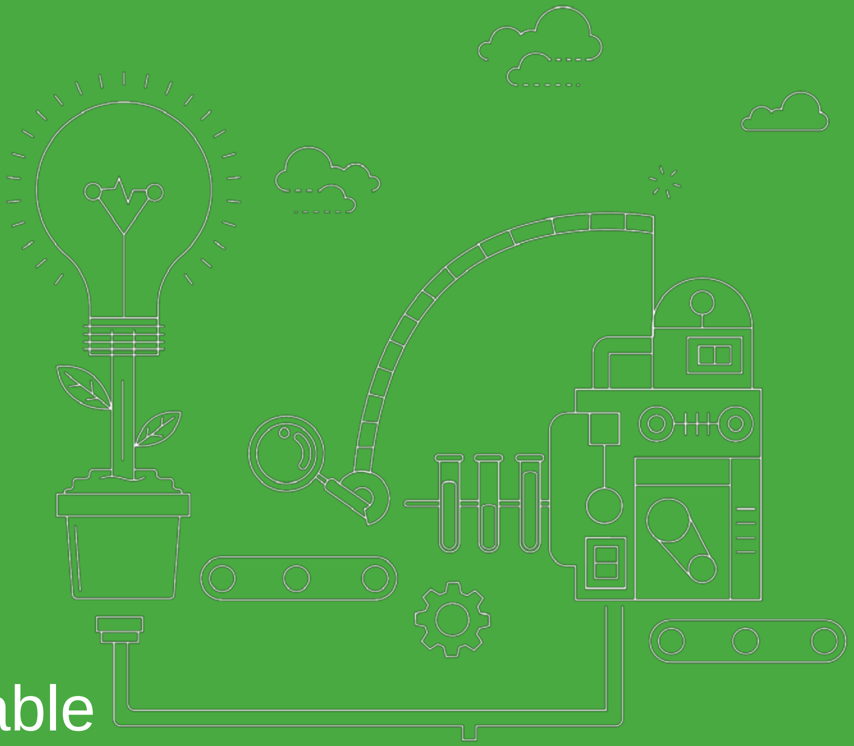

Determining the fixed and variable lease payments

Fixed and variable lease payments

- IFRS 16, paragraph 27. Lease payments to include in the measurement of the lease liability comprise the following:
    - Fixed payments (including in-substance fixed payments) less any lease incentives receivable
    - Variable lease payments that depend on an index or rate
    - Amounts expected to be payable by lessee under residual value guarantees
    - The exercise price of a purchase option if lessee is reasonably certain to exercise the purchase option
    - Payments of penalties to terminate the lease option if lessee is reasonably certain to exercise a termination option

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Fixed and variable lease payments

The silo on the wharf

- A cement factory is granted a lease over a silo on a wharf, for its own exclusive use; In order for it to be useable for the purposes intended, $6m of expenditure was incurred by the owner in making modifications to the silo

- Instead of requiring the lessee to incur the costs and reimburse them, the costs were incurred prior to inception of the lease by the lessor

- The lease contract included separately identified components:

  - The fixed rent for the silo, payable quarterly; and

  - An additional amount, payable in 3 instalments, a “Wharf Improvement Rent”

How should you account for these reimbursements to the landlord?

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Fixed and variable lease payments

The silo on the wharf

- The wharf improvement costs incurred by the landlord were in effect incurred to be able to enter the lease: without incurring the costs, the asset was not fit for the purpose of the lease.
- The wharf improvement cost reimbursements were written into the contract as fixed payments.
- **The ‘wharf improvement rent’ is part of the fixed payments to include in the measurement of the lease**: recognise a right of use asset and lease liability, with the lease liability measured at the present value of the future payments to be made by the lessee.

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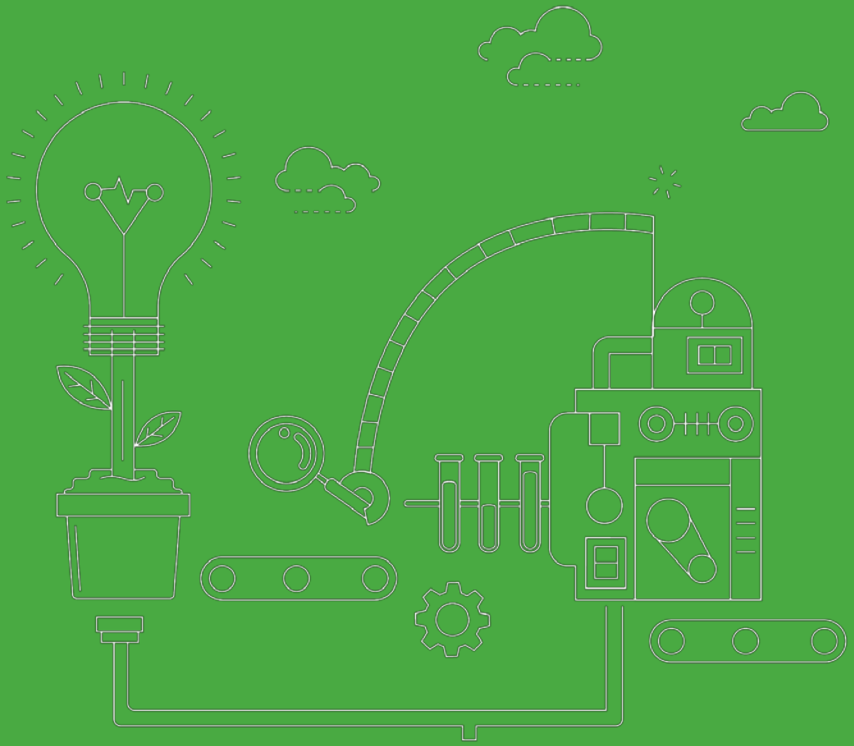

Intercompany leasing arrangements

Consolidated financial statements

There could be situations where one company in a group leases an asset to another company in the same group.

IFRS 10 requires that assets and liabilities, income and expenses, and cash flows relating to transactions between group entities be eliminated in full.

IFRS 16

Consolidated financial statements

For leases classified by the lessor entity as operating leases, the lessee entity will have to reverse all entries relating to the right-of-use asset and recognise the lease payments as an expense, then eliminate the lease payments against the rental income in the lessor entity.

For leases classified by the lessor entity as finance leases, the lease payable of the lessee entity will need to be offset against the lease receivables of the lessor entity, and the right-of-use asset of the lessee would be reclassified as property, plant and equipment.

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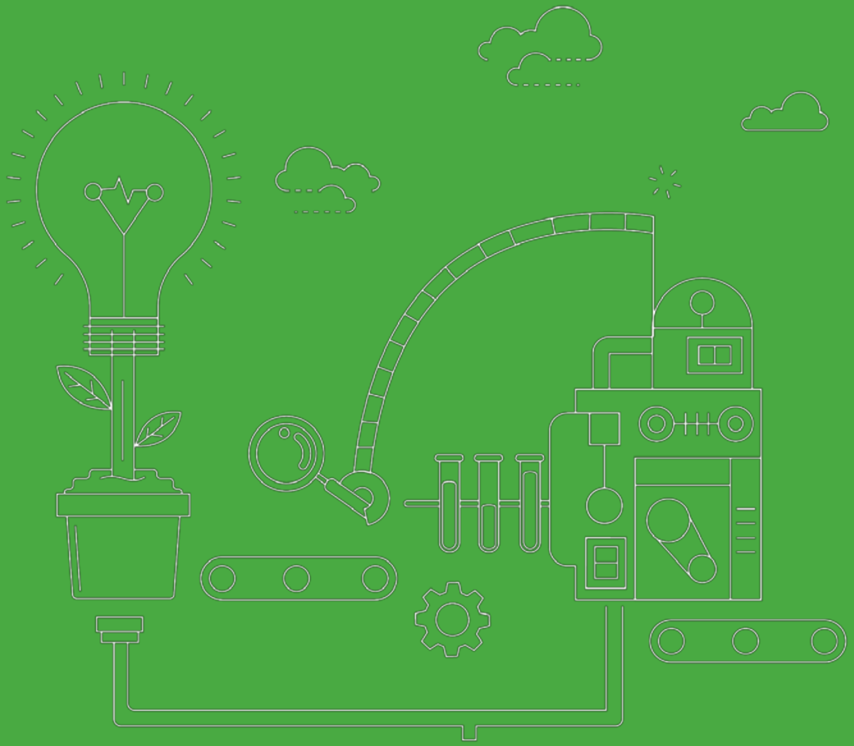

Current and deferred tax

IFRS 16

Tax implications – current tax

- For true finance leases where ownership will pass at the end of the lease, the Income Tax Act allows capitalisation and claiming of wear and tear allowances in place of depreciation

- For other leases:
  - Depreciation and interest expense have to be added back
  - Lease payments in the period will be allowed as a tax deduction
  - Initial direct costs that have been capitalised should also be allowed as a tax deduction in year one

Tax implications – deferred tax

- For leases that are not finance leases as defined by the Income Tax Act, both the RoU asset and the lease liability will have a tax base of zero

- A deferred tax liability should be recognised on the taxable temporary difference on the RoU asset and a deferred tax asset recognised on the deductible temporary difference on the lease liability

RSM

IFRS 16 - Leases

Illustration

- A company has entered into a 5 year lease of office premises from 1 January. Rent is payable on the first day of each year. The rent is CU1,000 for the first year and increases by 5% each year to allow for inflation.

- The company's incremental borrowing cost is 10%

RSM

Illustration – lease of office space

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
	CU	CU	CU	CU	CU	CU
Rent payment	1,000	1,050	1,103	1,158	1,216	5,526
P&L expense under IAS 17	1,105	1,105	1,105	1,105	1,105	5,526
Net present value, at 10%	1,000	955	911	870	830	4,566
Depreciation of RoU asset	913	913	913	913	913	4,566
Interest expense	357	287	206	111	0	960
Total charge to P&L under IFRS 16	1,270	1,200	1,119	1,024	913	5,526
Cash flow – principal (financing)	643	763	897	1,047	1,216	
Cash flow – interest	357	287	206	111	0	

Lessees - Transition

- Existing finance leases: may choose to retain existing accounting
- Existing operating leases: choose either full retrospective or modified retrospective approach (consistently for all leases)
- Modified retrospective approach
  - Exemption for leases ending within 12 months of transition date
  - No restatement of comparatives
  - Choice of measurement of RoU assets (i.e. retrospective basis or equal to lease liabilities) on a lease-by-lease basis

ACCOUNTING BY LESSORS

What does IFRS 16 change for lessors?

There is little change for lessors

- Applying IFRS 16, 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 requires lessors to apply:
  - New definition of a lease
  - New guidance on sale and leaseback transactions
  - New sub-leases guidance
  - New guidance on lessor accounting for lease modifications
- IFRS 16 also requires lessors to provide enhanced disclosures about their risk exposure arising from leasing activities

What does IFRS 16 change for lessors?

Sub-leases

- If entity A with an RoU asset sub-leases that asset to entity B, entity A has to determine, as lessor, whether the sub-lease is a finance lease or an operating lease by reference to the RoU asset – i.e. have substantially all the risks and rewards of owning the RoU asset (not the underlying asset) been transferred?

- If the sub-lease is classified as a finance lease, entity A will derecognise the RoU asset and recognise a lease receivable.
- If the sub-lease is classified as an operating lease, entity A will continue to recognise and depreciate the RoU asset and recognise lease income.

IFRS 16 - implementation

Actions that should have been taken **before** 1 January 2019

- Draw up an inventory of operating leases (where you are the lessee) identifying the term of the lease and the lease payments to be capitalised
- Pay special attention to:
  - Leases including provision of services
  - Variable lease payments
  - Options to renew
  - Options to cancel
- Decide which transition options to use
- Review systems and processes in place to capture accounting information needed

What’s changed - recap

Changes to lessor accounting

Substantially carry forward IAS 17 accounting requirements; some additional disclosure requirements

Changes to lessee accounting

Former operating leases capitalised. All* leases accounted for similarly to today’s finance leases.

Balance sheet:

- ↑ lease assets
- ↑ financial liabilities
- ↓ equity

Income statement:

- ↓ operating expenses
- ↑ finance costs

Cash flow statement:

- ↓ operating cash outflows
- ↑ financing cash outflows

Effect on reported information, but no effect on a lessee’s economic position or commitments to pay cash

** Exemptions for short-term leases and leases of low-value assets*

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