

FINANCIAL REPORTING GUIDE TO IFRS 16: LEASES

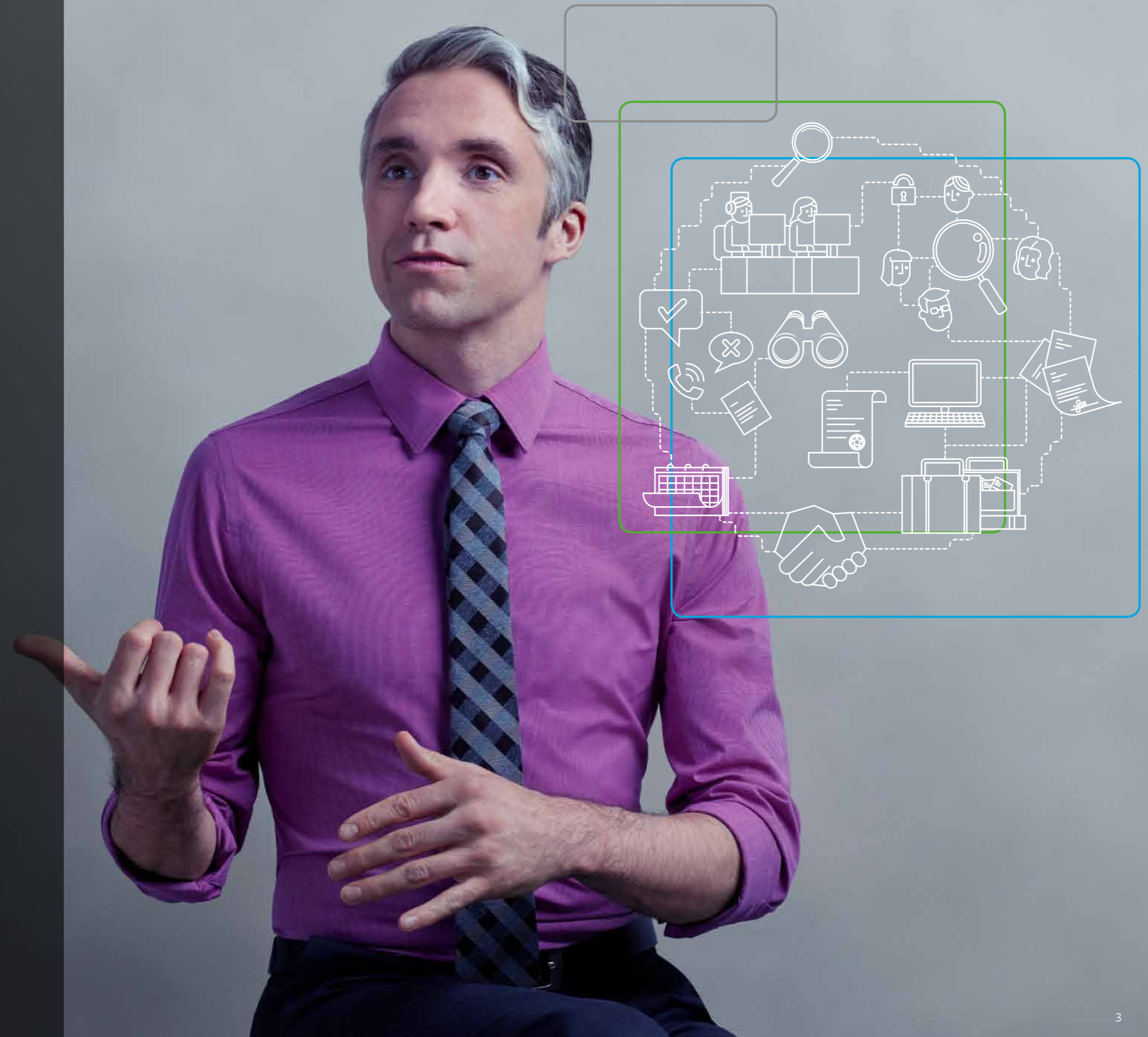
Helping lessees navigate the standard

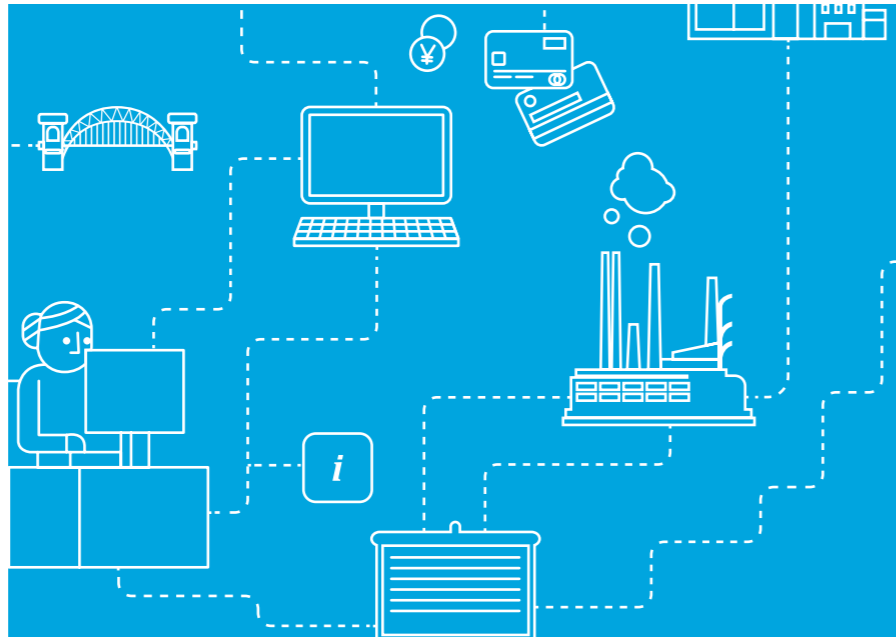
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INTRODUCTION

IFRS 16 comes into effect for periods commencing on or after 1 January 2019. Lessees with contracts that are currently treated as operating leases in their financial statements (ie the business pays rent) will definitely be affected by the forthcoming changes.

This guide will take you step by step through the lessee accounting provisions that will apply to current operating lease contracts when IFRS 16 is adopted for the first time, along with the new disclosures which will need to be made.

This guide focusses solely on the changes that will affect lessees as changes arising from IFRS 16 for lessors are minor. If you are also a lessor you may want to seek advice on the additional information to be disclosed in financial statements.

Why the change?

The International Accounting Standards Board ("the IASB") believes that the leasing of assets is of importance to many entities. Leases can be used to provide access to assets without significant upfront costs, and the use of those assets is of value to the entity. Without entities recognising these leased assets in their financial statements (along with the corresponding liability) users can neither see all the assets that the entity is benefiting from, nor easily compare their financial position to entities which have chosen to either buy the asset outright, or have entered into alternative financing arrangements.

What are the main changes?

IAS 17 Leases, the predecessor to IFRS 16, requires entities to classify their contracts as either operating leases or finance leases, based on the extent to which risks and rewards incidental to ownership of the leased asset lie with the lessor or the lessee. However, IFRS 16 removes the 'operating' and 'finance' lease classifications and replaces them with the concept of 'right-of-use' assets and associated financial liabilities. Put simply, this change results in the recognition of a lease liability on the balance sheet for operating leases (which reflects the present value of the future rental payments) and a corresponding asset which is referred to in the standard as a right-of-use asset.

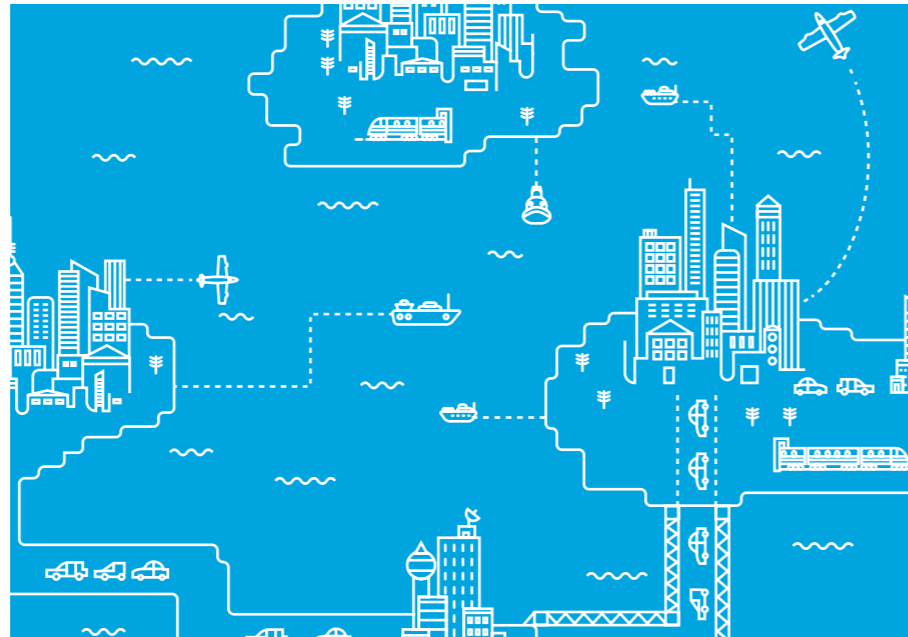
How will the changes affect the financial position and performance?

For companies with leases classified as operating leases under IAS 17, there may be a significant impact on the Statement of Financial Position as these assets and corresponding liabilities will have to be recognised. This will impact on current gearing levels and potentially on covenants provided to lenders and others. It is important to determine the impact sufficiently early to ensure that stakeholder expectations are managed.

There will also be an impact on the profit or loss. On adoption of IFRS 16, EBITDA is likely to rise because the lease expense (ie the rent) under IAS 17 for operating leases will be removed and replaced with additional depreciation and finance costs. The profit profile of the business will also change as more expense is recognised in earlier periods and less in later periods compared to the constant amount which was usually recognised under IAS 17.

ACCOUNTING TREATMENT FOR LESSEES

	Financial statement	IAS 17	IFRS 16
Operating leases	Statement of Financial Position	<ul style="list-style-type: none"> No liability recognised No asset recognised 	<ul style="list-style-type: none"> Lease liability is recognised at the present value of the future lease payments Corresponding right-of-use asset is recognised
	Income Statement	<ul style="list-style-type: none"> Total rentals are expensed (usually on a straight line basis) over the life of the lease 	<ul style="list-style-type: none"> Interest expense in relation to the lease liability is allocated using the effective interest method Depreciation is charged over the shorter of the lease term and the useful economic life
Finance leases	Statement of Financial Position	<ul style="list-style-type: none"> Lease liability is recognised at the present value of the future lease payments Actual asset recognised at the inception of the lease 	<ul style="list-style-type: none"> Lease liability is recognised at the present value of the future lease payments Corresponding right-of-use asset is recognised
	Income Statement	<ul style="list-style-type: none"> Interest expense in relation to the lease liability is allocated using the effective interest method The asset is depreciated over the shorter of the lease term and the useful economic life 	<ul style="list-style-type: none"> Interest expense in relation to the lease liability is allocated using the effective interest method The right-of-use asset is depreciated over the shorter of the lease term and the useful economic life



WILL MORE CONTRACTS BE ACCOUNTED FOR AS LEASES UNDER IFRS 16?

IFRS 16 largely retains the definition of a lease given in IAS 17. However, the guidance setting out how to apply that definition has changed. This means that potentially more contracts will be brought into the scope of the new Standard, and some contracts which were considered to contain a lease under IAS 17 may be scoped out.

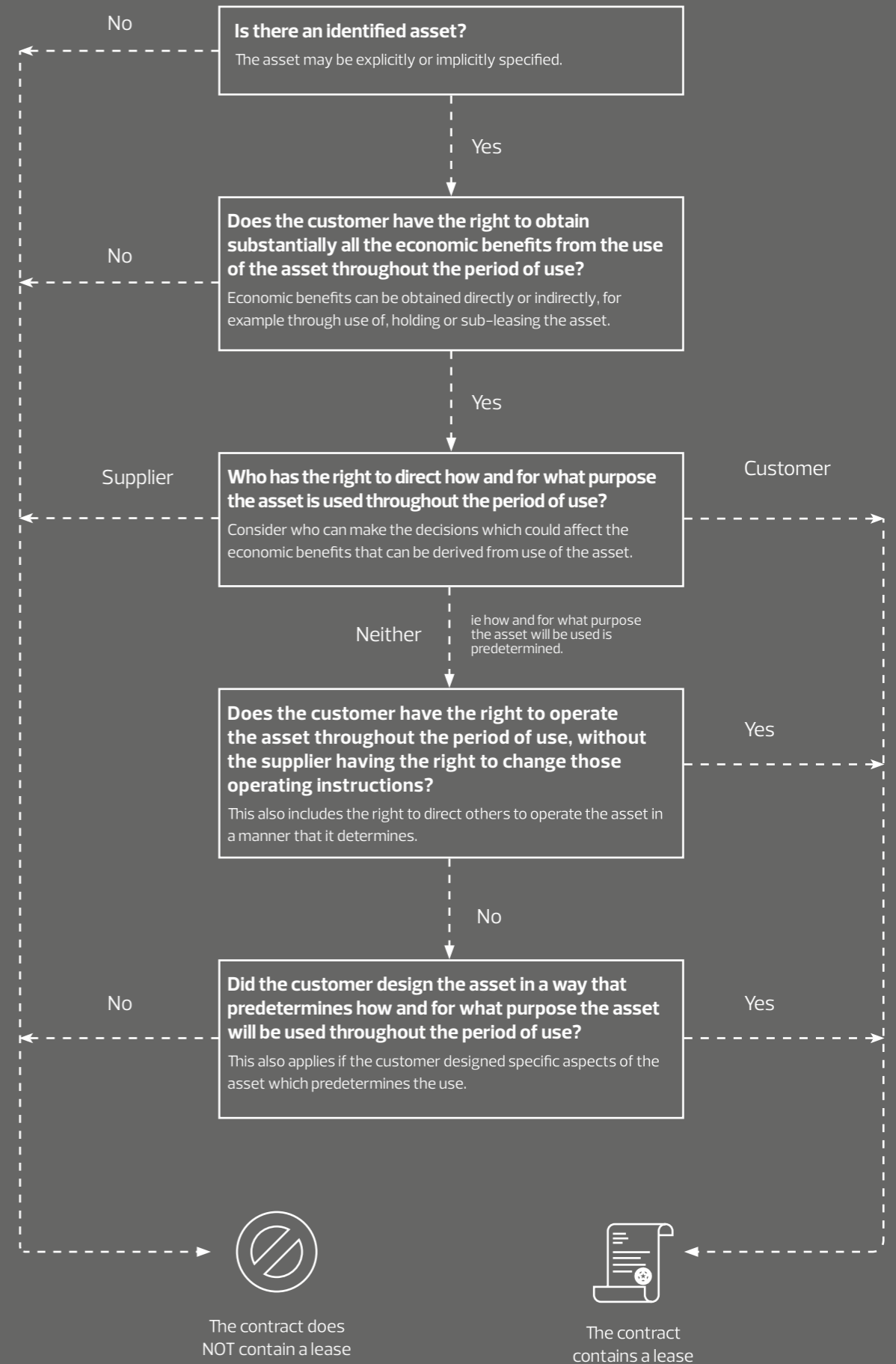
As illustrated in the following flowchart, whether a contract is, or contains, a lease is now driven much more by the question of which party to the contract controls the usage of the underlying asset for the period of use. It is not sufficient for a customer to have the right to obtain substantially all the benefits from the use of an asset any more, the customer must also have the ability to direct the use of the asset.



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



Definition of a lease under IFRS 16



WHEN AND WHAT SHOULD BE RECOGNISED AT THE COMMENCEMENT DATE?

At the commencement date (the date on which a lessor makes the underlying asset available for use by a lessee) you need to recognise:

- A lease liability for the present value of future lease payments made over the lease term that are economically unavoidable ('lease liability'); and
- a right-of-use asset at cost.

Step 1: 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

What is 'reasonably certain'?

In determining whether an option to extend or terminate a lease will be exercised, an entity must assess all facts and circumstances that create a financial/economic incentive to do so.

The following are examples, but not an exhaustive list, 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;
- 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.

Step 2: Calculating the future lease payments

Fixed lease payments (made over the lease term) (including variable payments that are in substance fixed)	X
Receivable lease incentives	(X)
Optional payments that are likely to be made (such as fees to take an option to extend a lease)	X
Variable payments that rely on an index or rate	X
Future lease payments	X
Discount to reflect the time value	(X)
Lease liability at commencement date	X
Step 3: Calculating the right-of-use asset at cost:	
Lease liability at commencement date	X
Payments made before commencement date	X
Initial estimate of any restoration costs	X
Any lease incentives received	(X)
Cost of right-of-use asset	X

Variable payments that are in substance fixed

Some payments are labelled as or appearing to be variable (in form), may in substance be fixed because, realistically, they are unavoidable.

Examples include:

- Payments that are dependent on the right-of-use asset operating throughout the lease;
- payments that only occur if a certain event happens, but that event has no genuine possibility of not occurring; and
- the provision of more than one set of payments but only one of those sets is realistic and the payments flowing from that set are fixed.

Variable payments which are not included in the measurement of the lease liability:

- Payments linked to production output or usage, such as a fee per unit produced or mile driven; and
- payments linked to performance, such as rental payments for a property based on a percentage of sales made from that property.

What discount rate do I use for the lease liability?

If there is a discount rate implicit in the lease, use that (the rate of interest which reconciles the present value of the lease payments and any residual guaranteed value to the fair value of the underlying asset and any initial direct costs of the lessor).

If that rate cannot be readily determined, use your incremental borrowing rate (the rate of interest that you would have to pay to borrow a similar amount of money to fund a similar right-of-use asset for a similar length of time with similar securities).

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WHEN AND WHAT SHOULD BE RECOGNISED IN SUBSEQUENT YEARS?

You will need to continue to recognise the right-of-use asset (using either the cost or fair value model) and the carrying amount of the lease liability.

Right-of-use asset

COST MODEL

- Cost less any accumulated depreciation and any accumulated impairment losses;
- Adjusted for any re-measurement of the lease liability in respect of a modification ([see page 14](#)).
- Depreciated from the commencement date to the end of the useful life if:
 - » Ownership of the underlying asset is transferred to the lessee by the end of the lease term; or
 - » the cost of the right-of-use asset reflects that the lessee will exercise a purchase option.
- Depreciated over the lease term in other circumstances in accordance with IAS 16 Property, Plant and Equipment (PPE).

FAIR VALUE MODEL

- An entity that has a fair value through profit and loss accounting policy for its investment properties must measure any right-of-use asset that meets the definition of an investment property at fair value.
- If right-of-use assets relate to a class of PPE to which the revaluation model applies, an entity may elect to apply the revaluation model to all of the right-of-use assets that relate to that particular class.

Lease Liability

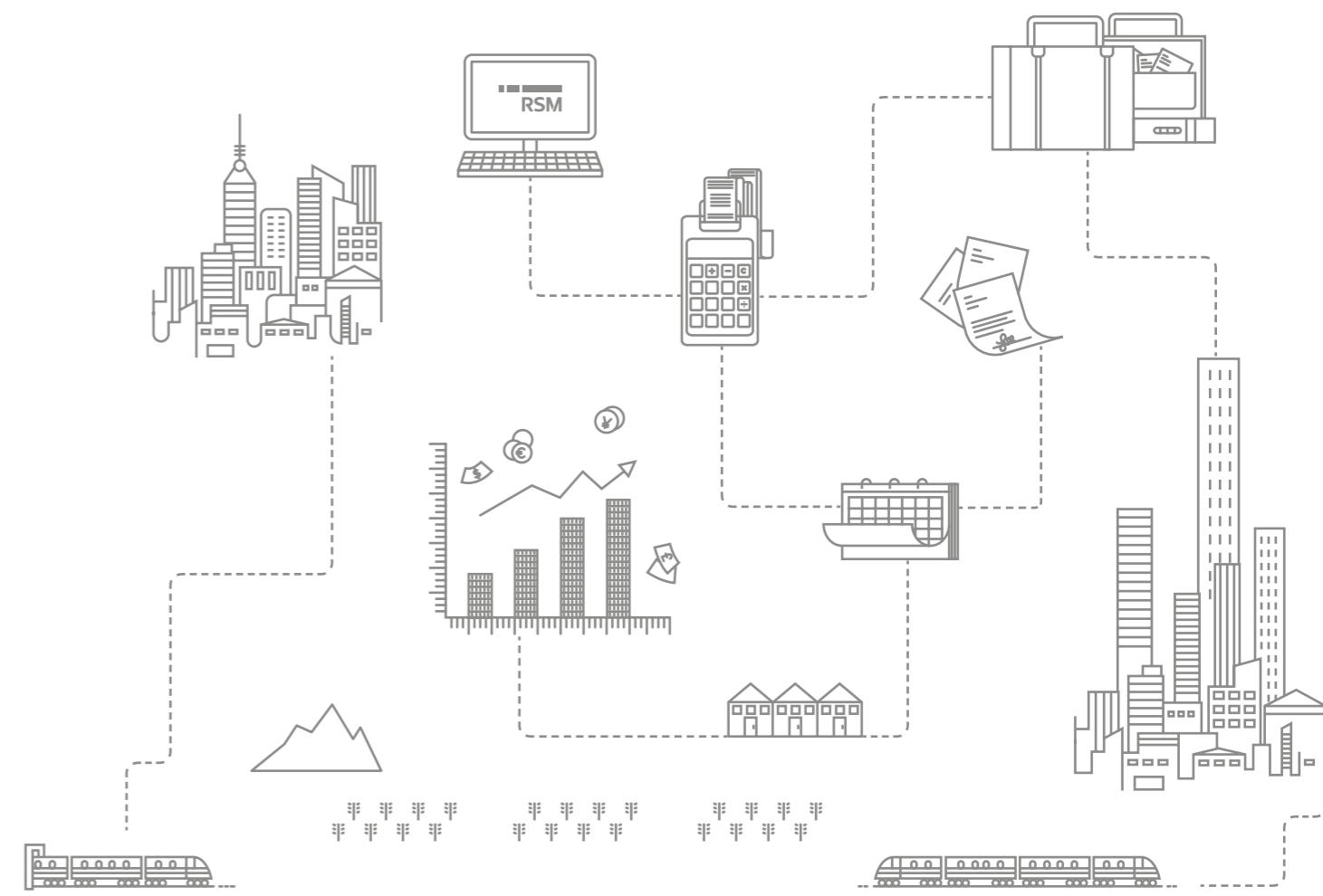
Carrying amount:

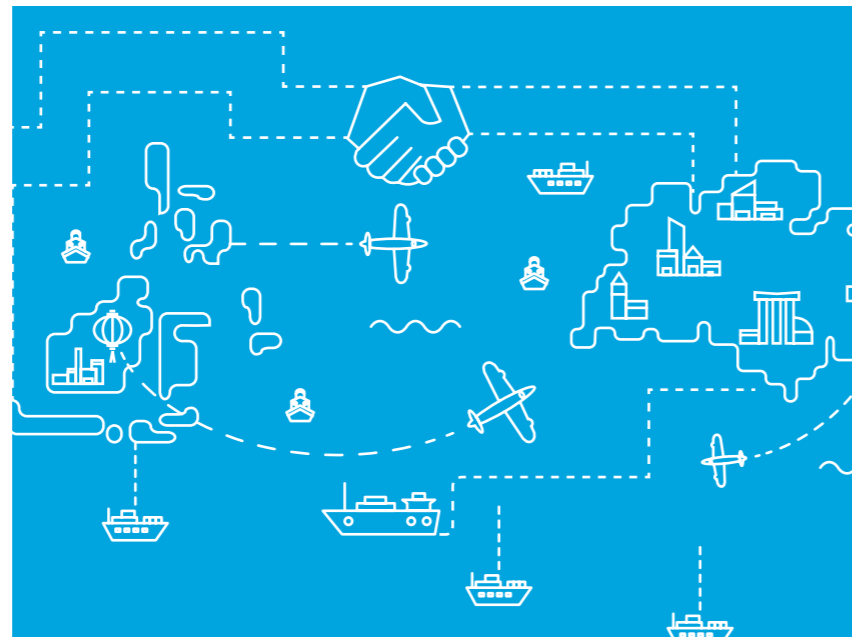
- Increased to reflect interest on the lease liability; and
- reduced to reflect the lease payments made.
- Re-measured to reflect:
 - » Any reassessment; or
 - » certain lease modifications; or
 - » revised in-substance fixed lease payments ([see page 9](#)).

Note:

- Interest on the lease liability is calculated to be the amount that produces a constant periodic rate of interest on the outstanding lease liability.

- The periodic rate of interest applied is the interest rate implicit in the lease, unless that cannot be readily determined. In such circumstances, the lessee's incremental borrowing rate should be used. Guidance on determination of this rate is given below. Additional guidance is provided if the lease is re-assessed ([see page 9](#)).
- Interest on the lease liability is recognised in profit and loss unless the costs are included in the carrying value of another asset in accordance with another accounting standard.
- Variable lease payments not included in the measurement of the lease liability are recognised in profit and loss in the period in which the event or condition that triggers those payments occurs, unless the costs are included in the carrying value of another asset in accordance with another accounting standard.





HOW ARE MODIFICATIONS TREATED?

IFRS 16 distinguishes lease modifications from a reassessment of a lease (eg whether or not you are reasonably certain to exercise an option to extend an existing lease).

Lease modifications change the scope of the lease or change the consideration for the lease by comparison with that detailed in the original terms and conditions of the contract. If the modifications, in substance, mean that the original lease has been terminated and a new lease created, then the lessee will account for the revised terms as a new lease.

A lease modification should be accounted for as a separate lease if:

- The modification adds the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount that is proportionate to the stand-alone price of the additional asset(s).

What about modifications that don't need to be accounted for as a separate lease?

When assessing the lease, a number of decisions must be made. For example, is an option to extend the lease reasonably certain to be taken? Are we reasonably certain that we won't want to exercise the option to terminate the lease? As time goes by, the answers to those questions may change.

Changes to the contract may also be made. Maybe a rent review takes place, and the fixed rental payments increase going forward? Or an extension to the lease is successfully negotiated?

Where these changes do not indicate a new lease agreement, the amount recognised for the lease liability and the right-of-use asset will need to be revisited.

After initial recognition, the right-of-use asset (unless it is an investment property or within a class of property, plant and equipment which is measured at fair value) is measured at cost less depreciation and any impairment in line with IAS 16 Property, Plant and Equipment. However, the cost will also be adjusted for any remeasurement of the lease liability.

How is the lease liability remeasured?

If there is a reassessment of the lease liability, either because the assumptions made about the lease term or the lease costs have changed, or because there has been a modification (which is not indicative of a new lease) then the liability will be remeasured as follows:



Change in lease term?

eg option to extend that was previously reasonably certain to be taken is now unlikely to be taken or an option to terminate the lease that was expected to be taken has not been.



Determine the lease payments based on the revised lease term.

don't forget to remove any option fees that were previously included in the lease payments calculation.



Determine a revised discount rate and apply this rate to calculate the present value of the recalculated lease payments.



Change to the lease payments?

eg a change to lease payments based on an index or rate used to determine the payment, such as a market rent review, or a change in the amount to be paid under a residual value guarantee.

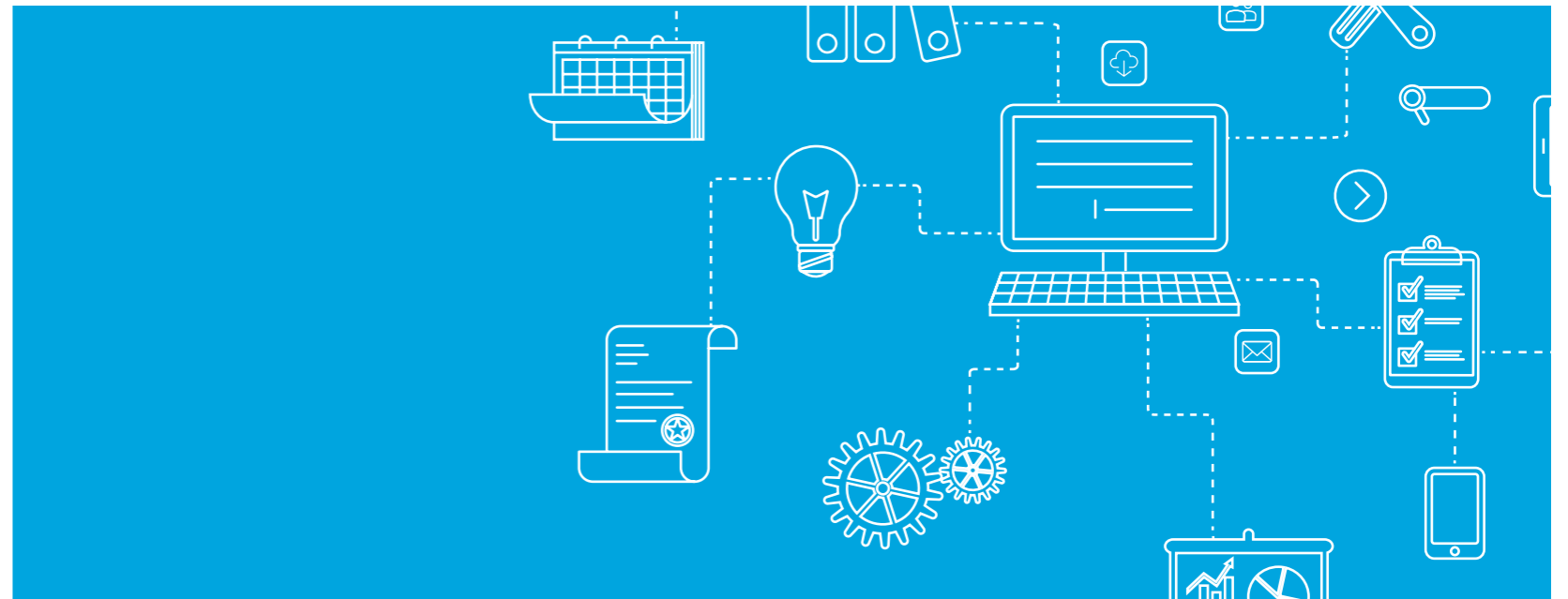


Determine the revised lease payments based on the remaining lease term.

if changes are based on an index movement or rate revisit the forecast movements included in this calculation to make sure they continue to be appropriate.



Apply the original discount rate to calculate the present value of the recalculated lease payments.



ARE THERE ANY EXCEPTIONS AND PRACTICAL EXPEDIENTS?

Not all leases need to be calculated using the lease liability and right-of-use asset method. There are some exemptions available as well as some practical expedients.

EXEMPTION	DETAILS	CONDITIONS TO USE EXEMPTION	POSSIBLE EXAMPLES	TREATMENT
Short-term lease	Short-term leases are leases of 12 months or less with no purchase option at the end.	<ul style="list-style-type: none"> Election must be made; election will apply by class of underlying asset to which the right of use relates; and any subsequent change or modification of the lease is treated as a new lease. 	<ul style="list-style-type: none"> Hire vehicle for use while main vehicle is being repaired. 3 month storage lease to expand capacity to hold stock in advance of peak season. Lease of equipment specifically for a one off project that will be completed in 6 months. 	Recognise the lease payments associated with the lease as an expense in the income statement on a straight-line (or other systematic) basis. This is the same treatment as applies to an operating lease under IAS 17.
Low value underlying assets	'Low value' is not defined but a value of less than US\$5,000 was anticipated in the Basis of Conclusions to IFRS 16.	<ul style="list-style-type: none"> Election must be made; election must be made on a lease-by-lease basis; and assets must not be dependent on, or highly interrelated with, other underlying assets. <p>The exemption may be taken even if the low-value assets are material to the accounts in aggregate.</p>	<ul style="list-style-type: none"> Mobile phone contract. Office equipment rental. PC or tablet rental. 	

Practical expedients

- Portfolio application** – IFRS 16 can be applied to a portfolio of leases with similar characteristics, if the effect on the financial statements is not materially different to accounting for the leases separately.
- Account for as a single lease component** – instead of separating non-lease components (services) from lease components of a contract the lessee can choose, by class of underlying asset, to account for the whole contract as a single lease.

WHAT ARE THE NEW DISCLOSURE REQUIREMENTS?

The objective of the disclosure requirements in IFRS 16 is for lessees to provide information that will assist users of the financial statements to assess the effect that leases have on the financial position, performance and cash flows of the business.

The following information is required to be presented in a tabular format unless another format is considered to more appropriate:

- By class of underlying asset:
 - » Depreciation expense
 - » Carrying value of right-of-use assets
- Additions to right-of-use assets
- Interest expense on lease liabilities
- Other expenses relating to:
 - » Short-term leases where the practical expedient has been applied (need not include leases with a lease term of one month or less);
 - » leases of low-value assets; and
 - » variable lease payments not included in the lease liability.
- Accounting policy for short-term leases and low value assets if the exemptions are taken
- Sub-letting income from right-of-use assets
- Total cash outflow for leases
- Gains and losses on sale and lease back transactions
- Costs that the lessee has included in the carrying amount of another asset.

Additional qualitative and quantitative disclosures will also be necessary about the entity's leasing activities if they are considered necessary to meet the overall disclosure objective set out above. This may include for example, details of the leasing activities entered into, the variability of future cash outflows, restrictions or covenants imposed by the lessor.

WHAT ARE THE TRANSITION MODELS AND ARE THERE ANY RELIEFS?

There is no requirement to reassess whether a contract is, or includes a lease (this is given as a practical expedient). IFRS 16 will only be applied to the contracts that were previously identified as a lease under IAS 17 and IFRIC 4. If contracts are not reassessed, this should be disclosed and applied to all such contracts at the date of initial application.

There are two transition models that are available, however, one model must be selected and applied consistently to all leases.

Full Transition Method

Under the full transition method, IAS 8 is applied in full, meaning that the financial position at the beginning of the comparative period is restated to reflect the carrying value of the right-to-use assets and the financial liabilities as if IFRS 16 had been applied from the inception of each lease.

Cumulative Catch Up Approach

Under the cumulative catch up approach, the initial application date is determined to be the first day of the financial period in which IFRS 16 is being applied. This means that corresponding amounts are presented having applied IAS 17. Whilst this method may be considered to be easier to apply than the full transition method, the prior period financial position and results will not be comparable with the performance and position presented for the current period. For this reason, entities are required to disclose the effect of applying this approach including:

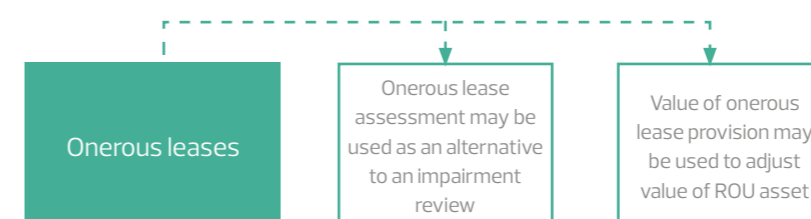
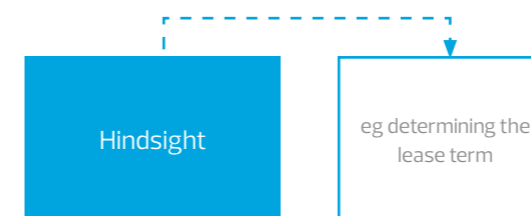
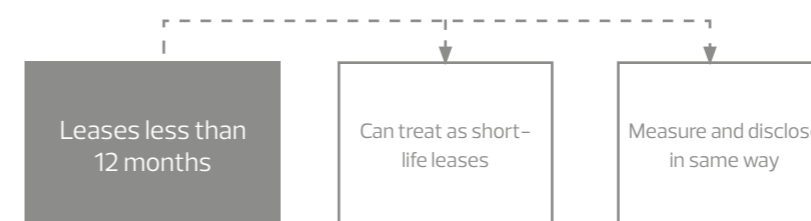
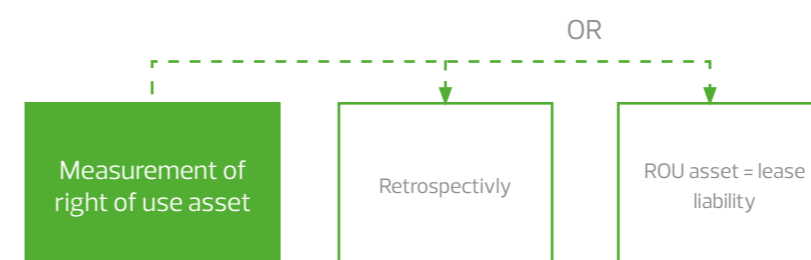
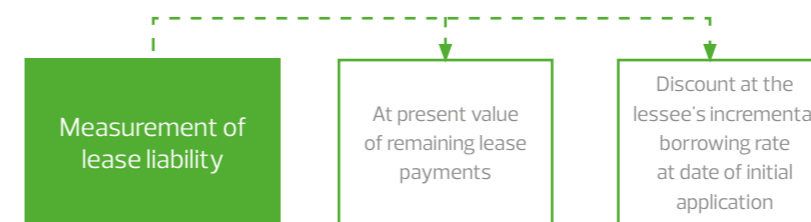
- An explanation of any difference between the operating lease commitments disclosed for the corresponding period discounted using the incremental borrowing rate and the lease liabilities recognised on initial application of IFRS 16; and
- The weighted average incremental borrowing rate that has been applied to lease liabilities recognised at the date of initial application.

Under this approach there is also the option of applying some additional practical expedients. These can be applied on a lease by lease basis and entities can select which ones (if any) they wish to apply.

Other transitional provisions – previously recognised business combinations

If an asset or liability was previously recognised relating to a favourable or an unfavourable lease under IFRS 3 Business Combinations, the lessee must derecognise that asset or liability and adjust the carrying value of the right-of-use asset by a corresponding amount at the date of initial application.

Cumulative catch-up approach – practical expedients



Measurement of lease liability

Entities are not required to go back to the start of the lease and amend for any modifications. As an alternative, entities can calculate the lease liability by discounting the remaining lease payments using the incremental borrowing rate at the date of initial application.

Measurement of the right-of-use asset

Entities can choose to measure the right-of-use asset at the same value as the lease liability adjusted to take into account any prepayment/accrued lease payments that were previously recognised. This means that no adjustment will need to be made to equity at the initial application date. However, this is likely to mean that the future depreciation expense will be higher than if this practical expedient was not applied. For this reason, it may be beneficial not to apply this practical expedient to low volume, high value contracts but to apply it to low value, high volume contracts.

Leases with a remaining lease term of less than 12 months

An entity can choose not to restate these leases ie continue to treat them in the same way as operating leases under IAS 17.

Portfolio discount rate

IFRS 16 permits an entity to apply a single discount rate to a portfolio of leases that have reasonably similar characteristics ie. leases with remaining lease terms that are similar and relate to a similar class of underlying asset in a similar economic environment.

Hindsight

Hindsight can be applied when applying IFRS 16 for the first time. For example, if a lease has been extended or terminated, this known information can be used in determining the lease term.

Onerous leases

If an onerous lease assessment has been performed in a previous period, the standard permits this to be used as an alternative to an impairment review. In such circumstances, the onerous lease amount replaces any impairment loss and hence is adjusted against the value of the right-of-use asset. The reason this is permitted is that onerous lease provisions will cease to exist going forward as all lease obligations will already be recognised in the balance sheet.

HOW CAN RSM HELP?



Assess the impact of the new standard on your key performance indicators, loan and employee agreements.



Develop an implementation plan to ensure a smooth and cost effective transition and project manage the implementation process.



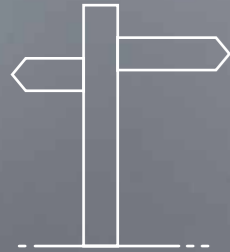
Help you understand the impact of implementation on your financial statements and your business.



Assess whether your existing systems will be able to cope with the implementation of the new standard and advise on a selection of software vendors.



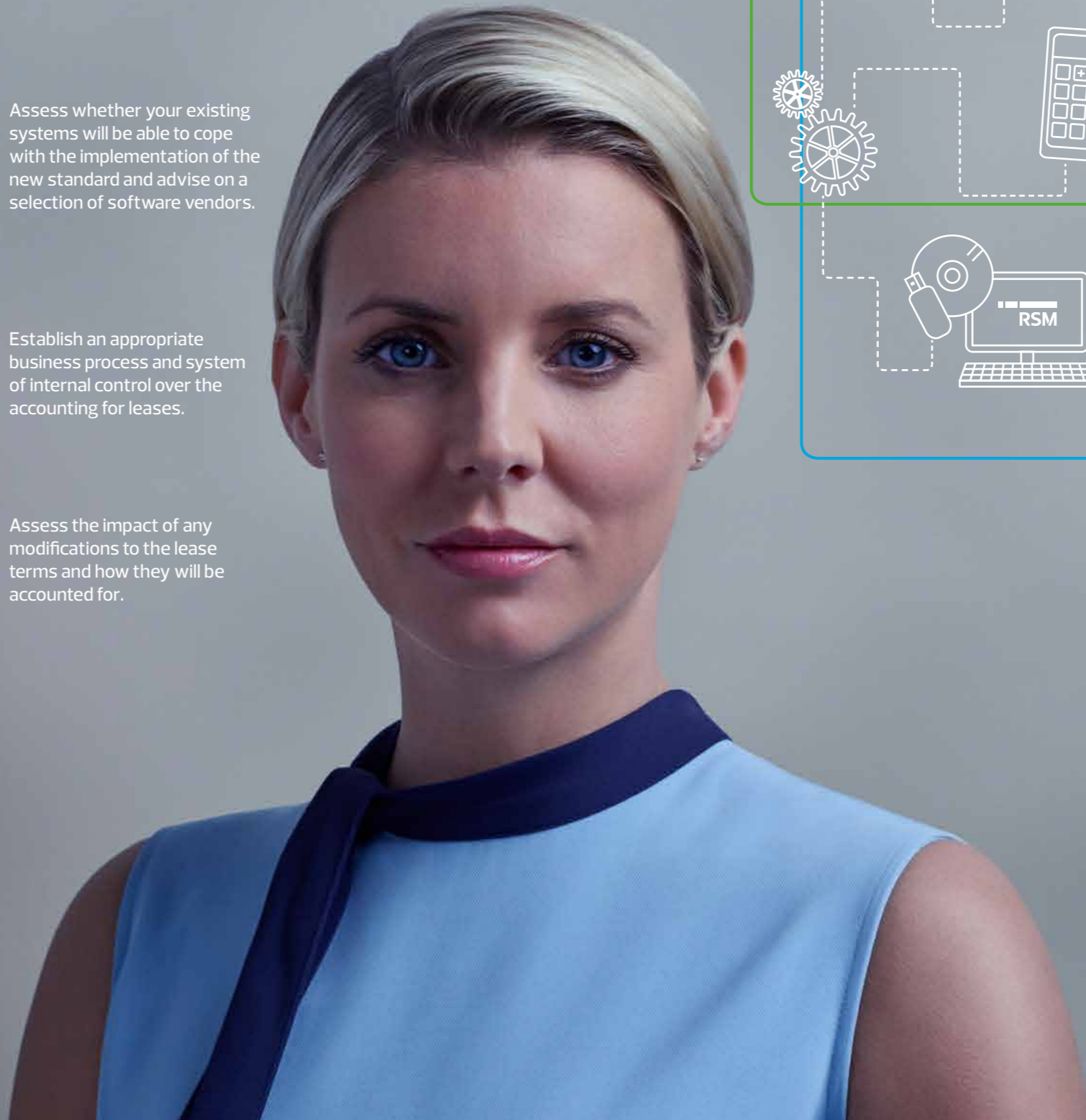
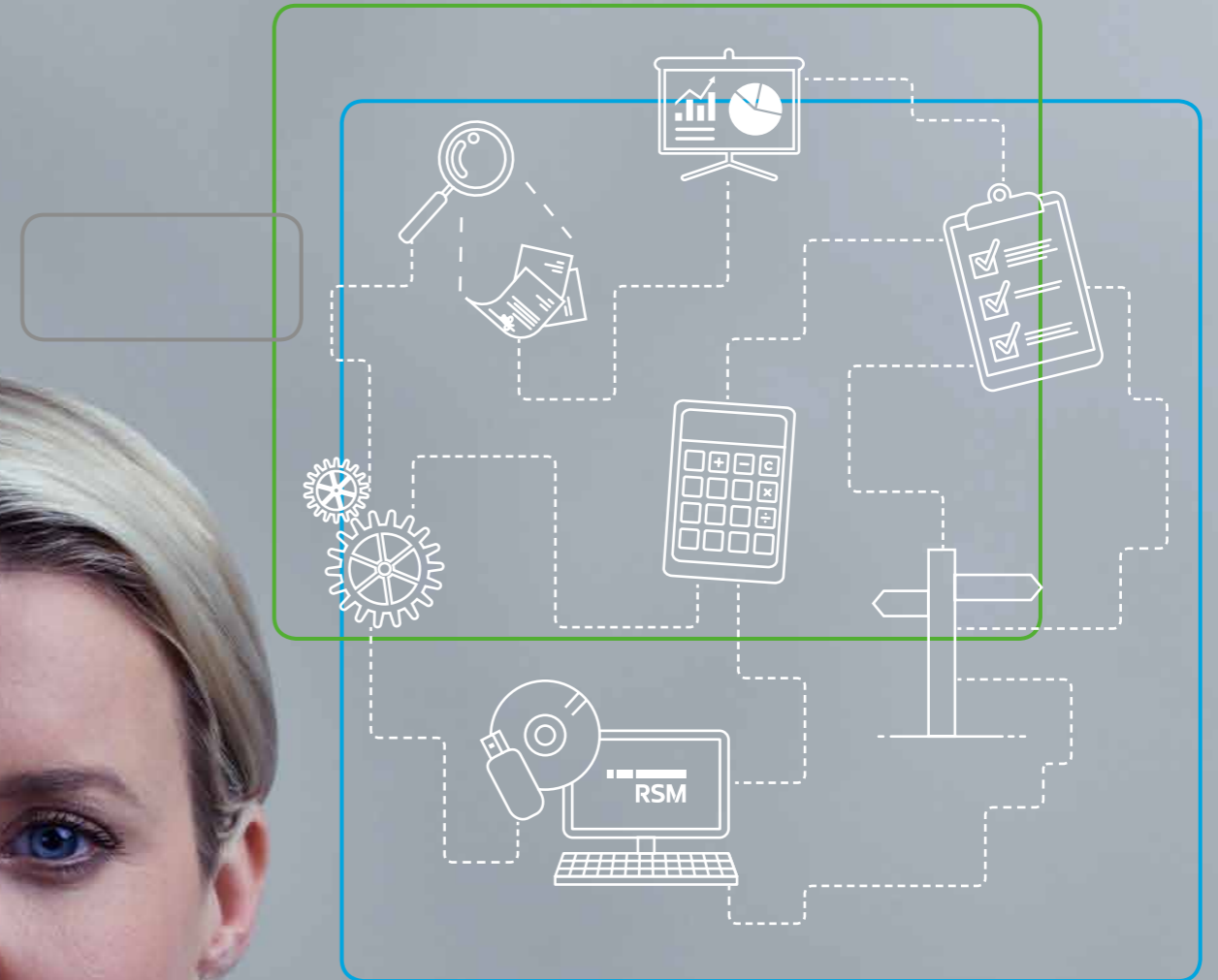
Establish an appropriate business process and system of internal control over the accounting for leases.



Identify, collate and analyse the data required to help you determine what financing decisions, if any, you need to make.



Assess the impact of any modifications to the lease terms and how they will be accounted for.



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