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IFRS 16 *Leases*

Presenter:
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Anton van Wyk is a **chartered accountant** and independent consultant in International Financial Reporting Standards (IFRS and IFRS for SMEs). As former subject head of Financial Accounting at various higher education providers (including the University of Johannesburg and Monash University South Africa), he has gained valuable insights into and understanding of the important principles underlying the International Financial Reporting Standards (IFRS). Anton is a well-known and popular presenter who has presented numerous IFRS updates for several accounting bodies across South Africa. He is known for his ability to simplify and highlight the most important principles contained in IFRS, whilst keeping the learning process enjoyable for attendees.

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Welcome to the webinar

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Welcome to this webinar dealing with **IFRS 16 *Leases***

Agenda:

1. Paying attention to some amendments to the Conceptual Framework (2018)
2. Webinar:
    1. Chapter 1: Introduction to IFRS 16 *Leases*
    2. Chapter 2: What is a “lease”? How to identify a lease in a contract…
    3. Chapter 3: The lease term
    4. Chapter 4: Lessee accounting
    5. Chapter 5: Lessor accounting

IFRS 16 *Leases*

Paying attention to

the (amended) Conceptual Framework (2018)

Amendments of note (1)

- A new definition of an “asset”
  - *Old: A resource controlled by the entity resulting from past events, from which future economic benefits are **expected** to flow to the entity*
  - New: A present economic resource controlled by the entity arising from past events
    - ➢ Present economic resource: A **right** that has the **potential** to produce economic benefits

Amendments of note (2)

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- Amended recognition criteria
  - *Old: An element will be recognised in the financial statements if it is probable (i.e. more likely than not) that future cash inflows/outflows will result AND the element has a cost or value that can be reliably measured*
  - New: An item will be **recognised** in the financial statements if it provides information that is USEFUL, i.e.
    - Relevant (incorporates, but not limited to, probability); and
    - Faithfully represented (incorporates, but not limited to, reliable measurement)

IFRS 16 *Leases*

<u>CHAPTER 1</u>

Introduction to IFRS 16

Understanding the need for a new IFRS 16

- Complex lease structuring
- Incorrect/complex lease classification
- Lease misclassification/deliberate incorrect lease classification

- *Accounting firms = "one of the most popular classification issues in practice"*

- Result for the AFS of the **lessee**: "off-balance sheet financing" = risk!!

- Hence: all <u>lessees</u> will capitalise leases on the statement of financial position!

Introduction to IFRS 16 *Leases* (1)

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- **The important areas in IFRS 16**
  - **Definitions** (Appendix A) – NB!
  - **Scope exclusions** (.03)
  - **Recognition exemptions** (.05) (IE11)
    - Short-term leases
    - Leases where underlying asset is of low value
  - **Identifying a lease** (.09) – *used to be IFRIC 4*
    - Is there a lease in the contract? (IE's 1 to 10)
    - Separating components of a contract (IE12)
      - Lessee
      - Lessor
  - **Lease term** (.18)
  - **Lessee** (.22) – a new approach *(all leases recognised the same way by lessee)*
    - Recognition
    - Measurement
      - Initial measurement
      - Subsequent measurement
    - Presentation
    - Disclosure
    - IE's 13 to 23

Introduction to IFRS 16 *Leases* (2)

- The important areas in IFRS 16 (continued)
  - **Lessor** (.61)
    - Classification of leases
    - Finance leases
      - Recognition and measurement
    - Operating leases
      - Recognition and measurement
    - Presentation and disclosure
  - ***Sale and leaseback transactions*** *(.98) (IE24)*
    - *Assessing whether the transfer of the asset is actually a sale*
  - **Appendix B** (Application guidance) **= NB!!**
    - Read the following paragraphs:
      - .B1 to .B2;
    - Carefully study <u>all</u> other paragraphs (.B3 to .B58)
      - .B9 to .B31 = how to identify whether a contract is or contains a lease (NB)
  - **Illustrative examples** (IEs)
    - See guidance on next two slides

Illustrative examples (IFRS 16) (1)

- Identifying a lease – how do I find a "lease" in a contract?
  - Examples 1 to 10
- Leases of 'low value assets' – an exemption to IFRS 16
  - Example 11
- Allocation of consideration to components of a contract – how?
  - Example 12 – what is componentisation of a lease? Impact on the lease payments?
- Lessee measurement (basic example of how it is done)
  - Example 13
- Variable lease payments (tricky, look carefully!)
  - Example 14
- *Lease modifications – leases get modified, what then?*
  - *Examples 15 to 19*

Illustrative examples (IFRS 16) (2)

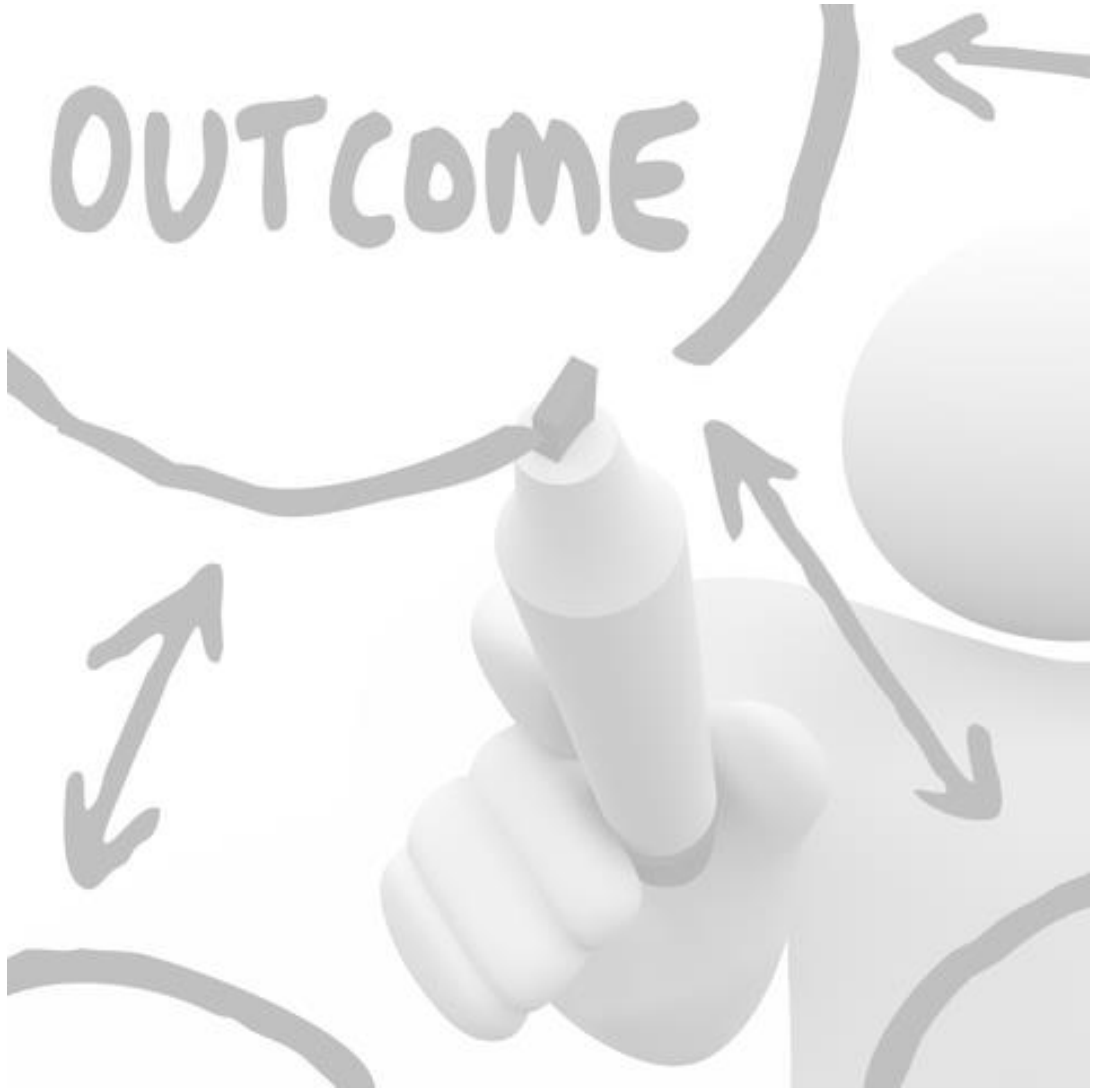
- Subleases – what if a lessee subleases to another lessee?
  - Examples 20 to 21

- Lessee disclosure – the notes to the AFS
  - Examples 22 to 23

- *Sale and leaseback transactions – what if an owner sells an asset and leases it back from the new owner immediately?*
  - *Example 24*

Important outcomes of IFRS 16 *Leases*

- Knowing when IFRS 16 does not apply
- Being able to identify ("find") a lease in an agreement
- Understanding how to properly assess "lease term"
- From the point of view of the lessee:
  - Understanding how to recognise a lease i.t.o. IFRS 16 (Dr and Cr)
  - Understanding initial and subsequent measurement of the "RoU asset"
  - Understanding initial and subsequent measurement of the lease liability
    - Including reassessment of the lease liability
  - Understanding how to deal with lease modifications (.44 - .46)
  - Being able to present and disclose leases in the AFS of the lessee
- From the point of view of the lessor:
  - Being able to correctly classify an identified lease (finance vs operating lease)
  - Understanding the accounting treatment of a finance lease for the lessor
  - Understanding the accounting treatment of an operating lease for the lessor
  - Manufacturer/dealer lessors (.71 to .74)
  - Lease modifications for the lessor (.79 to .80)
- Sale and leaseback transactions (.98 to .103)



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IFRS 16 *Leases*

CHAPTER 2

What is a "lease"? How to identify a lease in a contract?

Scope of IFRS 16 – *is the Standard applicable?*

Specific exclusions

- IFRS 16 applies to <u>all leases</u>, including leases of right-of-use assets in a sublease, but there are some exclusions!
- **Excluded from the scope of IFRS 16**
  - Leases to explore for (or use) *minerals, oil, natural gas and similar* non-regenerative resources;
  - Leases of *biological assets* (within the scope of IAS 41) <u>held by a lessee</u> (a biological asset is a living animal or plant);
  - *Service concession arrangements* within the scope of IFRIC 12 *Service Concession Arrangements* (e.g. toll roads and other public infrastructure operated on behalf of government);
  - *Licences of intellectual property* granted by a lessor (within the scope of IFRS 15 *Revenue from Contracts with Customers)*; and
  - Rights <u>held by a lessee</u> under *licensing agreements* within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights

- *<u>Important</u>: a lessee MAY, but is not required to, apply IFRS 16 to leases of intangible assets, OTHER than*

Must IFRS 16 <u>always</u> be applied?

- The **lessee** can <u>elect</u> not to apply IFRS 16's 'lessee accounting', for:
- <u>Short-term leases:</u> "at commencement date, a lease term of 12 months or less – *note: a lease containing a purchase option, is NOT a S/T lease*)"
  - Essential to read Basis for Conclusions (BC87 to BC97)
  - Election available per <u>class of underlying asset</u> (not lease by lease!)
  - Disclosure of lease expense required
  - Lease term to be reassessed by treating it as a new lease when the lease term changes/lease modification occurs
- <u>Low value assets:</u> "underlying asset, <u>when new</u>, is of low value"
  - Essential to read Basis for Conclusions (BC98 to BC104)
  - Election available on a lease-by-lease basis (not per class!)
  - Such as leases of tablets and personal computers, small items of office furniture and telephones
  - Maximum value approximately $5 000, professional judgement required i.t.o. integration of asset with other components (don't apply if integrated)
  - Disclosure of lease expense required

- **Recognise lease expense on straight-line basis over lease term (or another systematic basis <u>representing lessee's benefit</u> from lease)**

Lease identification…
(IFRS 16.9 to .17)

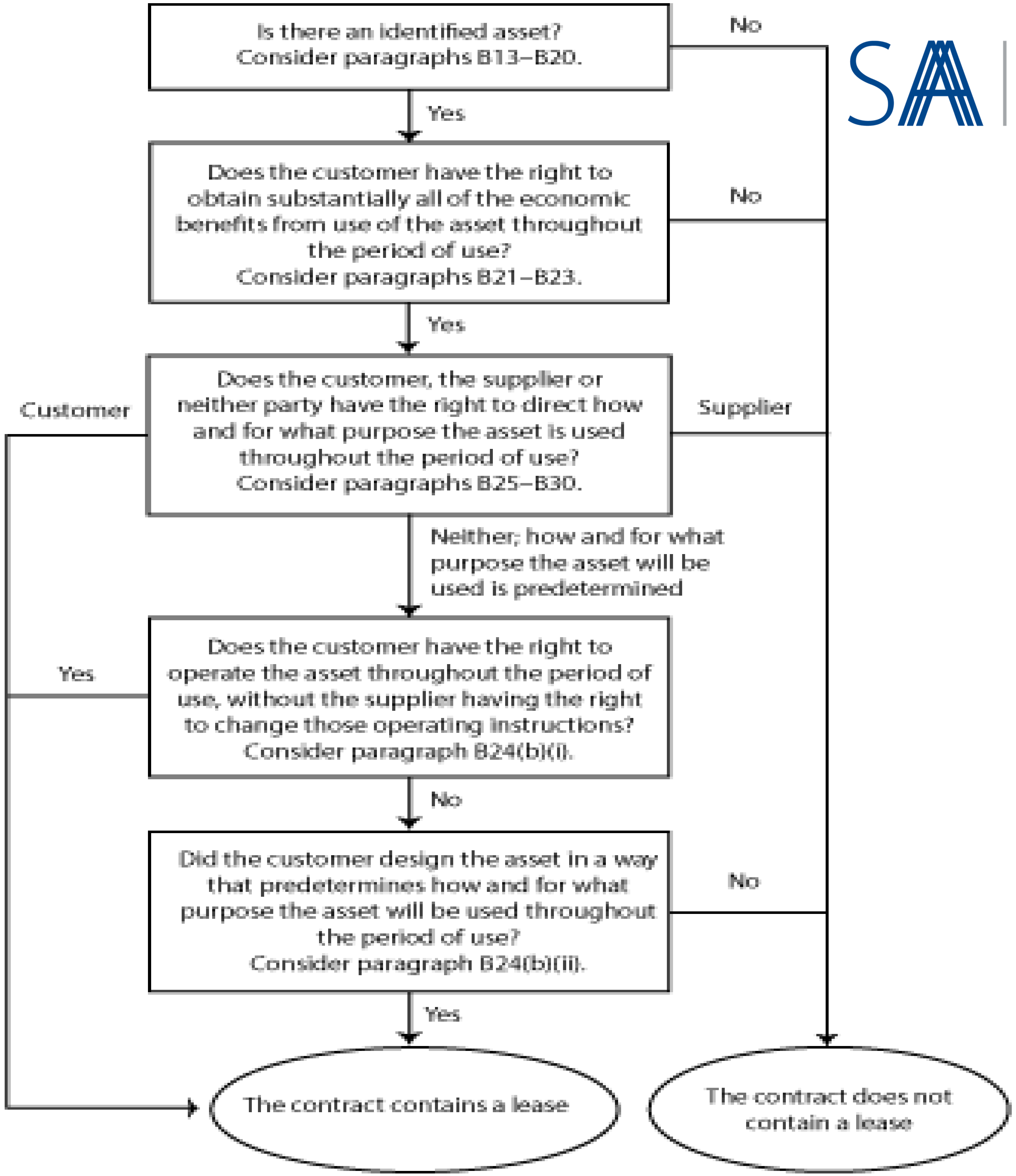
- At inception of a contract, an entity shall assess whether a contract is (or contains) a lease

- A contract is (or contains) a lease if the contract:
  - Conveys the right to control the use (i.e. 'right of/to use')
  - Of an identified asset
  - For a period of time
  - In exchange for consideration

- Also look at **Appendix B9 to B33**!!!
  - Use App B (par B31) to guide you through this area, otherwise you will be lost…

Par B.31 (NB!!!)

This decision diagram leads you through the process of deciding whether a contract is (or contains) a lease!!



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Example – identifying a lease

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- Elbunny Bread Limited decides to **outsource the transport and distribution** of their finished goods, being freshly baked bread, to Fresh 'n Fast (Pty) Ltd., in order for Elbunny Bread Limited to focus on their core operations, being high quality bread manufacturers…
- The **transport agreement** states the following:
  - Fresh 'n Fast (Pty) Ltd will dedicate 100 specific trucks to the arrangement with Elbunny Bread Limited
  - Elbunny Bread Limited will pay R3 million per month, for a period of 36 months (the term of the agreement)
  - Any excess kilograms of bread above R3 million, will be billed *ad hoc* on a monthly basis
  - Fresh 'n Fast (Pty) Ltd will operate the trucks at all times and provide the drivers for such
  - The trucks will never be on the premises of Elbunny Bread Limited, except to collect bread for delivery
  - Elbunny Bread (Pty) Ltd will determine:
    - ✓ The routes to be followed for delivery, as well as destinations
    - ✓ The conditions under which breads are transported
    - ✓ The times of delivery of the bread etc.
  - Fresh 'n Fast (Pty) Ltd agreed to brand the trucks using Elbunny's logo
  - The trucks will only be withdrawn from the agreement for routine and specific maintenance

How will Elbunny Bread (Pty) Ltd account for this agreement?

Example – suggested application

- The transport agreement should be assessed, at inception, to determine whether the agreement is, or may contain, a lease
- The following should be considered:
  - Agreement conveys the right to control the use (i.e. 'right of/to use')

    Control = ability to direct the use of the asset AND secure substantially all of the economic benefits arising from the use of the leased asset
  - Of an identified asset

    Identified asset = physically distinct AND owner/lessor has no substantive substitution rights
  - For a period of time
  - In exchange for consideration

- From the above application, it is clear that the transport agreement constitutes a lease agreement, and should be treated as such by Elbunny Bread Limited

Componentisation of leases
(IFRS 16.12 to .17)

- Some contracts contain lease and non-lease components…

- Lessees can "side-step" this problem by electing (per class of underlying asset) to apply the **practical expedient** in IFRS 16.15, which requires that they account for all components (lease and non-lease) as a single lease (i.e. ignore componentisation of the lease)
  - Always first determine whether the lessee has elected this expedient!!

- If the practical expedient is **not** used, the lessee shall allocate the consideration of the contract between lease and non-lease components on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components
  - Illustrative Example 12

- The lessee accounts for non-lease components using other IFRSs, and the lessor will use IFRS 15 *Revenue from Contracts with Customers* to allocate consideration between lease and non-lease components

IFRS 16 *Leases*

CHAPTER 3

The lease term

<u>Determining</u> the lease term

- IFRS 16.18 to .21 provide reference

- **Why is the lease term important?**

- The non-cancellable period for which a lessee has the right to use and underlying asset, TOGETHER with <u>both</u>:
  - Periods covered by an option to extend the lease, if the lessee is reasonably certain to exercise that option; and
  - Periods covered by an option to terminate the lease if the lessee is reasonably certain NOT to exercise that option

- Lessee 'reasonably certain', or not?
  - Consider all relevant facts and circumstances that create an **economic incentive** for lessee to extend or not to terminate (read B37 to B40)
  - Reasonable certainty to be reassessed upon occurrence of significant event/significant change in circumstances within the control of the lessee AND affects the reasonable certainty to extend or not to terminate

When is the lease term <u>revised</u>?

- **The lease term is revised when there is a change in the non-cancellable period of the lease**

- Examples that would lead to revision of lease term:
  - Lessee exercises an option not previously included in its determination of lease term
  - The lessee does NOT exercise an option previously included in its determination of lease term
  - An event occurs that contractually obliges lessee to exercise an option not previously included in its determination of lease term
  - An event occurs that contractually prohibits lessee from exercising an option previously included in its determination of lease term

- *Why is a revision of the lease term to be treated with care?*

IFRS 16 *Leases*

<u>CHAPTER 4</u>

"Lessee accounting" in terms of IFRS 16

Why the change from IAS 17 to IFRS 16?

- IAS 17 *Leases* specified the same approach for lessees and lessors

- IFRS 16 *Leases* requires lessees to capitalise ALL leases on the SoFP = called "lessee accounting"
  - *except for short-term leases and leases of low value assets*

- No more distinction between finance and operating leases for lessee!

- Lessee accounting addresses the risk of off-balance sheet financing
  - This is where finance leases are deliberately structured as operating leases to keep the lease liability off the SoFP (for purposes of debt : equity & other ratios)

- Lease classification between finance and operating leases is very challenging under certain circumstances, hence IFRS 16 has made it easier for lessees, as now all leases are capitalised…

- To say that all leases are finance leases for the lessee, is not correct…
  - *Lessee accounting* in IFRS 16 is different to *finance lease accounting* of IAS 17

The crux of 'lessee accounting' per IFRS 16 (.22 to .60) (1)

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- Approach the topic by focusing on **recognition**, **measurement**, **presentation** and **disclosure** from the point of view of the lessee

- **Recognition** is easy: there is a right-of-use asset (debit) and a lease liability (credit) at commencement date of the lease
  - Dr Right-of-use asset (SoFP) X
  - Cr Lease liability (SoFP) X

- **Measurement** is not so easy… (most struggle)
  - Initial measurement of the RoU asset at **cost** (crux: IFRS 16.24)
  - Initial measurement of the lease liability at **PV of unpaid lease payments** (.26)
    - Discount rate = rate implicit in the lease, *otherwise* *incremental borrowing rate*
    - What are 'unpaid lease payments'? (.27) = NB!!!
  - Subsequent measurement of RoU asset (cost, fair value, revaluation model = when which model?)
  - Subsequent measurement of lease liability (amortised cost, and take into account remeasurements (.39+) and lease modifications (.44+))

The crux of 'lessee accounting' per IFRS 16 (.22 to .60) (2)

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- Measurement of the right-of-use (RoU) asset

– PV of lease liability	XXX
– Plus: Lease payments before/on commencement date	XX
– Less: Lease incentives received from the lessor	(XX)
– Plus: Incremental direct costs (e.g. legal costs)	X
– Plus: PV of dismantling/restoration cost at initial recognition	X
	XXX

- Subsequently depreciated/amortised over lease term/useful life

The crux of 'lessee accounting' per IFRS 16 (.22 to .60) (3)

- **Presentation** (.47+)
  - Face of the AFS
- **Disclosure** (.51+)
  - Notes to the AFS
- **Contentious issues** in 'lessee accounting'
  - Determination of the rate implicit in the lease (App A)
    - The rate of interest that causes the PV of (a) the **lease payments** and (b) **unguaranteed residual value** to EQUAL the sum of (i) the **fair value of the underlying asset** and (ii) any **initial direct costs** of the lessor *(when calculating the interest rate implicit in the lease for the lessor)*
  - Determination of the lease payments (App A)
    - Detailed definition in App A and IFRS 16.26 = NB!!!
  - Determination of the lease term (App A)
    - Detailed definition in App A and IFRS 16.18 to .21 = NB!!!

Deferred tax i.r.o. lessee accounting (IAS 12) (1)

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- SARS grants **no allowances** to the lessee on the RoU asset (hence TB = zero), but this is not a permanent difference!
- SARS grants the **lease instalments** excluding VAT, as tax deductions to lessee
  - – VAT removed proportionately (weight of instalment), if lease = ICA per VAT Act (S23C(1))
  - – VAT removed x 15/115, if lease = **not** an ICA per VAT Act
- How to determine the **tax base** of a lease liability for deferred tax purposes?
  - – Equals CA, less amounts that will be deductible for NORMAL tax purposes in future
    - i.e. the capital of the liability, excluding VAT included in that capital amount
  - – Most often results that the TB is equal to the VAT in the remaining lease instalments, as VAT has already been claimed back (ICA) or will be claimed from SARS as lease payments are made (non-ICA) – remember lease instalments are deductible for tax purposes *exclusive* of VAT if the lessee is a qualifying VAT vendor and uses the asset for a qualifying purpose

Deferred tax i.r.o. lessee accounting (IAS 12) (2)

- Simple example of deferred tax…

- Dr RoU asset (SoFP) 100 000
- Dr Input VAT (at 15%) 15 000
- Cr Lease liability (SoFP) 115 000

Deferred tax (@initial recognition):	CA	TB	TD	DT
RoU asset	100k	0	100k	28k (L)
Lease liability	(115k)	(15k)	(100k)	(28k) (A)

- TB = CA of R115 000, less amount deductible for tax purposes in future (R115k – R15k (VAT in lease liability) = R100 000)
- = R15 000 (= effectively the VAT in the remaining lease instalments)

IFRS 16 *Leases*

CHAPTER 5

“Lessor accounting” in terms of IFRS 16

"Lessor accounting" i.t.o. IFRS 16

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- You need to now make a mind-shift from "lessee accounting"…

- The lessor needs to CLASSIFY all its identified leases between FINANCE and OPERATING leases…
  - IFRS 16.61 to .66 need to be consulted
  - First ensure that all leases are also identified, lease terms determined, etc.
  - Know the crux (.62): A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. If not, it is an operating lease.
  - Hence, we prove an operating lease by disproving a finance lease
  - ALWAYS remember: the classification of a lease depends on the SUBSTANCE of the transaction rather than the FORM of the contract!!
  - IFRS 16.63 and .64 are indicators of POSSIBLE situations that would be finance leases, but are not conclusive! You need to apply professional judgement!!!
  - Lease classification is done at inception date of the lease
  - *Changes in estimates* (e.g. economic life & residual value of leased asset) and *changes in circumstances* (e.g. default by the lessee) DO NOT AFFECT LEASE CLASSIFICATION
  - Only *lease modifications* lead to reassessments of lease classification

"Lessor accounting" i.t.o. IFRS 16

- Possible indicators that the lease constitutes a finance lease to the lessor:
  - Legal ownership of the underlying leased asset is transferred to the lessee at some stage during the lease term
  - The lessee has an option to acquire the underlying leased asset at an amount that is significantly below the fair value of the leased asset, so that the lessee is likely to exercise that option *(called a "bargain purchase option")*
  - The lease term represents the major part of the economic life of the underlying leased asset
  - At inception of the lease, the PV of the MLP represents at least substantially all of the fair value of the underlying leased asset
  - The underlying leased asset is of such specialised nature that only the lessee can use the asset without incurring significant alteration costs

“Lessor accounting” i.t.o. IFRS 16

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- **Finance leases (.67 to .80)**
  - CRUX: At commencement date, the lessor shall recognise assets held under a finance lease in its SoFP and present them as a receivable, at an amount equal to the NET INVESTMENT IN THE LEASE
  - **Consult IFRS 16.67 to .70, and .75 to .78**

– Dr Gross investment in the lease (SoFP)	XXX	
– Cr Unearned finance income (SoFP)		XXX
– Cr Output VAT		XX
– Cr Building		XXX

Amortised cost model

- A *rate implicit in the lease* needs to be determined (use definition)
  - Initial direct costs included for lessor, hence impact the R.I.L.

– Dr Bank	XXX	
– Cr Gross investment in the lease		XXX
– Dr Unearned finance income (SoFP)	XXX	
– Cr Finance income (P/L)		XXX

“Lessor accounting” i.t.o. IFRS 16

- **Operating leases (.81 to .87)**
  - CRUX: A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis (if the latter is more representative of the pattern in which benefit from the **use** of the underlying asset is diminished)
  - RISKS you need to consider:
    - Straight-lining of uneven operating lease instalments where benefits earned evenly? VAT and tax treatment not straight-lined, hence deferred tax!!
    - Lease incentives, leasehold improvements, lease premiums and their tax treatments
    - Treatment of initial direct costs of the lessor (capitalised to CA of the underlying leased asset, BUT depreciated *over lease term*, rest of asset depreciated over useful life!)
    - Deferred tax issues relating to underlying leased asset (W&T versus depreciation etc.)

"Lessor accounting" i.t.o. IFRS 16

- **Presentation** of leases by the lessor (face)
  - Face of the AFS
  - IFRS 16.88
- **Disclosure** of leases by the lessor (notes)
  - Notes to the AFS
    - Finance leases
      - No longer 0-1, 2 – 5, 5+…
      - Instalments for years 1, 2, 3, 4, 5, >5,
      - Less: Unearned FI = N.I.L.
    - Operating leases
  - IFRS 16.89 to .97

Deferred tax for the lessor (IAS 12)

- Simple example (ignore VAT)

• Dr Gross investment in lease	1 000	
• Cr Output VAT		0
• Cr Unearned finance income (SoFP)		550 *(effectively a negative asset)*
• Cr Equipment (SoFP) at carrying amount		450 *(unclaimed W&T = 500)*

Lessor's deferred tax calculation	CA	TB	TD	DT
Net investment in the lease (1 000 – 550)	450	0	450	126 (L)
Equipment	0	500	500	140 (A)

Tax base of equipment = remaining W&T (capital allowances) on asset (will usually depend on how the lessee uses the leased asset, e.g. in a process of manufacture, etc.)

SEE NEXT SLIDE FOR COMPLETION…

VAT treatment by the lessor (complex) – quick revision

- If lease = ICA i.t.o. VAT Act
  - Lessor taxed on lease instalments, including VAT
  - Output VAT from lease then added to the cost price of leased asset, when W&T (capital deductions) calculated, i.e. to "compensate" lessor
  - For deferred tax: TB of gross investment = zero; AND tax base of leased asset to be carefully calculated based on above complexity (cost price plus output VAT)

- If lease = not ICA i.t.o. VAT Act
  - Lessor taxed on lease instalments received, excluding VAT
  - W&T (capital deductions) on leased asset based on cost price of leased asset, no compensation necessary
  - For deferred tax: TB of gross investment = zero; AND tax base of leased asset is easy to calculate

Manufacturer/dealer lessor

- Sales revenue LIMITED to amount when commercial interest % is used!!!
- Journal entries:
  - Dr Gross investment in the lease XXX
  - Cr Revenue (P/L) XXX
  - Cr Output VAT (SoFP) XXX
  - Cr Unearned finance income (SoFP) XXX

  - Dr Cost of sales (P/L) XX
  - Cr Inventory (SoFP) XX

- PV of unguaranteed residual value:
  - Dr Inventory (SoFP) XX
  - Cr Cost of sales (P/L) XX

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