IFRS 16 : LEASES

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IFRS 16, *LEASES*
AGENDA

BACKGROUND OF IFRS 16, *LEASES*

A Long journey

- March 2009 - IASB & FASB issued joint Discussion Paper,
- Aug 2010 - joint Exposure Draft (ED) and
- May 2013 - second joint ED was issued.
- **IFRS 16 issued by IASB in Jan 2016 is effective from 1 January 2019.**
- Though a product of joint project, some differences exist between IFRS 16 & US GAAP (Topic 840)

IFRS 16 supersedes

- IAS 17, *Leases*;
- IFRIC 4, *Determining whether an Arrangement contains a Lease*;
- SIC-15, *Operating Leases—Incentives*; and
- SIC-27, *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

- One IASB member (Mr Wei-Guo Zhang) has given dissenting opinion.

LEASE – PRIMARY REQUIREMENTS UNDER IAS 17, LEASES

I AS 17 requires classification of lease between operating and finance lease	
Operating lease	• Lease payments recognised as an expense on a straight-line basis over the lease term.
Finance lease	• Lease asset recognised in balance sheet as asset and liability at amount equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments. • Initial direct costs added to the amount recognised as an asset. • Lease payments apportioned between the finance charge and the reduction of the outstanding liability. • Finance lease gives rise to depreciation expense for depreciable assets as well as finance expense for each accounting period.

LEASE – NEED FOR CHANGE IN ACCOUNTING FOR LESSEE AS ENVISAGED BY IASB/FASB

The need for change

In 2005, the US Securities and Exchange Commission (SEC) estimated that US public companies may have approximately US$1.25 trillion of off balance sheet leases. Responding to concerns about the lack of transparency of information about lease obligations, the IASB and the FASB initiated a project to improve the accounting for leases. To meet this objective, the IASB and the FASB agreed that a customer (lessee) leasing assets should recognise assets and liabilities arising from those leases. This is because at the start of a lease a lessee obtains the right to use an asset for a period of time and, if payments are made over time, incurs a liability to make lease payments. Contrary to that view, most leasing transactions were not reported on a lessee's balance sheet applying previous lease accounting requirements. The significance of the missing information varied by industry and region and between companies. However, for many companies, the effect on reported assets and financial leverage was substantial. The absence of information about leases on the balance sheet meant that investors and analysts were not able to properly compare companies that borrow to buy assets with those that lease assets, without making adjustments.

Source
IFRS 16 Effect Analysis by IASB

Industry sector	Number of companies	Total assets (in millions of US$)	Future payments for off balance sheet leases (undiscounted) (in millions of US$)	Future payments for off balance sheet leases / total assets	Present value of future payments for off balance sheet leases (estimate) (in millions of US$)	Present value of future payments for off balance sheet leases / total assets
Airlines	50	526,763	151,549	28.8%	119,384	22.7%
Retailers	204	2,019,958	571,812	28.3%	431,473	21.4%
Travel and leisure	69	403,524	115,300	28.6%	83,491	20.7%
Transport	51	585,964	90,598	15.5%	68,175	11.6%
Telecommunications	56	2,847,063	219,178	7.7%	172,644	6.1%
Energy	99	5,192,938	400,198	7.7%	287,858	5.5%
Media	48	1,020,317	71,743	7.0%	55,764	5.5%
Distributors	26	581,503	31,410	5.4%	25,092	4.3%
Information technology	58	1,911,316	69,870	3.7%	56,806	3.0%
Healthcare	55	1,894,933	72,149	3.8%	54,365	2.9%
Others	306	13,959,223	401,703	2.9%	306,735	2.2%
Total	1,022	30,943,502	2,195,510	7.1%	1,661,787	5.4%

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LEASE – NEED FOR CHANGE IN ACCOUNTING FOR LESSEE AS ENVISAGED BY IASB

The accounting requirements under previous lease standard failed to meet the needs of the user of financial statements since:

- Information reported about operating leases lacked transparency and did not meet the needs of users of financial statements.
- Existence of two different accounting models for leases, in which assets and liabilities associated with leases were not recognised for operating leases but were recognised for finance leases, meant that transactions that were economically similar could be accounted for very differently which reduced comparability for users of financial statements.

Why a single accounting model under IFRS 16

- lessee's right to use the underlying asset meets the definition of an asset
- lessee's obligation to make lease payments meets the definition of a liability
- Results in a more faithful representation of a lessee's assets and liabilities
- With enhanced disclosures, results in greater transparency of a lessee's financial leverage and capital employed.

EXPECTED SIGNIFICANT IMPACT OF IFRS 16

- The IASB expects IFRS 16 to significantly improve the quality of financial reporting for companies with material off balance sheet leases.
- Applying IAS 17, most leases were not reported on a lessee's balance sheet. Consequently, a lessee did not provide a complete picture of the assets it controlled and used and the lease payments
- Off balance sheet lease financing numbers which are substantial will now get disclosed in financial statements.

EXPECTED SIGNIFICANT IMPACT OF IFRS 16

- In an analysis conducted by the IASB, it observed that over 14,000 listed companies (of about 30,000 listed companies) disclose information about off balance sheet leases totalled US$2.86 trillion (on an undiscounted basis).

- IFRS 16 is expected to affect the amounts reported by almost half of listed companies.

- An analysis conducted by IASB shows that the use of off balance sheet leases is highly concentrated within some industry sectors and within some companies.

- The IASB in an analysis compared the off balance sheet leases to the total assets of 1,022 companies.

EXPECTED SIGNIFICANT IMPACT OF IFRS 16

- IFRS 16 is expected to significantly improve the comparability of financial information.
- It will reduce opportunities to structure leasing transactions to achieve off balance sheet accounting.
- The IASB also expects that the exemption for leases of low-value assets will be of particular benefit for smaller companies that apply full IFRS.

EXPECTED IMPACT: HIGH LEVEL SUMMARY

Impact Summary (as issued by IASB)

- There will be an impact on 'Three Components' of financial statements viz. Statement of Financial Position, Statement of Profit and Loss and Statement of Cash Flows.
- Key financial metrics or ratios will change e.g. Leverage ratios, Operating ratios.
- The IASB expects that
  - ✓ it will significantly improve the quality of financial reporting for companies with material off balance sheet leases. Applying previous standard, most leases were not reported on a lessee's balance sheet. Consequently, a lessee did not provide a complete picture of the assets it controlled and used and the lease payments.
  - ✓ affect the amounts reported by many listed companies.
  - ✓ significantly improve the comparability of financial information.
  - ✓ exemption for leases of low-value assets will be of particular benefit for smaller companies that apply full IFRS.

IFRS 16: HIGH LEVEL SUMMARY

Lessor Accounting

- Substantially carries forward the lessor accounting requirements in IAS 17, except disclosures which are enhanced now.
- Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently.

Lessee Accounting

- Eliminates the classification of leases as either operating leases or finance leases as is required by IAS 17 for **lessee.**
- Introduces **a single lessee accounting model** whereby lessee accounts for all leases in same way.
- Applying single lease model, a lessee is required to recognise:
  - ✓ assets and liabilities for all leases except (a) leases with a term of less than 12 months or (b), the underlying asset of low value; and
  - ✓ depreciation of lease assets separately from interest on lease liabilities in the income statement.

EXPECTED IMPACT: HIGH LEVEL SUMMARY

Statement of Financial Position Impact : How will it change?

	IAS 17		IFRS 16
	Finance lease	**Operating lease**	**All Leases**
Assets	XXX		XXX
Liabilities	XXX		XXX
Total	**XXX**		**XXX**
Off balance sheet rights/obligation		XXX	

Total Balance Sheet (B/S) Size will increase due to off B/S exposures getting recognised as on B/S assets and liabilities.

EXPECTED IMPACT: HIGH LEVEL SUMMARY

Statement of Profit and Loss – How will it change?

	IAS 17		IFRS 16
	Finance lease	**Operating lease**	**All Leases**
Revenue	xxx	xxx	xxx
Operating costs (excluding depreciation and amortisation)	---	xxx Single expense	
EBITDA			
Depreciation and amortisation	Depreciation	---	Depreciation
Operating profit			
Finance costs	Interest	---	Interest
Profit before tax			

Net Profit/Loss is not expected to change significantly for many companies BUT Expense Line items, EBIDTA and Operating Profit/Loss will change due to reclassification of expenses.

EXPECTED IMPACT: HIGH LEVEL SUMMARY

Statement of Cash Flows: How will it change?

	IAS 17		IFRS 16
	Finance lease	**Operating lease**	**All Leases**
Operating Activities		XXX	
Investing Activities			
Financing Activities	XXX		XXX (Interest + Principal Payments)
Net Cash Flows	**XXX**		**XXX**

Net Cash flows will not change BUT cash flows from Operating Activities will improve and Financing Activities will increase.

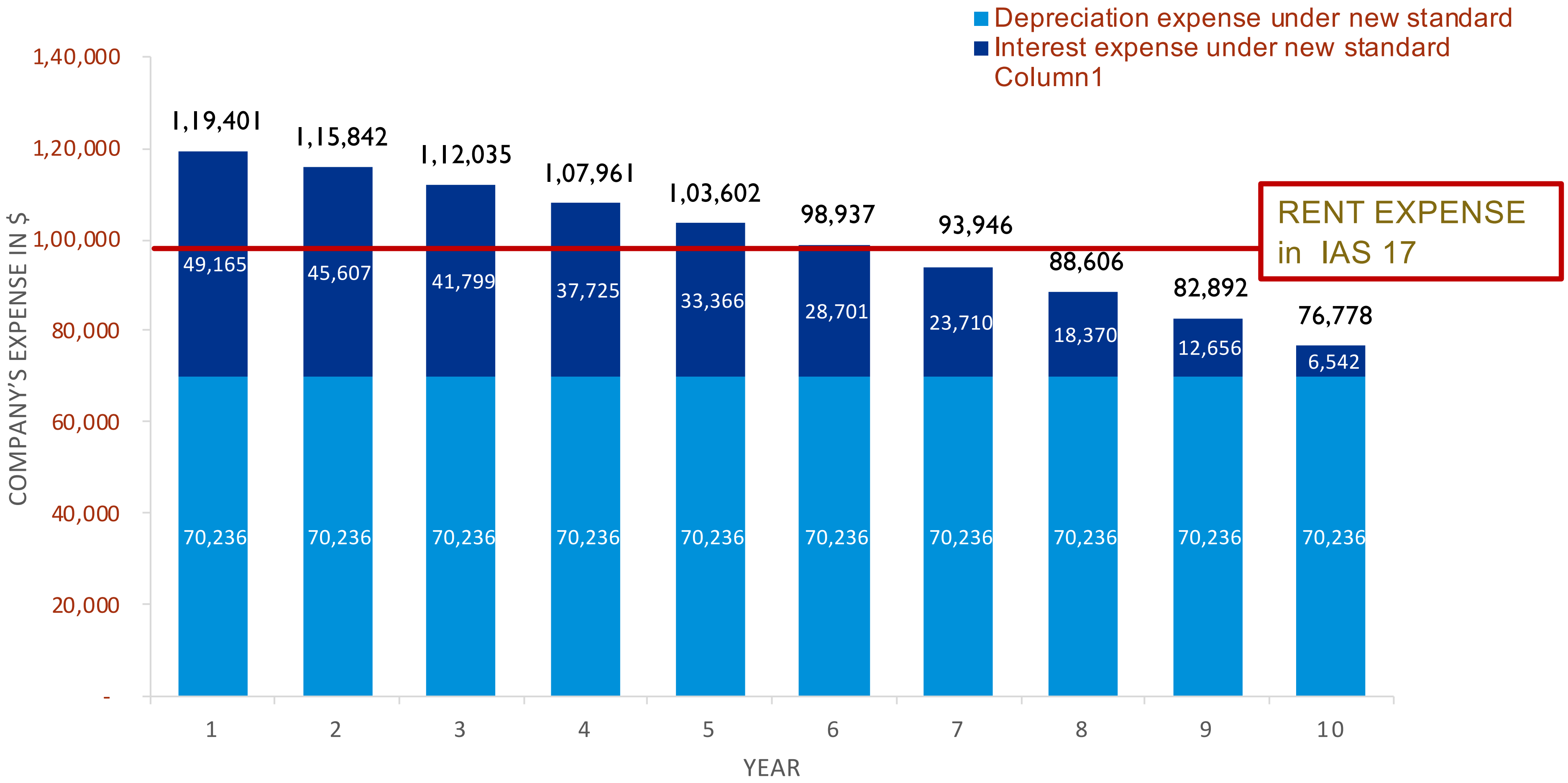
EXPECTED SIGNIFICANT IMPACT OF IFRS 16

- A comparative analysis of IFRS 16 vs. IAS 17 in case of Airline Company is given in the next slide.

Illustration 1: Airline

Balance sheet	IAS 17	IFRS 16
Property, plant and equipment	27,886	27,886
Lease assets	12,030	25,430
Other[74]	9,114	8,952
Total non-current assets	49,030	62,268
Total current assets	21,152	21,152
Total assets	**70,182**	**83,420**
Borrowings	9,430	9,430
Lease liabilities	10,516	25,277
Other liabilities	34,818	34,818
Total liabilities	**54,764**	**69,525**
Equity	15,418	13,895
Total liabilities and equity	**70,182**	**83,420**
Income statement	**IAS 17**	**IFRS 16**
Revenue and other income	67,272	67,272
Operating costs (excl depr and amort)	(60,893)	(58,340)
EBITDA	**6,379**	**8,932**
Depreciation and amortisation	(3,908)	(5,674)
Operating profit	**2,471**	**3,258**
Net finance costs	(865)	(1,656)
Profit before tax	**1,606**	**1,602**
Income tax	(285)	(285)
Profit for the year	**1,321**	**1,317**
Cash flow statement	**IAS 17**	**IFRS 16**
Operating activities	6,265	8,026
Investing activities	(5,190)	(5,190)
Financing activities	(851)	(2,612)
Total cash inflow	**224**	**224**

IMPACT ON P&L – IFRS 16 VS IAS 17



ASSUMPTIONS:

1. 10 YEAR LEASE 2. RENT OF $100,000 PER ANNUM 3. DISCOUNT RATE OF 7%

PRESENTATION

Balance sheet under current IAS 17	Inception	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Assets		-	-	-	-	-	-	-	-	-	-
Liabilities		-	-	-	-	-	-	-	-	-	-
Balance sheet under IFRS 16											
Right of use asset	$702,358	$632,122	$561,887	$491,651	$421,415	$351,179	$280,943	$210,707	$140,472	$70,236	$0
Lease liability	($702,358)	($651,523)	($597,130)	($538,929)	($476,654)	($410,020)	($338,721)	($262,432)	($180,802)	($93,458)	$0
Net equity	**$0**	**($19,401)**	**($35,243)**	**($47,278)**	**($55,239)**	**($58,841)**	**($57,778)**	**($51,724)**	**($40,330)**	**($23,222)**	**$0**
		Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**	**Year 10**
Income statement under IAS 17											
Operating lease expense		100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Income statement under IFRS 16											
Amortisation expense		$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236	$70,236
Interest expense		$49,165	$45,607	$41,799	$37,725	$33,366	$28,701	$23,710	$18,370	$12,656	$6,542
Total expense		**$119,401**	**$115,842**	**$112,035**	**$107,961**	**$103,602**	**$98,937**	**$93,946**	**$88,606**	**$82,892**	**$76,778**
Difference		**(19,401)**	**(15,842)**	**(12,035)**	**(7,961)**	**(3,602)**	**1,063**	**6,054**	**11,394**	**17,108**	**23,222**

LEASE : IFRS 16 DEFINES LEASE AS:

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.

Right to control the use

- Right to obtain substantially all of economic ***benefits from use*** of identified asset through out the period of use; and
- Right to ***direct the use*** of identified asset through out the period of use.

Identified Asset

- Specified EXPLICITLY - *e.g.,* Specific serial number
- Specified IMPLICITLY - Only one asset available that is capable of being used to meet the contract terms.
- Portions of Assets - a portion of a bigger asset is an identified asset if it is physically distinct. eg: a floor of a building could be an identified asset .

Substantive substitution rights

If the supplier has a substantive right to substitute asset, there is no identified asset and no lease.

- Supplier has practical ability to substitute - eg: alternative assets are readily available and customer cannot prevent the substitution and
- Supplier would benefit economically from substituting - ie: benefits of substituting exceed costs.

PARTY THAT DIRECTS THE USE

- The determination of which party directs the use of the underlying asset may require judgement.
- Decisions regarding operating an asset are generally about the decisions about how and for what purpose an asset is used.
- In certain types of contracts the entity and the supplier, both may have some involvement in deciding how and for what purpose the asset is used. Therefore, the determination of which party directs the use of the underlying asset may require judgement.

SEPARATING COMPONENTS OF CONTRACT

Lease component

allocate consideration

Non-lease (service) component

Lessee:

- Allocate consideration on basis of relative stand-alone price.
- Estimation is permitted - relative stand-alone prices is not readily available.
- Optional practical expedient: account for a lease component and non-lease components as a single lease component.

Lessor:

- Allocate the consideration based on requirements of IFRS 15 (paragraphs 73-90) – relative stand-alone selling prices.

When to separate components?

a) Lessee can benefit from use of asset on its own or with other resources readily available

b) Items are neither highly dependent nor high interrelated

LEASE – RECOGNITION BY LESSEE

A. Recognition: At commencement date, recognise a right-of-use asset and a lease liability.

B. Recognition exemptions: Two major optional exemptions

Short term	Leases of low value assets
1. ≤ 12 months lease term 2. apply by class of **underlying asset** 3. not applies to lease containing **purchase option**	1. apply to leases for which **underlying asset** is of **low value** 2. apply on a **lease by lease** basis 3. for e.g., tablet, personal computers, etc.

Low value asset exemption applies:

- to underlying asset when new
- on an absolute basis
- irrespective of materiality

Low value asset exemption cannot be applied:

- to head lease in case of subleases
- if the nature of the underlying asset, when new, is ***not typically low value***

LEASE – LEASE TERM

- The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.
- Lease term is determined together with periods covered by option to terminate or extend the lease term if lessee is reasonably certain to do so.
- After the commencement date, a lessee needs to reassess the lease term upon the occurrence of a significant event or change in circumstances that is within the control of lessee

LEASE – MEASUREMENT BY LESSEE

	Initial Measurement	Subsequent Measurement
Right-of-use Asset	At cost which comprises • the amount of the lease liability • lease prepayments, less lease incentives received • lessee's initial direct costs • estimate of restoration, removal and dismantling costs	Cost model unless entity applies Revaluation model under IAS 16.
Lease liability	Present value of unpaid lease payments (discounted using *interest rate implicit in the lease* if readily determinable; otherwise, incremental borrowing rate) which include following • Fixed payments (including in-substance fixed payments) • Variable lease payments that depend on index or rate • Residual value guarantees • Exercise price of purchase options • Termination penalties	Measured by • Increasing carrying amount to reflect interest on lease liability; • Reducing carrying amount to reflect lease payments made; and • Re-measuring carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments

LEASE – PRESENTATION BY LESSEE

Present in Balance Sheet or disclose in notes

- **Right-of-use assets** separately from other assets. If not disclosed separately, including right-of-use assets within the same line item within which the corresponding underlying assets would be presented if they were owned and disclose which line items in balance sheet include those right-of-use assets.
- **Lease liabilities** separately from other liabilities. If not disclosed separately, disclose which line items in the balance sheet include lease liabilities.

Present in Statement of profit and loss

- Interest expense on the lease liability separately from the depreciation charge for the right-of-use asset.
- Interest expense on the lease liability as a component of finance costs, which as per IAS 1, *Presentation of Financial Statem*ents, requires to be presented separately in the statement of profit or loss.

Classify under Statement of Cash Flows

- Cash payments for the principal portion of the lease liability within financing activities;
- Cash payments for the interest portion of the lease liability applying the requirements in IAS 7 *Statement of Cash Flows* for interest paid; and
- 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.

LEASE – MODIFICATION BY LESSEE

Modifications accounted as a separate lease if:

- it increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

If modification **not** accounted as a separate lease at the effective date of lease modification, lessee shall:

(a) allocate consideration between lease and non-lease component

(b) determine the lease term of modified lease

(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate and accounting it as follows:

Modification decreasing the scope of lease

- ✓ Decrease carrying amount of right-of-use asset to reflect partial or full termination
- ✓ Recognise any gain or loss in profit or loss

For other modification (say lease rentals change)

- ✓ Make corresponding adjustment to carrying amount of right-of-use asset
- ✓ Adjust lease liability to reflect re-measurement

LEASE : SALE AND LEASE BACK

- If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease
- Determine whether transfer of asset is sale or not as per IFRS 15 – when a performance obligation is satisfied.
- If transfer of asset **is a** sale-

  Seller lessee - measure right-of-use asset at the proportion of the previous carrying amount that relates to right-of-use retained by the seller-lessee. Hence, gain/loss recognised to the extent of rights transferred to the buyer-lessor.

  Buyer Lessor- account for purchase of asset with reference to applicable standards and for lease apply this standard.
- If transfer of asset **is not a** sale-

  Seller lessee - continue to recognise transferred asset and recognise financial liabilities equal to transfer proceeds applying IFRS 9

  Buyer Lessor

  - transferred asset not recognised
  - recognise financial asset at amount equal to transfer proceeds applying IFRS 9

LEASES : DISCLOSURES
(EMPHASIS HERE IS ON NEW DISCLOSURES)

Lessee :

- IFRS 16 includes an overall disclosure objective, and requires a company to disclose:

(a) Qualitative and quantitative information about nature of leasing activities assets and expenses and cash flows related to leases (link to IFRS 7 removed) except for maturity analysis of lease liabilities) ; and

(b) IFRS 16 requires to disclose fact that lease is accounted for as short term leases or leases of low value assets.

Lessor :

IFRS 16 requires enhanced disclosures as follows and de-links these from IFRS 7

- Nature or leasing activities and risk management
- Maturity analysis **buckets changed- on annual basis for each of first 5 years** & total for remaining years
- Disclosure of different components income- lease income and variable payments & separately for those not linked to indexes or rates

LEASES: EFFECTIVE DATE AND TRANSITION

Effective Date

IFRS 16 is applicable for annual reporting periods beginning on or after 1st January, 2019.

Transition

Definition of lease

- An entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application.
- Instead, permitted to
  - ✓ Apply IFRS 16 to contracts that were previously identified as leases applying IAS 17, *Leases*
  - ✓ Apply IFRS 16 lease IDENTIFICATION requirements **only to contracts entered into after** the date of transition

Lessor:

- No adjustments on transition for leases and account for leases applying IFRS 16 from the date of initial application.

LEASES: EFFECTIVE DATE AND TRANSITION CONTD…

Lessee

- Decide following transition method
- Shall apply the method consistently to all of its leases in which it is a lessee.

Full retrospective application:

- Apply IAS 8
- Prepare financial statements as if IFRS 16 had always been applied
- Restate comparative information
- Disclose effect on each line item

Cumulative catch-up:

- Recognise cumulative effect of initial application as an adjustment to the opening balance of retained earnings or other component of equity
- Do not restate comparative information
- Disclose effect of applying cumulative catch-up approach

LEASES: EFFECTIVE DATE AND TRANSITION CONTD…

Cumulative catch-up approach to:

Leases previously classified as operating leases

- Recognise lease liability measured at the present value of the **remaining** lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.
- Recognise a right-of-use asset at the date of initial application by measuring either
  a) its carrying amount as if the IFRS 16 had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; **or**
  b) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the balance sheet immediately before the date of initial application

Leases previously classified as finance leases

- Carrying amount of the lease asset and lease liability measured applying IAS 17 shall become the carrying amount of the right-of-use asset and the lease liability at the date of initial application.

ISSUE : FOREIGN CURRENCY LEASE LIABILITY

- As a financial liability, lease liability if denominated in foreign currency is affected by foreign currency risk exposure .
- There is no specific requirement in IFRS 16 relating to effects of foreign currency exchange differences of lease liabilities denominated in a foreign currency.
- Accordingly, foreign currency exchange differences on lease liability are required to be recognised in profit or loss applying IAS 21.

Issue:

- Recognition of foreign currency exchange differences on lease liability in profit or loss applying IAS 21 would bring volatility in profit or loss.

ISSUE : FOREIGN CURRENCY LEASE LIABILITY CONTD...

Solution: Reasons for recognition of foreign currency exchange differences relating to lease liabilities in profit or loss are as follows:

- it is consistent with the requirements of IAS 21 for foreign exchange differences arising from other financial liabilities.
- it represent the economic effect of the lessee's currency exposure to the foreign exchange risk.
- it matches with the accounting followed by lessee entering into derivatives to hedge its exposure to foreign currency risk.
- subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item. Consequently, it would be inappropriate to include such changes in the re-measurement of the right-of-use asset.

ISSUE : DUAL ACCOUNTING

Issue:

- IFRS 16 requires single lease model for Lessee and accordingly Right-to-Use asset needs to be capitalised in the books of Lessee on the basis of control concept.
- Presentation of leased assets and liabilities in the books of lessee amounts to double accounting.
- Retaining dual lease model in the books of the Lessor is not appropriate.
- For example, in case of an arrangements which are considered as Operating leases (as per IAS 17), Lessee has to capitalise Right-to-use asset like other non-financial liabilities and Lessor also records the asset which is given to lessee on lease as other non-financial asset like Property, Plant and Equipment. In the case both lessor and lessee is capitalizing the asset and recording depreciation in Profit and loss.

Response:

- It is not mandatory to have full mirror accounting in the books of lessor and lessee.
- In such cases, generally asset is obtained on lease for part of its useful life and lessee recognises right-to-use only for that portion. De-recognition of asset for part of the useful life by the lessor is not appropriate. Accordingly, recognition of asset in books of both i..e. lessor and lessee is appropriate.

ISSUE : IMPACT ON KEY FINANCIAL RATIOS

Issue:

- EBITDA ratios will be impacted because :
  - ✓ under IFRS 16 operating lease expense previously recorded on a straight line basis will be recorded as depreciation of the right-of-use asset and interest incurred on the lease liability.
  - ✓ these changes to the income statement affect both the timing and nature of lease expense, which may have significant impacts to financial KPIs (key performance indicators)

Solution:

- Under IFRS 16, pricing models may need to be adjusted if they are based on EBITDA because the new standard will have the effect of making EBITDA higher.

ISSUE : INCOME TAX IMPLICATIONS

Issue:

- IFRS 16 may have a broad impact on the tax treatment of leasing transactions, as tax accounting for leasing is often based on accounting principles.
- Given that there is no uniform leasing concept for tax purposes, the effect of the proposed lease accounting model will vary significantly, depending on the tax jurisdiction.
- In some jurisdictions IFRS principles and/or IFRS financial statements may be relevant for determining certain tax thresholds (e.g. in the Netherlands and UK).
- Items that may be impacted include the applicable depreciation rules, specific rules limiting the tax deductibility of interest (for example, thin capitalisation rules for debt versus equity, percentage of EBITDA rules), and existing transfer pricing agreements, sales/indirect taxes and existing leasing tax structures (in territory and cross-border leases).

Solution:

- A reassessment of existing and proposed leasing structures should be performed against the new standard to ensure continued tax benefits and/or management of (new) tax risks on the horizon.

ISSUE : SEPARATING LEASE AND NON-LEASE COMPONENT

Issue:

- For contracts with multiple components, entities are required to identify and separate non-lease components (e.g., operations, maintenance services) from the lease component.
- Today, many entities may not focus on identifying the distinct components because their accounting treatment (i.e., the accounting for an operating lease and a service contract) is often the same.
- IFRS 16 does also allows lessees to recognise the lease and non-lease components as a single lease component on the balance sheet, but that would have the effect of increasing the lease obligation on the balance sheet.

Solution:

- Lessees may find that policy attractive when the non-lease components are not a significant aspect of the arrangement.
- Therefore, lessees that do not elect to combine lease and non-lease components may need to put robust processes in place to identify and account for the separate components if they wish to minimise the impact of IFRS 16 on their balance sheets.

ISSUE : LEASE PAYMENTS DEPENDENT ON RATE/INDEX

Issue: Lease liability to be re-measured for lease payments dependent on rate/index

- Standard prescribes re-measurement of the lease liability every time there is a change in the cash flows resulting from change in index/rate and to recognise the corresponding effect in right-of-use asset.
- In case of multiple assets on lease, lease payments may have to re-measured very frequently.

Solution:

- Systems can be developed to re-measure the ROU and lease liability to reflect the impact of change in index.
- It is conceptually better as index related inflation is accounted for appropriately.

ISSUE : RECOGNITION OF SECURITY DEPOSITS

Issue:

- On or before the date of commencement of a lease, sometimes lessee is required give interest free security deposit to the lessor.
- There are situations in which as per lease agreements such security deposits are for material amount and may result into lower lease rentals.

Solution:

- Security deposit does not meet the definition of a lease payment under IFRS 16 because it is not a payment relating to the right to use the underlying asset
- Security deposit of this nature should be accounted for as a financial asset because it is collateral provided to the lessor.
- Security deposit be recognised initially at fair value in accordance with IFRS 9 Financial Instruments and will normally be measured subsequently at amortised cost, resulting in the recognition of interest revenue over the lease term for the difference between the fair value at the commencement of the lease and its nominal amount receivable at the end of the lease term.

ISSUE : RECOGNITION OF SECURITY DEPOSITS CONTD…

***Solution*:**

- The difference between the nominal amount of the deposit and its fair value at the commencement of the lease represents, in effect, an additional lease payment which is prepaid.
- Consequently, it is added to the initial carrying amount of the right-of-use asset in accordance with IFRS 16:24(b) and recognised in profit or loss over the lease term as part of the depreciation of that asset.

ISSUE : OTHER ISSUES

Issue:

- Identifying embedded leases is the most common challenge

Solution:

- IFRS 16 provides guidance and illustrative examples. However, the same needs to applied carefully.

Issue:

- Establishing an appropriate Incremental Borrowing Rate (IBR): Because the interest rate implicit in a lease is often difficult to obtain by a lessee, many lessees are turning to an incremental borrowing rate instead. But determining the IBR requires significant judgment.

Solution:

- Calculating IBR will be a recurring requirement in the future so it is essential that the process for estimating it is sound and aligns to the objective of the leases standards.
- With regard to tackling the IBR challenge specifically, the following may be possible
  - ✓ to plan internally estimate of the IBR for each lease
  - ✓ to obtain direct quotes from a lender.
  - ✓ to hire a third party to help them estimate the IBR.

ISSUE : OTHER ISSUES CONTD…

Issue:

- Integrating a lease accounting system into the existing IT system environment.

Solution:

- Lessees need to identify system gaps and changes that may be needed in their IT environment.
- Entities need to implement sustainable lease software solutions that are capable of dealing with the new lease accounting requirements.

Appendix: Few Examples

LEASE : IDENTIFICATION

(Source : IFRS 16 Leases Illustrative Examples)

Example 1A : Rail Cars

- Contract between customer and freight carrier (supplier) that provides customer with the use of 10 rail cars of a particular type for five years.
- Customer determines when, where and which goods are to be transported using the cars. Rails cars when not in use are kept at customer's premises. Customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that Customer cannot transport particular types of cargo (for example, explosives).
- The contract also requires Supplier to provide an engine and a driver when requested by Customer. Supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport goods of other customers but within a similar timeframe, Supplier can choose to attach up to 100 rail cars to the engine).
- Supplier can substitute the rail cars only for service or repair and nothing else.

Right to control use of the asset	***Identified asset***	***No Substitution right***
√	√	√

Contract contains lease of rail cars. Provision of engine and driver is not a lease contract.

LEASE : IDENTIFICATION

(Source : IFRS 16 Leases Illustrative Examples)

Example 1B : Rail Cars

- The contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for five years.
- Supplier has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. Similarly, Supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers.
- The contract also requires Supplier to provide an engine and a driver when requested by Customer. Supplier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods.

Right to control use of the asset	***Identified asset***	***No Substitution right***
×	×	×
Contract does not contain lease of rail cars nor engines		

LEASE : IDENTIFICATION

(Source : IFRS 16 Leases Illustrative Examples)

Example 2A : Concession Space

- A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period.
- The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.
- Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer: Customer uses a kiosk (that it owns) that can be moved easily to sell its goods.

Right to control use of the asset	*Identified asset*	*No Substitution right*
√	×	×

Contract does not contain lease

LEASE : IDENTIFICATION

(Source : IFRS 16 Leases Illustrative Examples)

Example 2B : Concession Space – Retail Outlet in a Shopping Mall

- Customer enters into a contract with a property owner (Supplier) to use Retail Unit A (part of a larger space) for a five-year period to operate its well-known store brand to sell its goods during the hours that the larger retail space is open. Customer makes all of the decisions about the use of the retail unit during the period of use.
- Supplier can require Customer to relocate to another retail unit. In that case, Supplier is required to provide Customer with a retail unit of similar quality and specifications to Retail Unit A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favourable to cover the costs of relocating Customer and other tenants in the retail space. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise.

Right to control use of the asset	*Identified asset*	*No Substitution right*
√	√	√

Contract contains lease of Retail Unit Space. (for supplier it is not economically beneficial to substitute space)

SHARED CAPACITY

In BC 116, it is concluded that

- a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example, if it is a 20 per cent capacity portion of a pipeline).
- customer is unlikely to have the right to control the use of its portion because decisions about the use of the asset are typically made at the larger asset level.

Consequently, the IASB concluded that widening the definition to include capacity portions of a larger asset would increase complexity for little benefit.

Issue: whether situations like shared capacity of network services etc will be considered as service contracts and not a lease which is change compared to existing practice?

LEASE : SALE AND LEASE BACK

(Source : IFRS 16 Leases Illustrative Examples)

- An entity (Seller-lessee) sells an Aircraft to another entity (Buyer-lessor) for cash of CU1,800,000 which had book carrying amount of CU 1,000,000.
- It leases back the aircraft for 18 years under operating lease with annual instalment of CU 105,000. Interest rate implicit in the lease if 4.5%. Present Value of 18 annual payments will be CU 1,276,800.
- Now the calculation of gain/loss on sale and lease back and measurement amount for recognition of Right of Use and Financial Liability is as follows.

IAS 17		IFRS 16	
Sale Value	1,800,000	ROU as proportion to the previous carrying amount 1,000,000/1,800,000 x 1,276,800 = 709,333	
Carrying Value	1,000,000		
Gain to be recognised immediately, sale is at fair value	**800,000**	Gain/loss relating to the ROU transferred 800,000 / 1,800,000 x (1,800,000-1,276,800) = **232,533**	
		Dr Cash	1,800,000
		Dr ROU	709,333
		Cr PPE Air Craft	1,000,000
		Cr Financial Liability	1,276,800
		Cr Gain on sale /lease back	232,533

MY TAKE ON WINDS OF CHANGE

- Data is connected from the source to the ledger via cloud-based applications. Accounting is morphing into what economists call "interaction jobs", where technical knowledge is assumed and higher value is applied to a person's ability to interact with internal and external clients, identify problems, come up with alternative solutions, determine which are affordable at this point in time and communicate and influence to deliver an outcome.

- The successful accountants of the future will be strong communicators, possess greater IT skills combined with strategic vision and they will be devoted to ongoing professional development. Globalisation is the future of accounting as more and more businesses require real-time manufacturing and information, mobile marketing and online tools, including the cloud, to expand their customer base internationally. Thus accounting, auditing and finance professionals with knowledge of international standards and regulations will thrive.

- ICAI is geared to this reality and 32 overseas chapters of ICAI is a testimony apart from embracing International accounting and assurance standards. Indian Chartered Accountants, thanks to the rigorous training and enviable forward looking curriculum, possess right insights and foresight to overcome challenges and make the best use of the opportunities.

COMPARISON WITH US GAAP

US GAAP and IFRS requires recognition and measurement of leases in similar manner with certain minor differences, such as:

- IFRS 16 allows companies to exclude leases of low-value assets considering these would be immaterial while US GAAP does not allow the same.

- Treatment with regard to former leases classified as operating leases is different

  - IFRS requires single lease model i.e. all leases to be recognised in the same manner

  - US GAAP requires dual lease model i.e. to continue with the previous classification and to account for the same differently.

- Under IFRS inflation-linked payments are reassessed when those payments change while under US GAAP these are not reassessed.

COMPARISON WITH US GAAP

- Differences with regard to disclosures

  - IFRS 16 does not include prescriptive qualitative disclosures requirements and requires companies to determine the information that would satisfy those objectives.

  - Under US GAAP specific qualitative items are required to be disclosed, e.g., terms and conditions of extension and termination options in leases.

  - It is expected that information disclosed about features in leases, such as, extension and termination options, will be different

Thank You

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