Grant Thornton
An instinct for growth™

IFRS News Special Edition on Lease Accounting

Major reforms to global lease accounting

- IFRS 16 Leases (upcoming MFRS 16 Leases)

IFRS News Special Edition
April 2016

The IASB has published IFRS 16 'Leases' completing its long-running project on lease accounting.

This special edition of IFRS News explains the key features of the new Standard and provides practical insights into its application and impact.

We have covered the introduction and scope of IFRS 16 in the March 2016 issue. In this issue, the details of the new lessee accounting approach are discussed.

The new lessee accounting approach

Subject to the optional accounting simplifications for short-term and low-value asset leases (see below), a lessee will be required to recognise its leases on the balance sheet. This involves recognising:

- a 'right-of-use' asset; and
- a lease liability.

Lessees have the option to apply the model to a portfolio of similar leases if the effect is reasonably expected to be materially the same as a lease-by-lease approach.

Optional accounting simplifications

IFRS 16 provides important reliefs or exemptions for:

- low-value asset leases
- short-term leases.

If these exemptions are used, the accounting is similar to operating lease accounting under IAS 17. Lease payments are recognised as an expense on a straight-line basis over the lease term or another systematic basis (if more representative of the pattern of the lessee's benefit). The two exemptions are discussed further below.

Low-value asset leases

IFRS 16 provides an optional exemption for leases of 'low-value' assets. The assessment of value is based on the value of the underlying asset when new, regardless of its actual age. The exemption is available whether or not these leases are (individually or collectively) material to the reporting entity.

The Basis for Conclusions accompanying IFRS 16 explains that, when deciding on this exemption, the IASB had in mind leases of assets with a value when new of around US$5,000 or less. Accordingly, leases of assets such as low value IT equipment, office equipment and furniture would typically qualify, but vehicle leases would not. It should be noted that the reference to a US$5,000 threshold is not in the main body of the new Standard and does not establish a 'bright-line' rule. Factors such as price inflation and changes in foreign exchange rates (for entities whose functional currency is not the US Dollar) may reduce the relevance of this guideline over time.

The use of this exemption is an accounting policy choice that is available on a lease-by-lease basis.

Example – Low-value asset leases

A financial services company enters into a single lease contract for ten office printers/copiers. The lease has a three year, non-cancellable term. One of the assets is a high-end production printer with a purchase price when new of US$20,000. The other nine assets are more basic models with prices when new of $3,000 each.

Although the ten assets are under the same lease, the company concludes that each asset is a separate 'lease component' because:

- the company benefits from each asset on its own
- the assets are not highly interrelated.

Analysis

Because each asset is a distinct lease component, IFRS 16 treats this contract as containing ten separate leases in principle. The total lease payments are then allocated to each of the ten components on a relative stand-alone selling price basis.

The company can then elect to apply the low-value asset exemption to some or all of the nine basic model lease components. If it does so, these are accounted for similarly to operating leases under IAS 17.

The lease of the high-end production printer must be accounted for 'on-balance sheet'.

Short-term leases

IFRS 16 provides another optional exemption for short-term leases. A lease is short-term if it has a lease term of 12 months or less at the commencement date. However, a lease cannot qualify if it contains a purchase option.

Importantly, the lease term excludes any optional extension periods unless the lessee is reasonably certain to exercise its option (or reasonably certain not to exercise an option to terminate the lease.

The use of this exemption is an accounting policy choice that must be made consistently for each class of underlying asset.

Example – Short-term lease

A mining company has entered into several leases of transport vehicles. Each lease has a stated term of 36 months, but with break clauses allowing the company to terminate each lease after 12 months and 24 months without penalty.

At the commencement date of each lease the company assesses the likelihood that it will exercise its 12-month termination option. This assessment considers all relevant facts and circumstances that create an economic incentive not to terminate the lease early. Management concludes that it is not ‘reasonably certain’ that the termination option will not be exercised (said differently, there is a realistic possibility that the 12-month termination option **will** be exercised).

In reaching this conclusion, management takes into account that:

- there is no significant termination penalty
- the rentals in years 2 and 3 are not below market
- the business’s transport needs tend to change with sufficient speed that the existing vehicle fleet may no longer be optimal in 12 months’ time and alternative vehicles could be sourced and introduced into the operations without significant cost or disruption.

Analysis

The leases of transport vehicles qualify for the short-term election. The mining company has an accounting policy choice to either apply the general IFRS 16 lessee model or account similarly to operating leases under IAS 17 (ie recognise the lease payments on a straight-line basis over the lease term or another systematic basis if more representative of the pattern of benefit). This accounting policy must be applied consistently to all short-term leases of underlying assets of the same class (eg all short-term leases of transport vehicles).

Applying the new lessee accounting approach

Initial accounting

At the commencement date the lessee recognises a lease liability and a right-of-use asset. The liability is initially measured at the present value of future lease payments. For this purpose, lease payments include fixed, non-cancellable payments for lease elements, amounts due under residual value guarantees, certain types of contingent payments and amounts due during optional periods that are ‘reasonably certain’. Termination penalties are included if the lease term reflects the exercise of a termination option.

The lease liability does not include:

- payments for non-lease elements (unless the practical expedient permitting non-separation of non-lease elements is applied – see below)
- payments in optional extension periods unless extension is ‘reasonably certain’
- future changes in variable payments that depend on an index or rate
- variable payments linked to the lessee’s future sales or usage of the underlying asset.

The discount rate is the rate implicit in the lease, if readily determinable. If not, the lessee’s incremental borrowing rate is used.

The diagramme summarises the initial measurement of the lease liability:

Initial measurement of the lease liability

Fixed (and in-substance fixed) future payments for lease elements, less any lease incentives receivable over the lease term (including payments in optional extension periods if extension ‘reasonably certain’)

+

Variable payments linked to an index/rate based on level of index/rate at commencement

+

Amounts expected to be payable under residual value guarantees

+

Exercise price of a purchase option if the lessee is reasonably certain to exercise that option

+

Termination penalties if lease term reflects exercise of a termination option

Discounted at rate implicit in the lease (or lessee’s incremental borrowing rate)

The initial measurement of the right-of-use asset is based on the lease liability. Adjustments are made for any:

- prepaid lease payments
- lease incentives received
- initial direct costs incurred
- an estimate of costs the lessee is obliged to incur to dismantle, remove or restore the underlying asset and/or site.

The diagramme summarises how the initial right-of-use asset is measured starting with the lease liability:

Initial measurement of the right-of-use asset

Initial amount of lease liability

\+

Lease payments made to lessor at or before commencement date

–

Lease incentives received

\+

Initial direct costs

\+

Estimated cost of removing and/or restoring leased asset

Right-of-use asset

Subsequent accounting for right-of-use asset and lease liability

In subsequent periods, the right-of-use asset is accounted for similarly to a purchased asset. The lease liability is accounted for similarly to a financial liability. Accordingly:

- the right-of-use asset is depreciated
- the lease liability is accounted for under the effective interest method. Lease payments are apportioned between interest expense and a reduction of the lease obligation.

Said differently, the accounting is similar to today's accounting for finance leases.

The initial and subsequent accounting for a simple 3-year lease are illustrated in the following example.

Example – Lessee accounting for a simple three-year lease

On 1.1.20X1 a company enters into a three-year lease of office premises. The rentals are CU10,000 payable at the end of each year. There are no services or other non-lease elements. No initial direct costs are incurred or incentives received. The applicable discount rate (see below) is 5%.

Analysis

The initial measurement of the right-of-use asset and lease liability is CU27,232 (10,000/1.05 + 10,000/1.05^2 + 10,000/1.05^3). The table below summarises the cash flows and balance sheet and profit and loss account treatment (assuming straight-line depreciation over three years):

Cash flow and P&L	1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU
Lease payments	–	10,000	10,000	10,000
Depreciation expense	–	9,077	9,077	9,078
Interest expense	–	1,362	930	476
Total expense	–	10,439	10,007	9,554
Balance sheet (CU)				
Right-of-use asset	27,232	18,155	9,078	–
Lease liability	27,232	18,594	9,524	–

The accounting entries on initial recognition are:

	Debit (CU)	Credit (CU)
Right-of-use asset	27,232	
Lease liability		27,232

The subsequent accounting entries in Year 1 are:

	Debit (CU)	Credit (CU)
Depreciation expense	9,077	
Interest expense	1,362	
Lease liability	8,638	
Cash		10,000
Right-of-use asset		9,077

The accounting entries in Years 2 and 3 continue in the same pattern.

The lessee initially recognises a lease liability (which is the present value of future lease payments) and a right-of-use asset (which is based on lease liability).

Practical insight – Front-loading of lease expense
In this example rentals over the three years are CU30,000 in total. Under IAS 17, assuming this is an operating lease (which is likely for a three-year property lease), the annual expense will be CU10,000. Under IFRS 16 the total expense over the three years is also CU30,000 but this is 'front-loaded' – in other words the expense is higher in the early years. This results from recognising interest at a constant rate of return on the outstanding liability.

The lease liability is re-measured (with a corresponding adjustment to the right-of-use asset) when:
- the lease term is revised (see below under 'Renewal and termination options')
- future lease payments based on an index or rate are revised (see below under 'Variable lease payments')
- the lease is modified (see below under 'Lease modifications')
- there is a change in the amounts expected to be paid under residual value guarantees.

Renewal and termination options
As noted above, the initial lease liability takes into account lease payments during option periods only if exercise of an option to extend is considered reasonably certain (or non-exercise of an option to terminate the lease is reasonably certain). This is consistent with IFRS 16's definition of the 'lease term'.

Definition of lease term:
IFRS 16 defines the lease term as the non-cancellable period of the lease, together with both of the following:
(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

The lessee must reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, if there is a significant event or change in circumstances that:
- is within the lessee's control; and
- affects whether exercise (or non-exercise) is reasonably certain.

A change in this assessment triggers a re-measurement of the lease liability. Similarly, re-measurement is required if the lessee actually exercises an extension option that was not considered reasonably certain, or does not exercise a termination option that was considered reasonably certain. To account for these events the lessee:
- adjusts the lease liability by (i) including the lease payments over the revised term; (ii) applying a revised discount rate (the interest rate implicit in the lease for its remaining term if readily determinable, or the lessee's incremental borrowing rate at the date of reassessment if not)
- makes a corresponding adjustment to the right-of-use asset.

The accounting for a reassessment of an extension option is illustrated in the following example:

Under IFRS 16, the expense is 'front loaded' – in other words the expense is higher in earlier years.

Example – Reassessment of an extension option

A restaurant operator enters into a five-year lease of real estate on 1.1.20X1 (the commencement date). The annual rental is CU5,000 payable in advance. The contract contains an option for the operator to extend the lease for a further five years at an annual rental of CU6,000. At the commencement date, management concludes that exercise of the extension option is not reasonably certain. This takes account of all relevant facts and circumstances, including that:

- the site will be used for a new restaurant format that is not yet proven in the local market
- leasehold improvements are expected to be at the end of their useful economic lives by the end of year five
- the rentals during the extension period are not expected to be below market rates.

Accordingly, management concludes that the lease term is five years. On 1.1.X1 the operator recognises a right-of-use asset and lease liability using its incremental borrowing rate of 4% (having concluded that the interest rate implicit in the lease is not readily determinable):

1.1.20X1	Debit (CU)	Credit (CU)
Right-of-use asset	23,150	
Lease liability		18,150
Cash		5,000

The right-of-use asset will be depreciated on a straight-line basis over five years.

After three years, on 31.12.20X3, it is evident that the new restaurant brand has been unsuccessful. Management decides to make a significant investment in rebranding the site to another format that has been very successful. Management determines that this is a significant change of circumstances that makes exercise of the extension option reasonably certain. Accordingly, management reassesses the total lease term to be ten years, of which seven years remain. At the date of reassessment the operator's incremental borrowing rate is 3% (the interest rate implicit in the lease for its remaining term is not readily determinable).

Analysis

As a result the lease liability is re-measured at 31.12.20X3. The new liability is the present value of two payments of CU5,000 due on 1.1.X4 and 1.1.X5, plus five payments of CU6,000 due from 1.1.X6 to 1.1.X10, discounted at 3% (CU36,533). The lease liability at 31.12.20X3 before reassessment is CU9,808. The increase (CU26,725) is added to the lease liability and the right-of-use asset:

31.12.20X3	Before reassessment CU	Adjustment CU	After reassessment CU
Right-of-use asset	9,260	26,725	35,985
Lease liability	9,808	26,725	36,533

Subsequently, the revised right-of-use asset is depreciated over its revised useful life (eg straight-line over seven years). The revised lease liability is measured using the new effective interest rate of 3%.

Variable lease payments

The accounting for variable lease payments depends on the nature of the variability. Payments that vary based on an index or rate are included in lease payments for classification and measurement purposes based on the prevailing index or rate at the measurement date. The lease liability is re-measured when the index or rate changes and the lease payments are revised. This differs from current practice; future changes in inflation are often not included in minimum lease payments under IAS 17.

Payments that vary based on future usage of the leased asset are not included in lease payments for classification and measurement purposes. However, variable payments that are in-substance fixed payments are included in the lease payments.

Practical insight – In-substance fixed lease payments

IFRS 16 provides the following examples of lease payments that are variable in legal form but should be treated as fixed in-substance:

- payments that must be made only if an asset is proven to be capable of operating during the lease
- payments that must be made only if an event occurs that has no genuine possibility of not occurring
- payments that are initially variable but for which the variability will be resolved in future (which become 'in-substance fixed' when resolved)
- arrangements in which there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case the lease payments are the realistic set of payments.

The diagramme summarises the initial and subsequent accounting requirements for variable lease payments:

Accounting for variable lease payments

Type of variable payment	Initial accounting	Subsequent accounting
Variable lease payments that depend on an index or a rate	Include in lease liability and asset based on level of index/rate at the commencement date	Adjust lease liability and asset when revised index/rate changes the lease payments (using original discount rate)
Other variable lease payments (eg payments linked to sale or usage)	Exclude from lease liability and asset	Recognise an expense in the period that the event or condition that triggers the payments occurs
In-substance fixed lease payments	Treat as fixed lease payments	Treat as fixed lease payments

Non-lease elements

Non-lease elements

Many contracts contain both lease and non-lease elements. Examples of non-lease elements include: maintenance, security and other onsite services in a property lease, the supply of goods in a contract manufacturing agreement, operational services in a transport or outsourcing contract and the lessor paying insurance costs or property taxes that relate to the underlying asset. The lessee needs to account for non-lease elements separately from the lease element(s). This requires an allocation of the total contractual payments to lease and non-lease elements based on relative stand-alone selling prices. Non-lease elements are then accounted for under the applicable IFRS guidance.

IFRS 16 includes a practical expedient allowing lessees to make an accounting policy election (by class of underlying asset) to treat non-lease elements as part of the lease.

Practical insight – Including non-lease elements in the lease accounting

Taking advantage of the practical expedient to not separate non-lease components from lease components will certainly simplify the accounting for a contract that contains a lease. However, this will also increase the amount of assets and liabilities recognised and could have implications for impairment.

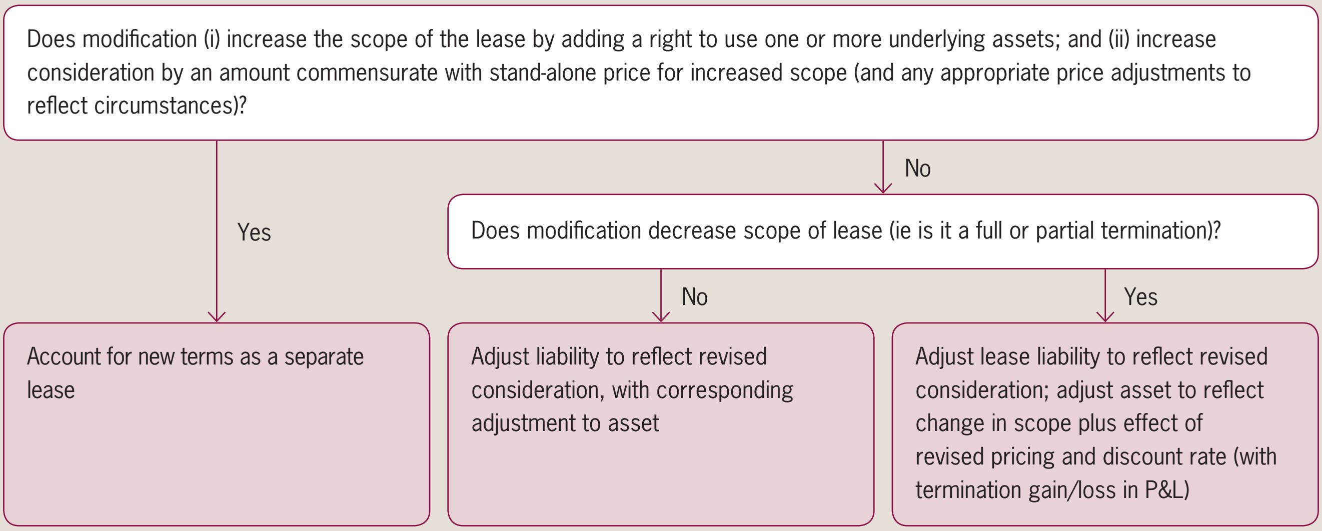
Lease modifications

Accounting for a modification to a lease depends on the nature of the modification. The possible outcomes are to account for the change as:

- a separate lease
- a re-measurement of the lease liability using a discount rate determined at that date, and corresponding adjustment to the right-of-use asset
- a re-measurement of the lease liability using a discount rate determined at that date and partial termination of the lease. The asset is adjusted to reflect its reduced scope, and the impact of revised pricing and the change in discount rate on the remaining scope. A termination gain or loss is recognised (calculated as the difference between pre-modification carrying values of the asset and liability multiplied by the proportionate reduction in scope). Example 17 accompanying IFRS 16 illustrates this accounting.

IFRS 16's requirements on accounting for a lease modification are summarised in the diagramme:

Types of lease modification



IFRS 16 includes a practical expedient allowing lessees to make an accounting policy election (by class of underlying asset) to treat non-lease elements as part of the lease.

In the coming issues, we will be covering the topics of:

May 2016 : Lessor accounting, Sale and leaseback accounting

June 2016 : Presentation and disclosure, Effective date and transition

Important Disclaimer:
This document has been developed as an information resource. It is intended as a guide only and the application of its contents to specific situations will depend on the particular circumstances involved. While every care has been taken in its presentation, personnel who use this document to assist in evaluating compliance with International Financial Reporting Standards should have sufficient training and experience to do so. No person should act specifically on the basis of the material contained herein without considering and taking professional advice. Neither Grant Thornton International Ltd, nor any of its personnel nor any of its member firms or their partners or employees, accept any responsibility for any errors it might contain, whether caused by negligence or otherwise, or any loss, howsoever caused, incurred by any person as a result of utilising or otherwise placing any reliance upon this document.

Grant Thornton
An instinct for growth™

Winner 2015 International Accounting Bulletin — Winner Employer of the year 2015

MPF Awards For Management Excellence 2015 — Winner Best Programme for Leadership Development

Most Attractive Employers World Universum 2015 — Position #37 as voted by more than 240,000 international students

KUALA LUMPUR

Levels 11,15 & 8
Sheraton Imperial Court
Jalan Sultan Ismail
50250 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 11848
F +607 224 9848

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126

www.grantthornton.com.my