IFRS News Special Edition on Lease Accounting

Grant Thornton
An instinct for growth™

Major reforms to global lease accounting

- IFRS 16 Leases (upcoming MFRS 16 Leases)

IFRS News Special Edition
February 2016

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

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

Introduction

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

IFRS 16 will require lessees to account for leases 'on-balance sheet' by recognising a 'right-of-use' asset and a lease liability. For many businesses, however, exemptions for short-term leases and leases of low value assets will greatly reduce the impact.

IFRS 16 also:

- changes the definition of a lease
- sets requirements on how to account for the asset and liability, including complexities such as non-lease elements, variable lease payments and option periods
- changes the accounting for sale and leaseback arrangements
- largely retains IAS 17's approach to lessor accounting
- introduces new disclosure requirements.

IFRS 16 represents the first major overhaul of lease accounting for over 30 years. The IASB has long believed that IAS 17's split between operating and finance leases is flawed, and has resulted in too much structuring and off-balance sheet financing. The IASB's solution has remained the same throughout the project: to do away with the operating versus finance lease distinction and account for all leases 'on-balance sheet'.

While many agree that reforms to lease accounting are long overdue, bringing all leases on-balance sheet is controversial. The IASB hopes to reduce controversy through various compromises – in particular by exempting short-term and low value asset leases. As a result businesses that lease only assets such as printers and laptops will face only a limited impact. For businesses that lease 'big-ticket' assets, such as property and high value equipment, this will however be a major change.

Whatever your views on the new Standard, businesses would be well-advised to start an impact analysis sooner rather than later.

Andrew Watchman, Global Head – IFRS

Background

IFRS 16 represents the first major overhaul of lease accounting for over 30 years. The new Standard replaces IAS 17 'Leases' along with three Interpretations (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').

IFRS 16 will affect most companies that report under IFRS and are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment.

The table summarises the main changes at a glance:

Issue	Effect
Who's affected?	• entities that lease assets as a lessee or a lessor
What's the impact on lessees?	• all leases will be accounted for 'on-balance sheet', other than short-term and low value asset leases • lease expense will typically be 'front-loaded' • lease liability will exclude: – option periods unless exercise is reasonably certain – contingent payments that are linked to sales/usage and future changes in an index/rate
What's the impact on lessors?	• only minor changes from the current Standard – IAS 17
Are there other changes?	• a new definition of a lease will result in some arrangements previously classified as leases ceasing to be so, and vice versa • new guidance on sale and leaseback accounting • new and different disclosures
When are the changes effective?	• annual periods beginning on or after 1 January 2019 • various transition reliefs • early application is permitted provided IFRS 15 'Revenue from Contracts with Customers' is applied.

History

IFRS 16 is the end-product of a leases project added to the IASB's agenda ten years ago. The initial discussion paper was published in 2009, followed by two exposure drafts.

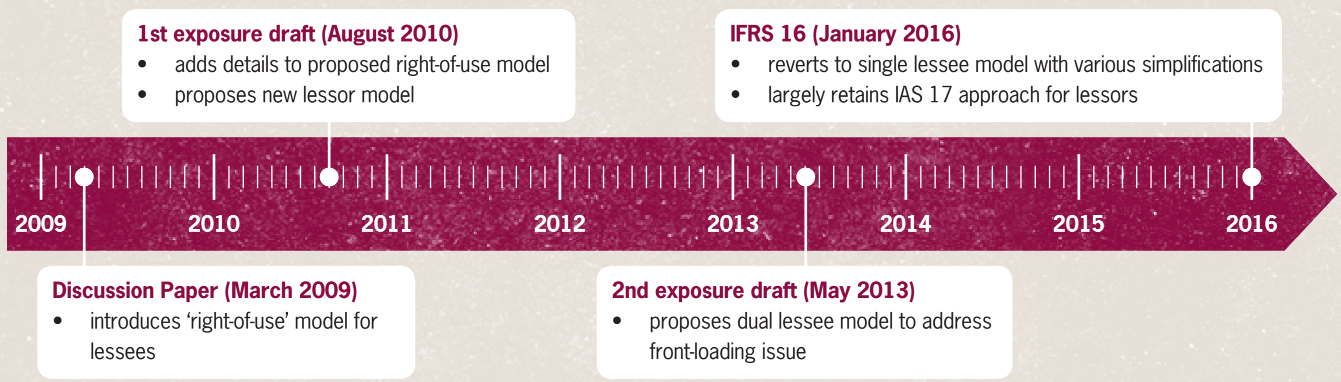
Throughout this time the IASB has maintained its view that all leases should be 'on-balance sheet' – a view that has inevitably been controversial. However, as the project has progressed the IASB has looked for ways to simplify the requirements and reduce the controversy. The diagramme summarises the key stages in IFRS 16's development:

Practical insight – US convergence

The new leases standard started out as a joint project between the IASB and its US counterpart, the FASB. However, as the project progressed the two Boards have made different decisions in some areas. The outcome is that IFRS 16 and the new US standard are not fully 'converged'. Two of the more significant differences are that the US standard:

- will divide leases into two types for lessees (financing and operating), similar to the proposals in the Boards' May 2013 exposure draft. Both lease types will be 'on-balance sheet' but the expense profile for operating leases will generally be 'straight-line'
- will not provide an exemption for low-value asset leases.

Development of IFRS 16



Scope

IFRS 16 applies to all leases for both the lessee and lessor, except for a few scope exclusions. These exclusions, some of which are similar to IAS 17's, are summarised in the table:

Scope exclusion	Standard to apply
Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	None specified. Depending on the circumstances IFRS 6 'Exploration for and Evaluation of Mineral Resources' or IAS 38 'Intangible Assets' might apply
Leases of biological assets in scope of IAS 41 held by a lessee	IAS 41 'Agriculture'
Service concession arrangements in scope of IFRIC 12	IFRIC 12 'Service Concession Arrangements'
Licences of intellectual property granted by a lessor in scope of IFRS 15	IFRS 15 'Revenue from Contracts with Customers'
Rights held under licensing agreements in scope of IAS 38 for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights*	IAS 38 'Intangible Assets'

* for leases of other types of intangible asset a lessee is permitted to apply IFRS 16 but not required to do so

In addition, IFRS 16 provides optional accounting simplifications for short-term and low-value asset leases. These are discussed in the lessee accounting section below.

Practical insight – impact on investment property

Under IAS 17 and IAS 40 'Investment Property', a lessee of property classified as investment property applies:

- IAS 40 to its interest in the property if the lease is a finance lease (and can choose either the cost model or the fair value model)
- IAS 17 if the lease is an operating lease. However, an investor-lessee can alternatively elect to treat the lease as a finance lease and apply IAS 40's fair value model to its interest in the property.

IFRS 16 makes extensive consequential amendments to IAS 40, including expanding its scope to include all investment property held under leases (including leases that would be classified as operating under IAS 17). IFRS 16 also applies to these leases. As a result, an investor-lessee recognises a lease liability and a right-of-use asset. The 'right-of-use' asset is accounted for:

- at fair value in accordance with IAS 40 if the investor-lessee uses the fair value model for owned investment property; or
- otherwise at cost less depreciation and impairment in accordance with IFRS 16.

The main change is therefore the accounting for investment property held under an operating lease (as defined by IAS 17). Under IFRS 16 these leases can no longer be accounted for 'off-balance sheet' (unless the lease is short-term).

IFRS 16 applies to all leases for both the lessee and lessor except for a few scope exclusions.

Definition of a lease

Because the new lease accounting results in many more leases being 'on-balance sheet', the evaluation of whether a contract is (or contains) a lease becomes even more important than today. IFRS 16 changes the definition of a lease and provides new guidance on applying the definition.

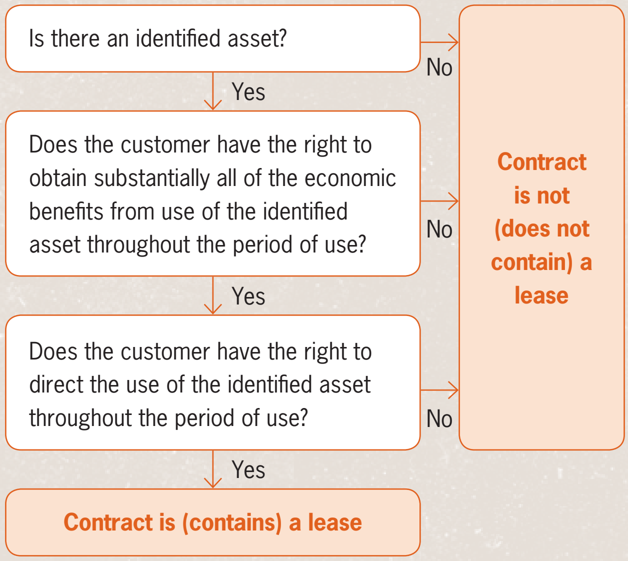
In practice, the main impact will be on contracts that are not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease – such as outsourcing, contract manufacturing, transportation and power supply agreements. Currently, this evaluation is based on IFRIC 4. IFRS 16 replaces IFRIC 4 with new guidance that differs in some important respects.

Practical insight – Key changes from IFRIC 4
One of the main changes from IFRIC 4 is the relevance of pricing when evaluating whether a contract to supply goods or services contains a lease. Under IFRIC 4, such contracts do not contain leases if the unit price paid by the customer is either fixed or at fair value at the time of delivery. IFRS 16 does not include this 'pricing exemption'.

As a result, some contracts that do not contain a lease today will do so under IFRS 16, and vice versa. If a contract contains a lease, the lease component is accounted for on-balance sheet in the same way as a standalone lease (unless it is a short-term or low-value asset lease).

Applying the new definition (see below) involves three key evaluations. These are summarised in the flowchart:

Flowchart: the three key evaluations



Lease definition:
Under IFRS 16 a lease is defined as: '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'.

A contract can be (or contain) a lease only if the underlying asset is 'identified'. Having the right to control the use of the identified asset requires having the right to:
- obtain all of the economic benefits from use of the identified asset; and
- direct the use of the identified asset.

The new Standard provides extensive guidance and illustrative examples to help apply this definition. The following table and simplified examples summarise the key points.

Applying the lease definition

Component of definition	Guidance
Is there an identified asset?	• an asset is 'identified' if it is explicitly specified in the contract, or implicitly specified when made available to the customer • as asset is not identified if the supplier has a substantive right to substitute another asset • a physically distinct portion of an asset can be an identified asset but a portion of an asset's capacity cannot
Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use?	• considers direct and indirect benefits such as using, holding, or sub-leasing the asset • considers only the economic benefits within the defined scope of a customer's rights to use an asset
Does the customer have the right to direct the use of the identified asset throughout the period of use?	• normally present if the customer has the right to decide how and for what purpose the asset is used • if relevant decisions about use of the asset are predetermined, the customer has control if it (i) has the right to operate the asset; or (ii) designed the asset (or aspects of it) in a way that predetermines its use

Example 1 – Executive jet

A multi-national business (the customer) enters into a five-year contract with an aviation company for the exclusive use of a particular executive jet. The contract details the interior and exterior specifications for the jet. The aviation company is permitted to use an alternative aircraft but this would be uneconomic due to various factors such as the cost of customising the aircraft to meet the contractual specifications.

Subject to certain restrictions, the customer decides where the executive jet will fly and which passengers will use it. The aviation company operates the aircraft using its own crew.

Analysis – The contract **contains a lease**. The contract specifies an executive jet. The aviation company's right to substitute another aircraft is not substantive because it would be uneconomic to exercise this right. The customer decides how and for what purpose the jet is used which provides it with the right to control the use of the jet.

Example 2 – Ship

A car manufacturer enters into a contract with a shipping company to transport cars from Hamburg to Singapore. The contract specifies a particular ship and the cars to be transported, which will require the full capacity of the ship. The shipping company operates and maintains the ship and is responsible for the safe passage of the cars to Singapore. The car manufacturer is not able to make changes (eg to the destination or nature of the cargo) once the contract has been signed.

Analysis – The contract **does not contain a lease**. After signing the contract the customer is not able to direct how and for what purpose the ship is used and does not therefore control the use of the asset. The contract pre-determines how and for what purpose the ship will be used and the customer neither operates nor designed the ship.

Example 3 – Contract manufacturing

A retailer enters into a contract manufacturing arrangement with a manufacturer to supply an own-brand food product for a three-year period. The recipe, packaging and quantity of the food product are specified in the contract.

The contract does not specify which factory (or factories) will be used, but the manufacturer has only one suitable factory. Constructing another factory would not be viable. Fulfilling this contract will not require all of the factory's capacity.

The manufacturer makes all decisions about the operations of the factory, including how to utilise the available capacity and what output to produce with that capacity.

Analysis – The contract **does not contain a lease**. Although the contract implicitly specifies an asset (the one suitable factory), the retailer does not have the right to decide how this factory is used after the contract has been signed. The recipe, packaging and quantity of the food product are pre-specified in the contract. Also, the retailer does not have the right to obtain substantially all the benefits from use of the factory because the manufacturer decides how to use the available capacity.

Example 4 – Power supply

A utility company contracts with a windfarm operator to purchase all of the electricity produced by a new windfarm for 30 years. The operator owns the windfarm. The utility company designed the windfarm before it was constructed and hired experts to assist in determining the location, obtaining permits and specifying the turbines to be used. The operator constructs the windfarm to the contractual specifications and then operates it. The operator will receive tax amortisation deductions on the windfarm, while the utility company receives green certificates.

Analysis – The contract **contains a lease**. The utility company has the right to obtain substantially all of the economic benefits from use of the windfarm over the 30-year contract period. The contract pre-determines how and for what purpose the windfarm is used, so neither party is able to take these decisions after the contract is signed. In this circumstance, the utility company's role in designing the windfarm means that it has control for IFRS 16 purposes.

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

April 2016 : The new lease accounting approach

May 2016 : Lessor accounting, Sale and leaseback accounting

June 2016 : Presentation and disclosure, Effective date and transition

Grant Thornton
An instinct for growth™

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

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

Most Attractive Employers World Universum 2015 — Grant Thornton 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