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IFRS News Special Edition on Lease Accounting

Major reforms to global lease accounting

- IFRS 16 Leases

equivalent to MFRS 16 Leases issued by Malaysian Accounting Standards Board on 15 April 2016

IFRS News Special Edition
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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 details of the new lessee accounting approach in April 2016 issue. In this issue, we will be covering the areas of lessor accounting and sale and leaseback.

Lessor accounting

IFRS 16's requirements for lessor accounting are similar to IAS 17's. In particular:

- the distinction between finance and operating leases is retained
- the definitions of each type of lease, and the supporting indicators of a finance lease, are substantially the same as IAS 17's (see below)
- the basic accounting mechanics are also similar, but with some different or more explicit guidance in a few areas such as variable payments.

Definitions of finance and operating leases

Finance lease
A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease
A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Summarised indicators of a finance lease

Examples of situations that individually or in combination would **normally** lead to a lease being classified as a finance lease	• the lease **transfers ownership** of the underlying asset to the lessee • lessee has a **bargain purchase option** • lease term is **major part of the economic life** of the underlying asset • **present value of the lease payments** amounts to substantially all of the fair value of the underlying asset • underlying asset is of a highly **specialised nature**
Indicators of situations that individually or in combination **could** also lead to a lease being classified as a finance lease	• if lessee can cancel lease it **bears resulting losses** for lessor • gains or losses from **changes in fair value** of the residual accrue to the lessee • lessee has the ability to continue the lease for a **secondary period at a bargain rent**.

Finance leases

For a **finance lease**, the lessor initially recognises a receivable at an amount equal to the net investment in the lease. The net investment in the lease is the present value of:

- the lease payments, which are determined consistently with IFRS 16's guidance for lessees (for example, variable payments that depend on an index or a rate are included, initially measured using the index or rate as at the commencement date); and
- any unguaranteed residual value accruing to the lessor.

The net investment is discounted using the interest rate implicit in the lease. This rate is defined in such a way that the initial net investment equals the sum of the fair value of the underlying asset and the lessor's initial direct costs.

Subsequently a finance lessor recognises finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the net investment in the lease.

Practical insight – Impairment of lease receivables

Under IFRS 9 'Financial Instruments' lessors will be required to account for impairment of lease receivables using a new 'expected loss' model. IFRS 9 is effective from 1 January 2018.

Operating leases

For an **operating lease**, the lessor:

- uses a depreciation policy for underlying assets subject to operating leases that is consistent with the normal depreciation policy for similar assets
- adds initial direct costs of obtaining the lease to the underlying asset and recognises them as an expense over the lease term on the same basis as the lease income
- recognises lease payments as income on either a straight-line basis or another systematic basis if more representative of the pattern in which benefit from use of the underlying asset is diminished.

Subleases

A sublease involves the re-leasing by a lessee of the underlying asset to a third party, while the 'head lease' between the original lessor and lessee remains in effect. Under IFRS 16 subleases are accounted for by the sub-lessor in the in the same way as other leases. The sublease is classified as 'operating' or 'finance' by reference to the right-of-use asset.

As an exception, if the head lease is short-term and accounted for using the optional simplification described above, the sublease is classified as an operating lease.

Practical insight – Lease modifications for lessors

IFRS 16 has new guidance on lease modifications for the two lease types:

Modification to a finance lease

A modification to a finance lease is accounted for as a separate lease if:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration increases by an amount commensurate with the stand-alone price for the increased scope and any appropriate adjustments to reflect the circumstances.

If these conditions are not met, the accounting depends on whether the lease would have been an operating lease if the new terms were in effect at inception. If so, the lessor accounts for the modified lease as a new operating lease from the modification date (measuring the underlying asset equal to the net investment in the original lease immediately before the modification). If not, the guidance in IFRS 9 on modified financial assets applies.

Modification to an operating lease

A modification to an operating lease is accounted for as a new lease from the modification date. Prepaid or accrued lease payments relating to the original lease are treated as payments for the new lease.

Manufacturer-lessors

IFRS 16's requirements on accounting for a finance lease by a manufacturer- or dealer-lessor are similar to IAS 17's. The manufacturer- or dealer-lessor recognises a selling profit at the commencement date made up of:

- revenue for the fair value of the underlying asset (or the present value of the lease payments if lower)
- cost of sales for the cost (or carrying amount if different) of the underlying asset less the present value of the unguaranteed residual value
- costs incurred in connection with obtaining the finance lease as an expense.

If a manufacturer- or dealer-lessor charges an artificially low interest rate, selling profit must be restricted to the amount that would apply based on a market interest rate.

A manufacturer-lessor does not recognise selling profit on entering into an operating lease.

Practical insight – Impact of IFRS 16 on lessors

IFRS 16's changes to lessor accounting are limited to some detailed matters and are mainly a consequence of changes to lessee accounting. The main changes from IAS 17 relate to:

- **subleases** – under IFRS 16 the head lease and a sublease are two separate contracts that are accounted for under the lessee and lessor models. The sublease is classified by reference to the right-of-use asset. IAS 17 has limited guidance but in practice subleases are often classified by the intermediate lessor by reference to the underlying asset
- **new definition of a lease** – see above
- **lease modifications** – see above
- **initial direct costs** – which are defined slightly differently than in IAS 17. IFRS 16's definition clarifies that these are incremental costs that would not have been incurred if a lease had not been obtained
- **variable payments** – under IAS 17 contingent rents are not part of 'minimum lease payments' and generally excluded from finance lease liabilities and assets
- **lessor disclosures** – see below.

Sale and leaseback accounting

IFRS 16 makes significant changes to sale and leaseback accounting.

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 determine whether the transfer qualifies as a sale. This determination is based on the requirements for satisfying a performance obligation in IFRS 15.

The different accounting treatments for whether or not the transfer qualifies as a sale are described below.

Transfer of the asset is a sale

If the transfer qualifies as a sale and the transaction is on market terms the seller-lessee effectively splits the previous carrying amount of the underlying asset into:

- a right-of-use asset arising from the leaseback; and
- the rights retained in the underlying asset by the buyer-lessor at the end of the leaseback.

The seller-lessee recognises a portion of the total gain or loss on the sale. The amount recognised is calculated by splitting the total gain or loss into (i) an unrecognised amount that relates to the retained rights; and (ii) a recognised amount that relates to the rights retained in the underlying asset by the buyer-lessor at the end of the leaseback. The leaseback itself is then accounted for under the lessee accounting model.

The buyer-lessor accounts for the purchase in accordance with the applicable standards (eg IAS 16 'Property, Plant and Equipment' if the asset is property, plant or equipment). The lease is accounted for under IFRS 16's lessor accounting requirements.

Adjustments are required if consideration for the sale is not at fair value and/or payments for the lease are not at market rates. These adjustments result in recognition of:

- a prepayment to reflect below-market terms
- additional financing provided by the buyer-lessor to the seller-lessee to reflect above-market terms.

Example – Sale and leaseback

SellCo sells a building to BuyCo for cash of CU1,800,000, which is its fair value at that date. The previous carrying value of the building is CU1,000,000. At the same time, SellCo enters into a lease with BuyCo conveying back the right to use the building for 18 years. Annual payments are CU120,000 payable at the end of each year, which is at market rate. The transfer qualifies as a sale based on the guidance on satisfying a performance obligation in IFRS 15.

The rate implicit in the lease is 4.5%, which is readily determinable by SellCo.

Analysis

(a) SellCo

The present value of the annual payments (18 payments of CU120,000, discounted at 4.5%) is CU1,459,200.

SellCo measures the right-of-use asset retained through the leaseback as a proportion of the previous carrying amount of the building. This is calculated as: CU1,000,000 (previous carrying value) x [CU1,459,200 (PV of lease payments)/ CU1,800,000 (fair value of building)]. The right-of-use asset calculated in this way is CU810,667.

SellCo recognises a portion of the total gain on the sale, to the extent it relates to the rights retained in the underlying asset by BuyCo at the end of the leaseback. The total gain on sale of building is CU800,000 (CU1,800,000 – CU1,000,000). This total is split into:

- the portion relating to the rights to use the building retained by SellCo, calculated as CU800,000 x [CU1,459,200/CU1,800,000] which is CU648,533; and
- the portion relating to the rights retained in the underlying asset at the end of the leaseback by BuyCo, calculated as CU800,000 x [(CU1,800,000 – CU1,459,200)/CU1,800,000], which is CU151,467

At the commencement date, SellCo's accounting entries are:

	Debit (CU)	Credit (CU)
Cash	1,800,000	
Right-of-use asset	810,667	
Building		1,000,000
Gain on sale		151,467
Lease liability		1,459,200

(b) BuyCo

At the commencement date, BuyCo's accounting entries are:

	Debit (CU)	Credit (CU)
Building	1,800,000	
Cash		1,800,000

BuyCo classifies the lease as an operating lease taking into account, among other things, that the present value of the lease payments is 19% less than the fair value of the building. BuyCo accounts for the lease accordingly.

Transfer of the asset is not a sale

If the transfer does not qualify as a sale the parties account for it as a financing transaction. This means that:

- the seller-lessee continues to recognise the asset and accounts for the amounts received as a financial liability
- the buyer-lessor does not recognise the transferred asset and accounts for the amounts paid as a financial asset.

In the coming issue in June 2016, we will be covering the topics of Presentation and disclosure, Effective date and transition.

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