"The journal is running a series of updates on IFRS, IAS, IFRIC and SIC. The updates mostly collected from different sources of IASB publication, seminars, workshop & IFRS website. This issue is based on a newly developed standard IFRS 16 which has been collected, collated & summarized by Mr. Md. Mahabubul Alam FCMA. He has been working as First Assistant Vice President for Al Arafah Islami Bank Limited. He is a fellow member of the Institute of Cost & Management Accountants of Bangladesh."

IFRS 16: Leases; a New Era of Lease Accounting!

In January 2016 the International Accounting Standards Board (IASB) issued IFRS 16-Leases, and thereby started a new era of lease accounting – at least for lessees! Whereas, under the previous guidance in IAS-17, Leases, a lessee had to make a distinction between a finance lease (on balance sheet) and an operating lease (off balance sheet), the new model requires the lessee to recognize almost all lease contracts on the balance sheet; the only optional exemptions are for certain short-term leases and leases of low-value assets. For lessees that have entered into contracts classified as operating leases under IAS- 17, this could have a huge impact on the financial statements.

At first, the new standard will affect balance sheet and balance sheet-related ratios such as the debt/equity ratio. Aside from this, IFRS 16 will also influence the income statement, because an entity now has to recognize interest expense on the lease liability (obligation to make lease payments) and depreciation on the 'right-of-use' asset (that is, the asset that reflects the right to use the leased asset). Due to this, for lease contracts previously classified as operating leases the total amount of expenses at the beginning of the lease period will be higher than under IAS-17. Another consequence of the changes in presentation is that EBIT and EBITDA will be higher for companies that have material operating leases.

IFRS-16 Leases:

In January 2016, the new standard about lease accounting IFRS 16 was issued and it introduced a few major changes. The most significant are:

- New definition of the lease can cause that some contracts previously treated as "service contracts" can now be treated as "lease contracts",
- Accounting for leases in the lessee's financial statements changed and lessees do not classify the lease anymore. Instead, they should account for all the leases in the same way.

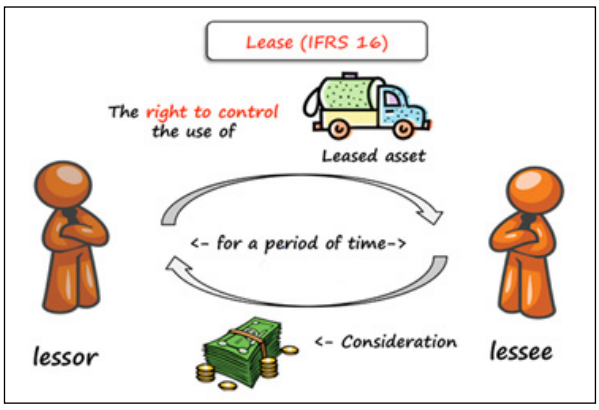
Why IFRS-16 Leases?

The objective of the standard IFRS 16 Leases is to **specify the rules for recognition, measurement, presentation and disclosure of leases.**

But, why is there a new lease standard when we had an older IAS 17 Leases? The main reason is that under IAS 17, lessees were still able to hide certain liabilities resulting from leases and simply not present them on the face of the financial statements. Under the new standard, lessees will need to show all the leases right in their statement of financial position instead of hiding them in the notes to the financial statements.

What is a lease under IFRS 16?

A contract is or contains a lease if it **conveys the right to control the use of an identified asset for a period of time in exchange for consideration** (IFRS16, par.9).



This definition of lease is **much broader** than under the old IAS 17 and we must assess all our contracts for potential lease elements. We should carefully look at:

- Can the asset be identified? E.g. is it physically distinct?
- Can the customer decide about the asset's use?
- Can the customer get the economic benefit from the use of that asset?
- Can the supplier substitute the asset during the period of use?

If the answer to these questions is YES, then it's probable that your contract contains a lease.

Under IFRS 16, you need to separate lease and non-lease components in the contract. For example, if you rent a warehouse and rental payments include the fees for cleaning services, then you should separate these payments between the lease payments and service payments and account for these elements separately. However, lessee can optionally choose not to separate these elements, but account for the whole contract as a lease (this applies for the whole class of assets).

Entities most likely to be affected by the changes (IFRS-16):

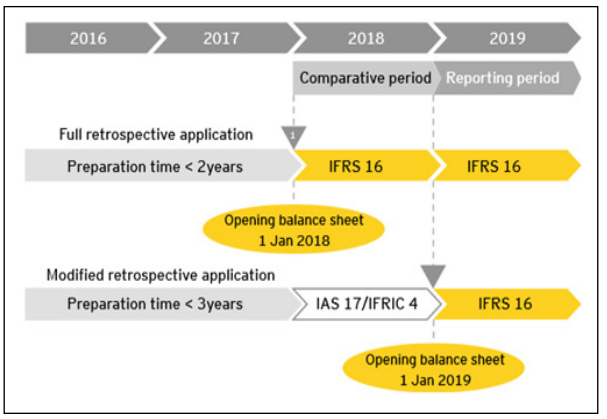
The effects of IFRS 16 will need to be assessed on the facts and circumstances relevant to each entity. This will further be impacted by the different capital structures that entities have adopted, for example an entity that typically rents office space, which is being accounted for as an operating lease, will be more significantly impacted than an entity that has purchased office space. It is expected that certain industries will be more significantly impacted than others. Some of the types of contracts that entities would need to consider include:

- Retail and consumer product entities
- Telecommunications entities
- Banking and other financial services
- Metals and mining entities
- Oil and gas entities
- Insurance entities

Transition Period:

The new standard is effective for annual periods beginning on or after 1 January 2019. Early application is permitted if IFRS 15 has already been applied or is applied at the same date as the new leases standard. Lessees with existing finance leases and lessors carry over existing balances at the date of initial application of the new standard (except for intermediate lessors in a sublease). Lessees are permitted to choose either a full or a modified retrospective transition approach for leases existing at the date of transition. Certain transition relief is available under the modified approach. Disclosures are required in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, with certain revisions.

Early preparation is recommended due to complexity of challenges.



Accounting for leases by lessees:

Initial recognition

At lease commencement, a lessee accounts for two elements:

1. **Right-of-use asset:** Initially, a right-of-use asset is measured in the amount of the lease liability and initial direct costs. Then it is adjusted by the lease payments made before or on commencement date, lease incentives received, and any estimate of dismantling and restoration costs.
2. **Lease liability:** The lease liability is in fact all payments not paid at the commencement date discounted to present value using the interest rate implicit in the lease (or incremental borrowing rate if the previous one cannot be set). These payments may include fixed payments, variable payments, payments under residual value guarantees, purchase price if purchase option will be exercised, etc.

Outline of Journal Entries:

1. Lessee takes an asset under the lease:
   - Debit Right-of-use asset
   - Credit Lease liability (in the amount of the lease liability)
2. Lessee pays the legal fees for negotiating the contract:
   - Debit Right-of-use asset
   - Credit Suppliers (Bank account, Cash, whatever is applicable)
3. The estimated cost of removal, discounted to present value (lessee will need to remove an asset and restore the site after the end of the lease term):

- Debit Right-of-use asset
- Credit Provision for asset removal (under IAS 37)

Subsequent measurement: After commencement date, lessee needs to take care about both elements recognized initially:

1. Right-of-use asset: Normally, a lessee needs to measure the right-of-use asset using a cost model under IAS 16 Property, Plant and Equipment. It basically means to depreciate the asset over the lease term:
   - Debit Profit or loss – Depreciation charge
   - Credit Accumulated depreciation of right-of-use asset

However, the lessee can apply also IAS 40 Investment Property (if the right-of –use asset is an investment property and fair value model is applied), or using revaluation model under IAS 16 (if right-of-use asset relates to the class of PPE accounted for by revaluation model).

2. Lease liability: A lessee needs to recognize an interest on the lease liability:
   - Debit Profit or loss – Interest expense
   - Credit Lease liability

Also, the lease payments are recognized as a reduction of the lease liability:

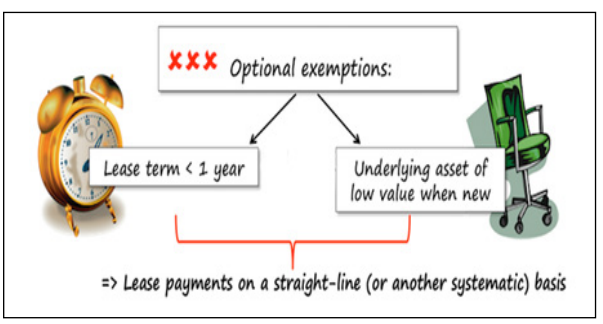
- Debit Lease liability
- Credit Bank account (cash)

If there is a change in the lease term, lease payments, discount rate or anything else, then the lease liability must be re-measured to reflect all the changes.

Is this too complicated? Exemptions exist!

IFRS 16 permits two exemptions (IFRS 16, par. 5 and following):

1. Leases with the **lease term of 12 months or less with no purchase option** (applied to the whole class of assets)
2. Leases where **underlying asset has a low value when new** (applied on one-by-one basis)



So, if we enter into the contract for the lease of PC, or we rent a car for 4 months, then we don't need to bother with accounting for the right-of-use asset and the lease liability. We can simply account for all payments made directly in profit or loss on a straight-line (or other systematic) basis.

Accounting for leases by lessors:

Nothing much changed in accounting for leases by lessors, so I guess you already are familiar with what follows.

Classification of leases: Unlike lessees, **lessors need to classify the lease first**, before they start accounting. There are 2 types of leases defined in IFRS 16:

1. A **finance lease** is a lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.
2. An **operating lease** is a lease other than a finance lease.

IFRS 16 (IFRS 16, par. 63) outlines examples of **situations that would normally lead to a lease being classified as a finance lease** (and they are almost carbon copy from older IAS 17):

1. The lease **transfers ownership** of the asset to the lessee by the end of the lease term.
2. The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date of the option exercisability. It is reasonably certain, at the inception of the lease, that the option will be exercised.
3. The **lease term is for the major part** of the economic life of the asset even if the title is not transferred.
4. At the inception of the lease the present value of the lease payments amounts to at least substantially **all of the fair value of the leased asset.**
5. The leased assets are of such a **specialized nature** that only the lessee can use them without major modifications.

Accounting for finance lease by lessors:

Initial Recognition: At the commencement of the lease term, lessor should recognize **lease receivable** in his statement of financial position. The amount of the receivable should be equal to the **net investment in the lease**. Net investment in the lease equals to the payments not paid at the commencement date discounted to present value (exactly the same as described in lessee's accounting) plus the initial direct costs.

The journal entry is as follows:

- Debit Lease receivable
- Credit PPE (underlying asset)

Subsequent Measurement: The lessor should recognize:

1. A finance income on the lease receivable:
   - Debit Lease receivable
   - Credit Profit or loss – Finance income
2. A reduction of the lease receivable by the cash received:
   - Debit Bank account (Cash)
   - Credit Lease receivable

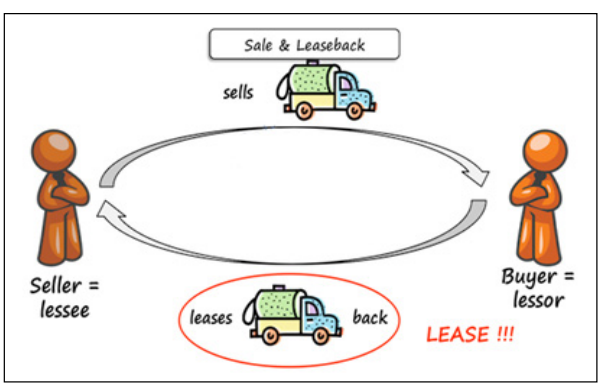
Finance income shall be recognized based on a pattern reflecting **constant periodic rate of return** on the lessor's net investment in the lease. IFRS 16 then also specifies accounting for manufacturer or dealer lessors.

Accounting for operating lease by lessors:

Lessor keeps recognizing the leased asset in his statement of financial position. Lease income from operating leases shall be recognized as **an income on a straight-line basis over the lease term**, unless another systematic basis is more appropriate. Here we can see that the accounting for operating leases is asymmetrical: both lessees and lessors recognize an asset in their financial statements (it's a bit controversial and there were huge debates around).

Sale and Leaseback transactions: A sale and leaseback transaction involves the **sale of an asset and the leasing the same asset back**.

In this situation, a seller becomes a lessee and a buyer becomes a lessor. This is illustrated in the following scheme:



Accounting treatment of sale and leaseback transactions depends on the **whether the transfer of an asset is a sale** under IFRS 15 Revenue from contracts with customers.

1. **If a transfer is a sale:**
   - The seller (lessee) accounts for the right-of-use asset **at the proportion of the previous carrying amount** related to the right-of-use retained. Gain or loss is recognized only to the extend related to the rights transferred. (IFRS 16, par.100)
   - The buyer (lessor) accounts for a purchase of an asset under applicable standards and for the lease under IFRS 16.
2. **If a transfer is NOT a sale:**
   - The seller (lessee) keeps recognizing transferred asset and accounts for the cash received as for a financial liability under IFRS 9 Financial Instruments.
   - The buyer recognizes a financial asset under IFRS 9 amounting to the cash paid.

Example 1:

Imagine you want to rent some space in the warehouse for storing your goods. You'd like to enter into a three years rental contract. The owner of that warehouse offers two options to you:

- You will occupy a certain area of XY cubic meters, but the specific place will be determined by the owner of the warehouse, based on actual usage of the warehouse and free storage.
- You will occupy the unit n. 13 of XY cubic meters in the sector A of that warehouse. This place is assigned to you and no one can change it during the duration of the contract.

Both contracts look like lease contracts, and indeed, in both cases, you would book the rental payments an expense in profit or loss under older IAS 17. Under new IFRS 16, you need to assess whether these contracts contain lease as defined in IFRS 16. The first thing you would look at is whether an underlying asset can be identified.

The first contract does not contain any lease, because no asset can be identified. The reason is that the supplier (warehouse owner) can exchange one place for another and you lease only certain capacity. Therefore, you would account for rental payments as for expenses in profit or loss.

The second contract does contain a lease, because an underlying asset can be identified– you are leasing the unit n. 13 of XY cubic meters in the sector A. Therefore, you need to account for this contract as for the lease and it means recognizing some asset and a liability in your balance sheet.

Under new IFRS 16, you need to split the rental or lease payments into lease element and non-lease element, because you need to:

- Account for a lease element as for a lease under IFRS 16 (if it meets the criteria in IFRS 16); and
- Account for a service element as before, in most cases as an expense in profit or loss.

From our example above: let's say you took the option 2 and you pay CU 10,000 per year. This payment includes the payment for rental of the unit n. 13 and its cleaning once per week. Therefore, you need to split the payment of CU 10,000 into lease element and cleaning element based on their relative stand-alone selling prices (i.e. for similar contracts when got separately).

You find out that you would be able to rent out similar unit in the warehouse next door for CU 9,000 per year without cleaning service, and you would need to pay CU 1,500 per year for its cleaning.

- Allocate CU 8,571 (CU 9,000/(CU 9,000+CU 1,500)) to the lease element and account for that as for the lease; and
- Allocate CU 1,429 (CU 1,500/ (CU 9,000+CU 1,500)) to the service element and in this case, probably recognize it in profit or loss as an expense for cleaning.

This is not an easy thing, especially when the stand-alone selling prices are not readily available.

Let, Annual rental payments are CU 10,000, including the cleaning services, all payable in arrears (at the end of year). Appropriate discount rate is 5% and the lease term is 3 years. How would you account for this contract under IAS 17 and IFRS 16?

Accounting under IAS 17 Leases

Under IAS 17, you need to classify the lease first. Based on warehouse's economic life, lease payments, etc. you assess that this lease is operating. Therefore, accounting is very simple:

- At the commencement, you do nothing;
- At the end of each year, you simply book the rental expense of CU 10 000 in profit or loss.

Accounting under IFRS 16

Here, no classification is necessary as one accounting model applies to all leases. You need to follow 3 steps:

1. Is it a lease under IFRS 16? Yes, here it probably is. Please see the explanation above.
2. Is there some element other than lease element? Do we need to separate? Yes, we need to separate the cleaning element from the lease element. We did it above:
   - CU 8 571 relates to the lease element;
   - CU 1 429 relates to the cleaning element.
3. How do we recognize these elements?

At the commencement:

- You need to recognize **right to use a warehouse** in the amount equal to the lease liability plus some other items like initial direct costs.
- The lease liability is calculated at **present value of lease payments over the lease term**. In this case you need to calculate the present value of 3 payments of CU 8,571 (only lease element) at 5%, which is CU 23, 341.

Accounting entry is then:

Debit Right-of-use asset: EUR 23,341

Credit Lease Liability: EUR 23,341

Subsequently, when you make a payment and/or at the end of reporting period, you need to:

- Recognize depreciation of the right-of-use asset over the lease term, in this case CU 7,780 (CU 23,341/3) per year (I took straight-line depreciation);
- Recognize re-measurement of the lease liability to include interest, exclude amounts paid and take any lease modifications into account.

This simple table illustrates our example:

Year	Lease liability b/f	Add interest at 5%	Less amounts paid	Lease liability c/f
1	23, 341	1 ,167	- 8, 571	15 ,937
2	15, 937	797	- 8, 571	8, 163
3	8 ,163	408	- 8, 571	0
Total	n/a	2 ,372	- 25, 713	n/a

Summary of accounting entries under IFRS 16:

When	What	How much	Debit	Credit
At the commencement	Right-of-use asset + lease liability	23, 341	Right-of-use asset	Lease liability
At the end of the year 1	Interest	1 ,167	P/L: Interest expense	Lease liability
	Rental payment	10 ,000		Cash (bank account)
		8 ,571	Lease liability	
		1 ,429	P/L: Expenses for cleaning services	
	Depreciation	7 ,780	P/L: Depreciation	Right-of-use asset

Now, let's compare.

- Under IAS 17, the impact on profit or loss in the

year 1 was CU 10,000, as we recognized the full rental payment in profit or loss.

- Under IFRS 16, the impact on profit or loss in the year 1 was:
  - Interest of CU 1 167, plus
  - Depreciation of CU 7,780 plus
  - Expense for cleaning services of CU 1,429.
  - TOTAL of CU 10,376.

That's actually more expenses in the first year under IFRS 16 than under IAS 17, isn't it? The reason is that thanks to the new model, the pattern of expenses has changed: we have loads of interest in the beginning of the lease, but smaller expenses at the end of the lease when the lease liability is amortized.

In total, both models have the same profit or loss impact over total lease term:

Type of expense	IAS 17	IFRS 16	Note
Rental expense	30, 000	-	3*10 ,000
Interest expense	-	2 ,372	Table above
Depreciation	-	23 ,341	3*7, 780
Cleaning expenses	-	4 ,287	3*1 ,429
Total	30, 000	30 ,000	

Example 2:

Company A leases a car for a period of four years starting on 1 Jan 20x9. The investment value is CU35,845. The lease requires payments of CU668 on a monthly basis for the duration of the lease term (i.e., CU8,016 pa). The annual lease component of the lease payments is CU6,672 and the service component is CU1,344. The residual value of the car at the end of the lease term is CU14,168. There is no option to renew the lease or purchase the car, and there is no residual value guarantee. The rate implicit in the lease is 5% The net present value of the lease payments using a 5% discount rate is CU24,192. The overall impact on the net profit is the same under IFRS 16 and IAS 17, however, with the application of the right-of-use model the presentation of lease payments in the statement of comprehensive income will change. Lease payments of an operating lease under IAS 17 are presented within operating expenses, while under the right-of-use model, depreciation and interest expense will be recognized separately, having a positive impact on EBITDA. The overall cumulative effect on the net profit is the same under IFRS 16 and IAS 17, however, with the application of the right-of-use model the lease expense recognition pattern during the lease term and presentation of lease payments in the statement of comprehensive income will change. Also a right-of-use asset and lease liability is recognized in the financial statements of the lessee.

IFRS 16 – Impact on financial position and income						
	Jan 2009	Dec 2009	Dec 2010	Dec 2011	Dec 2012	Total
Right-of-use asset	24,292	18,144	12,096	6,048	0	
Lease Liability	-24,192	-18,580	-12,687	-6,498	0	
Operating expense–service	0	1,344	1,344	1,344	1,344	5,376
Depreciation	0	6,048	6,048	6,048	6,048	24,192
Interest expense	0	1,083	797	496	120	2,496
Net Income	0	-8,475	-8,189	-7,888	-7,512	-32,064

IAS 17 – Impact on financial position and income						
	Jan 2009	Dec 2009	Dec 2010	Dec 2011	Dec 2012	Total
Right-of-use asset	0	0	0	0	0	
Lease Liability	0	0	0	0	0	
Operating expense–Lease and service	0	8,016	8,016	8,016	8,016	32,064
Net Income	0	-8,016	-8,016	-8,016	-8,016	-32,064

Contents	IAS 17	IFRS 16
Finance Lease (Major Changes)	Certain criteria to be met to recognize a lease as finance lease; such as substantially transfer of risks and rewards	IFRS 16 introduces a single lessee accounting model and requires a lessee to recognize assets (right-of-use) and liabilities for All leases with a term of more than 12 months (unless the underlying asset is of low value)
Operating Lease (Major Changes)	Lease is recognize as operating lease if the recognition criteria for finance lease is not met.	**For Lessee:** There's not concept of operating lease, however lessee may choose to EXPENSE out item of low value and lease with a term of less than 12 months. **For Lessor:** Lease is recognize as operating lease if the recognition criteria for finance lease is not met.
Sale and Lease back (Major Changes)	Lessor and lessee account for sale and lease back transactions as finance lease or operating lease and account for them as prescribed	For lessor and lessee, Accounting for sale and lease back depends on whether Transfer is sale or not a sale

Getting Ready for IFRS-16 (10 Key Questions on the New Leases Standard):

- How many Leases do you have?
- Who holds your Lease information?
- What new Leases will you sign by 2019?
- How will IFRS 16 affect your KPIs?
- Will your covenant compliance be affected?
- Which transition method will you apply?
- Will you apply the optional exemptions?
- Are your operating Lease complete and accurate?
- What will you say about IFRS 16 in your 2018 Annual Report?
- Who owns your IFRS 16 implementation projects?

[Source: IFRS website & IFRS provided free unaccompanied pdf version of the IFRS16]