ADAA – IFRS Accounting briefing paper

IFRS 16 Leases by ADAA's Ahmed Al Mazrouei

February 2017

IASB Chairman, Sir David Tweedie, 15 August 2002.
"I can guarantee almost all of you here have never flown in a plane that has appeared in the airline's balance sheet and the reason is they tend not to buy them, they lease them and we all have leasing standards, and the great news is these leasing standards are perfectly harmonised world-wide. They are all absolutely useless none of them work." 1 January 2019 everything changes. IFRS 16 brings all leases on the balance sheet. IFRS Reporters told the IASB implementing IFRS 16 would be time consuming and challenging. It will be for some, which is why there is a three-year grace period before the standard is effective, however most IFRS Reporters will find implementing IFRS 16 relatively straightforward. To help your understanding of the standard substantial guidance is available from the audit firms, and the IASB has a dedicated Lease projects implementation page. You must forget almost everything you previously knew about lease accounting. No 90%, 75% lines in the sand. No risk and rewards debates. The new standard is about rights and control.

Implementing the new standard. How to determine whether a contract contains a lease or not under IFRS 16?
IFRS 16.9: "At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. 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.…"
These questions help:

- Is there an Identifiable asset?
- Does the lessee obtain economic benefits from using the asset?
- Does the lessee direct the use of the asset?

The table below may help.

Does the contract contain a lease or not?
(to qualify as a lease under IFRS 16 all the answers should be on the left side of the table)

Contract contain a lease	Yes	Is there an Identifiable asset?	No	Contract does not contain a lease
	Customer	Who has the right to obtain substantially all economic benefits from the use of the asset?	Supplier	
		Who has the right to direct the use of the asset?		

Is there an Identifiable asset?
For an arrangement to be a lease there has to be a right to use a specific asset, such as a car, or a specific portion of an asset, such as a floor in a building. However, if the supplier has a substantive right to substitute the asset throughout the period of use there is no identifiable asset and there is no lease. IFRS 16.B19: *"If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive."* Therefore, the default conclusion for a right to use asset arrangement is to treat it as a lease, providing other conditions are met.

Who has the right to obtain substantially all of the economic benefits from the use of the asset?
There are examples in the standard but the answer to the question should be obvious. In business, to business commercial transactions customers do not normally enter into lease arrangements if the activity in which the leased asset is expected to be used results in the customer making a loss. Why lease an aircraft if you are going to lose money from selling seats to passengers?
IFRS 16. B21: *"To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use…"*
The IASB did not change the concept of economic benefits.

IFRS 16 approaches the accounting from the liability side not the asset side. The IFRS Framework 4.46 requires that a liability to is recognised when it is probable an outflow of resources embodying economic benefits will result from a settlement of a present obligation and it can be measured reliably. 'Embodying' covers both directly and indirectly. If a customer leases a crane for two years to use in the construction of a building, the economic benefits of the crane are transferred to the asset constructed and realized by the customer from sale or rent of the building when finished. The economic benefits are not the payments by the customer to use the crane.

Who has the right to direct the use of the asset?
Certain conditions must be met before it is concluded the lessee has the right to direct the use of the asset throughout the period of use:
a) The customer has the right to direct how and for what purpose the asset is used (can change the type, when, where, the quantity of the output, or whether to produce or not).
b) The relevant decisions about how and for what purpose the asset is used is already predetermined:
  i. the customer has the right to operate the asset, or
  ii. the customer designed the asset which effectively predetermines its use.
If all conditions are met the contract is a lease.

Are any leases exempt from IFRS 16?
It is not practical or particularly useful to capture all type of leases.
IFRS 16.6 exempts: "…short-term leases or leases for which the underlying asset is of low value, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis."
Short term is less than 12 months, or a long-term agreement that has the option to terminate without a penalty (if option to terminate is available without penalty, at the anniversary of the agreement it is considered a short-term lease).
Determining what low value is based on original cost/value not current value. For example on first time adoption a motorcycle costing AED 40,000 with a value of AED 10,000 in year 4 (if adoption is in year 4) is assessed at AED 40,000 not AED 10,000.

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Measuring the lease liability (Lessee)

Although recognition of a leased asset commences from an assessment of the asset, measurement commences from an assessment of the liability. IFRS 16.26: *"At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate."*

Lease payments

Fixed payments are included less any incentives received. Such as contract expiring in 5 years, that allows an extension for 5 additional years at a 15% discount to the prevailing market rate. Then the discount is included in the lease payments.

If the lease includes variable payments that depend on an index or a rate, such as increasing annually with CPI then CPI is included in determining the lease payments.

Sales or volume related payments are not. This is the same as the accounting for contingent rent in IAS 17. There is difference though. IFRS 16.B42 specifically includes variable payments as fixed payments when they cannot be avoided for example where an asset has to stand ready to be available for use in working condition even if it is not used by the customer, sometimes referred to as capacity payments.

Determining payments as contingent is much harder with B42.

Interest rate

Interest rates can vary due to the value and nature of the underlying asset, the expected residual value, the term of the lease and market rates. All, need to be considered for every lease.

IFRS 16.26 *"The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate."*

Given the historical nature of the data. It is likely incremental borrowing rates may be defaulted to quite quickly. However…

Implicit rate

*"The rate of interest that causes the present value of the **lease payments** and the **unguaranteed residual value** to equal the sum of the **fair value** of the **underlying asset** and any **initial direct costs** of the lessor."* Implicit rate is asset related.

Incremental borrowing rate

*"The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment."* Incremental borrowing rate is entity related.

Residual value guarantee If the lessee is expecting the residual value of the underlying asset to be below the fair value at the end of the lease, it should be considered at inception (or whenever an indication subsequent to inception arises that requires a revision of the lease liability).

Lease term (period)

The lease term is the period the lessee is reasonably certain to have use of the leased asset for which includes the non-cancelable period of the lease, the extension option period (if expected to be exercised), and the period up to the option to terminate (if expected to be exercised).

Measuring the right-of-use asset (Lessee)

The right-of-use asset is the lease liability and any payments made by the lessee at or before commencement of the lease including initial direct costs and costs of dismantling or removing the asset incurred by the lessee, less any lease incentives.

The asset is depreciated, and it is not as straight forward as straight lining until the end of the lease term. There may be options to purchase and a residual value to consider. History suggests this is where management judgement and the auditors' professional skepticism may be tested.

IFRS 16.31: *"A lessee shall apply the depreciation requirements in IAS 16 Property, Plant and Equipment in depreciating the right-of-use asset."*

IFRS 16.32: *"If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term."*

This 'rule' is carried over from IAS 17 and makes a great deal of sense. Useful life is the period the asset is available for use by the lessee and the lessor. Economic life is the period the lessor expects to obtain economic benefits from the asset. Useful life may be shorter than economic life. It cannot be longer. The lease term was 'played with' by lessees in IAS 17 to achieve operating lease accounting that option no longer exists and the lease term is much easier to determine.

The useful life and residual value of the asset is tested annually for impairment. IFRS 16.33: *"A lessee shall apply IAS 36 Impairment of Assets to determine whether the right-of-use asset is impaired and to account for any impairment loss identified."*

The new reality is that former operating lease assets are accounted for the same as finance leased assets and purchased assets. Which is what the IASB wanted from the start.

It is possible based on different interpretations of the facts and circumstances to achieve asymmetric accounting for lessee and lessor unless of course you are in the same group, when obviously it is not.

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Transition.

On transition to IFRS 16 the standard provides a very useful practical expedient. Appendix C3 states: *"an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted:*
To apply the standard to contracts that were previously identified as leases applying IAS 17 and IFRIC 4.
Not to apply this standard to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4."

The IASB's intention is to get all leases on balance sheet, which this expedient does cheaply and pragmatically. It does not seem challenging and time consuming. If you do not like the outcome then you still have the IFRS 16 preferred option of a detailed full retrospective implementation by reassessing every arrangement applying the recognition and measurement criteria of the new standard.

Impact for 2016 and 2017

Reporters issuing financial statements shortly after publication of IFRS 16 universally reported that they did not know what the financial impact of the new standard would be. This seems strange since the accounting profession has been expecting a new standard with a right of use model for a considerable time see page 6 here.

IAS 8.30 requires disclosure of *"known or reasonably estimable information relevant to assessing the possible impact that the application of the new IFRS will have…or if that impact is not known or reasonably estimable a statement to that effect."*

As 2016 progressed the 'I don't know the impact of IFRS 16' position became more and more untenable. Particularly since some IFRS Reporters early adopted IFRS 15. Skeptics might conclude this is due to there being no upside to implementing IFRS 16 whereas there was with IFRS 15.

In 2017 the minimum disclosure ADAA expects to see from IFRS Reporters is the impact if the practical expedient is applied because for the majority it is easy to do.
Audit firms should reinforce this position and should qualifying their audit opinions if the "I don't know' position is presented.
Some IFRS Reporters may consider this position harsh and may consider they have lots of these arrangements, they are very complex and it will take time to analyse them all.
We agree, but we also agree you did your due diligence properly and made your financial assessment before entering the arrangement.

The accounting pragmatist will apply Appendix C8 which requires measurement of the liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.
An equal amount is booked for the right of use asset, or the asset is measured at its carrying amount as if the standard were applied from the date of acquiring the asset, discounted using the same rate as for the liability.

The accounting purist will apply IFRS 16 by reassessing every arrangement.
Which is something you should consider if you have historically reported very large operating leases.
Because operating lease accounting front loads profit recognition whereas finance lease accounting defers profit recognition because of higher interest expense in the earlier years when repayment of the lease principal is lowest.
Therefore on implementing the new standard, if you have new assets on long operating leases you will get a profit hit, and if you have old assets on long operating assets you will get a profit lift.

Either approach will require full and appropriate disclosure

We expect most entities will follow the practical expedient option. Those that do not may have to look back at documents that could be a decade or more old and assess the facts and circumstances. That will be a challenge.

IFRS 16 is an improved lease accounting standard over IAS 17. We encourage entities to review their leasing arrangements and contracts carefully, and in conjunction with their business model, and assess whether those contracts are leases under IFRS 16 and adopt the changes as soon as possible.

A final thought

We have not discussed in this paper the difference between a service contract and a lease for the reason that these type of arrangements predate IFRS 16. Therefore the requirement to determine whether an arrangement was a service contract or an operating lease existed under IAS 17.
IFRS 16 has the practical expedient.
It would be strange if an IFRS Reporter revisited their operating lease arrangements and determined they were not operating leases after all and that they were in fact service contracts.
In such circumstance, a regulator might wish to take a very close look at the evidence and ask some very difficult questions of management and their auditor.

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Accounting briefing papers are designed to assist readers in determining their accounting treatments. However a briefing paper cannot provide a definitive answer since the treatment will depend on the facts and circumstances of each situation.

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