IFRS 16
Leases

1. Objective

IFRS 16 sets out the principles for the recognition, measurement and presentation of leases and the related information to be disclosed.

This Standard applies to all leases except:

- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- leases of biological assets within the scope of IAS 41;
- service concession arrangements within the scope of IFRIC 12;
- licences of intellectual property granted by a lessor within the scope of IFRS 15;
- rights held by a lessee under licensing agreements within the scope of IAS 38.

2. Scope

IFRS 16 defines the following terms:

An agreement is considered to be a lease, or to contain a lease, when it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Each lease component must be accounted for as a separate lease (unless a practical expedient is used instead to account for each lease component and any associated non-lease components as a single lease component, with the exception of embedded derivatives meeting the criteria of IFRS 9).

A **finance lease** is a contract which transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Certain criteria can be used to help determine if a contract constitutes a finance lease:

- the lease term is for the major part of the economic life of the underlying asset;
- at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset;

- the lessee can cancel the lease (the lessor's losses associated with the cancellation being borne by the lessee);
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

An **operating lease** is a contract that does not fulfil the criteria for recognition as a finance lease.

The **inception date of the lease** corresponds to the date of commitment by the parties to the principal terms and conditions of the lease, whether the contract has been signed or not.

The **commencement date** is the date on which a lessor makes an underlying asset available for use by a lessee and constitutes the initial recognition date of the lease.

The **lease term** is the non-cancellable period including any periods covered by an option to extend the lease and periods covered by an option to terminate the lease.

The **minimum lease payments** correspond to payments to be received by the lessor during the lease term. Such payments do not include variable lease payments (variable portion of the rent depending on other criteria than progress of the lease term), service costs, taxes on the property or the value of any guarantees made by the lessee or the lessor (residual value). The measurement of minimum payments is mainly determined using an implicit interest rate. This interest rate makes it possible on the commencement date of the lease to determine the fair value of the assets leased based on the aggregate discounted amount of rent and the residual value.

3. Accounting impact

Leases must be classified by type of lease from the date of inception of each lease. In the event of **substantial changes**, the modified lease must be considered a **new lease.**

3.1 Recognition by the lessee

At the commencement date of the contract, the lessee must recognise a right-of-use asset and a lease liability at the present value of the lease payments that are not paid at that date using the interest rate implicit in the lease if that rate can readily be determined, and if not, using the lessee's incremental borrowing rate.

3.1.1 Initial recognition

The cost of the right-of-use asset recognised must include:

- the amount of the initial measurement of the lease liability;
- lease payments made at or before the commencement date, less any lease incentives received, if any;
- any initial direct costs incurred by the lessee, if applicable;
- an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

3.1.2 Subsequent measurement

After the commencement date, the lessee must measure the right-of-use asset applying a cost model, but also has the option of applying fair value model under IAS 40 or the revaluation model under IAS 16.

The lessee must measure the lease liability by:

- increasing the carrying amount to reflect interest on the lease liability;
- reducing the carrying amount to reflect the lease payments made;
- remeasuring the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments.

3.2 Recognition by the lessor

The lessor must classify each of its leases either as an operating lease or a finance lease.

3.2.1 Initial recognition

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset to the lessee.

- **Finance lease.** Assets held under a finance lease must be recognised as a receivable in an amount equal to the net investment in the lease. Finance income over the lease term is recognised based on a pattern reflecting a constant periodic rate of return on the lessor's net investment. Initial direct costs, other than those incurred by manufacturer or dealer lessors, are immediately included in the initial measurement of the net investment in the lease. In the case of manufacturers and dealers, these costs are spread throughout the lease term.

- **Operating lease.** The assets are recognised as items of property, plant and equipment subject to an operating lease. The lessor must recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor must apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

3.2.2 Subsequent recognition

The lessor must recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. The lessor must apply the derecognition and impairment requirements in IFRS 9 to the net investment in the lease. In addition, the lessor must review regularly estimated unguaranteed residual values used in computing the gross investment in the lease.

The lessor must account for a modification to a finance lease as a separate lease if both:

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

The lessor must account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

Example 1: In the beginning of Year N, a lease is entered into under the following terms and conditions:

- payment: three annual instalments of 12,000 each at the end of the period,
- option to purchase: for a payment of 4,000 at the end of the lease,
- useful life of the asset: 4 years.

According to IFRS 16, the present value of minimum future payments must be recognised. For this purpose, an implicit interest rate of 9% will be used.

The present value of lease payments amounts to:
[12,000 × 1/1.09] + [12,000 × 1/(1.09)2] + [12,000 × 1/(1.09)3] = 30,375
The value of the asset leased is recognised as an asset and the corresponding debt as a liability.

Total minimum payments amount to 36,000 (12,000 × 3), the difference of 5,625 (36,000 – 30,375) represents the interest expense which must be spread throughout the lease term.

A summary of the lease information on an annual basis is given below:

BREAKDOWN OF INSTALMENTS

Year	Capital outstanding	Annual lease payment	Interest expense	Capital reimbursed
N	30,375	12,000	2,734	9,266
N+1	21,109	12,000	1,900	10,100
N+2	11,009	12,000	991	11,009
Total	0	36,000	5,625	30,375

DEPRECIATION OF FAIR VALUE OF ASSET LEASED

Year	Initial fair value	Depreciation	Net value end of period
N	30,375	7,594	22,781
N+1	22,781	7,594	15,187
N+2	15,187	7,594	7,593
N+3	7,593	7,593	0
Total		30,375	

Recognition on the commencement date of the lease **using IAS/IFRS**

Property, Plant and Equipment (B)	30,375	
Liabilities (B)		30,375

Annual recognition of lease payments **using traditional accounting methods**

Operating expenses (R)	12,000	
Cash (B)		12,000

Accounting for the period N **using IAS/IFRS**

Depreciation and impairment (R)	7,594	
Depreciation Property, Plant and Equipment (B)		7,594
Interest expenses (R)	2,734	
Liabilities (B)	9,266	
Operating costs (R)		12,000

➢ *For the purpose of simplification, we have ignored the impact of deferred taxes in the above example.*

3.3 Sale and leaseback transactions

For sale and leaseback contracts, different treatment is used:

- if it is a finance lease, any gain on sale over the lease term will continue to be amortised;
- if it is an operating lease, the leaseback right-of-use asset must be adjusted for any deferred gains or losses immediately in the statement of financial position.

4. Disclosure

4.1 Lessee disclosures

The Lessee must provide a single Note in a separate section of its financial statements with information on leases for which it is a lessee, as well as all qualitative and quantitative information to assess the effect leases have on its financial position, including:

- depreciation charge for right-of-use assets by class of underlying asset;
- interest expense on lease liabilities;
- the expense relating to short-term leases of low-value assets or with low-value underlying assets;

- the expense relating to variable lease payments not included in the measurement of lease liabilities;
- income from subleasing right-of-use assets;
- total cash outflow for leases;
- gains or losses arising from sale and leaseback transactions;
- the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

4.2 Lessor disclosures

- The Lessor must disclose the following for **finance leases:**
  - ✓ selling profit or loss;
  - ✓ finance income on the net investment in the lease;
  - ✓ income relating to variable lease payments not included in the measurement of the net investment in the lease, qualitative and quantitative information on significant changes in the carrying amount of the net investment in finance leases;
  - ✓ a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years, taking into account the reconciliation of undiscounted lease payments with the net investment in the lease.

For operating leases, underlying assets must be presented in the Statement of financial position according to their nature. Lease income must be presented separately for income relating to variable lease payments that do not depend on an index or a rate. The lessor must apply the disclosure requirements in IAS 16 and disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases separately from owned assets held and used by the lessor.

The lessor must also comply with IAS 36, IAS 38, IAS 40 and IAS 41. Finally, the lessor must disclose a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.