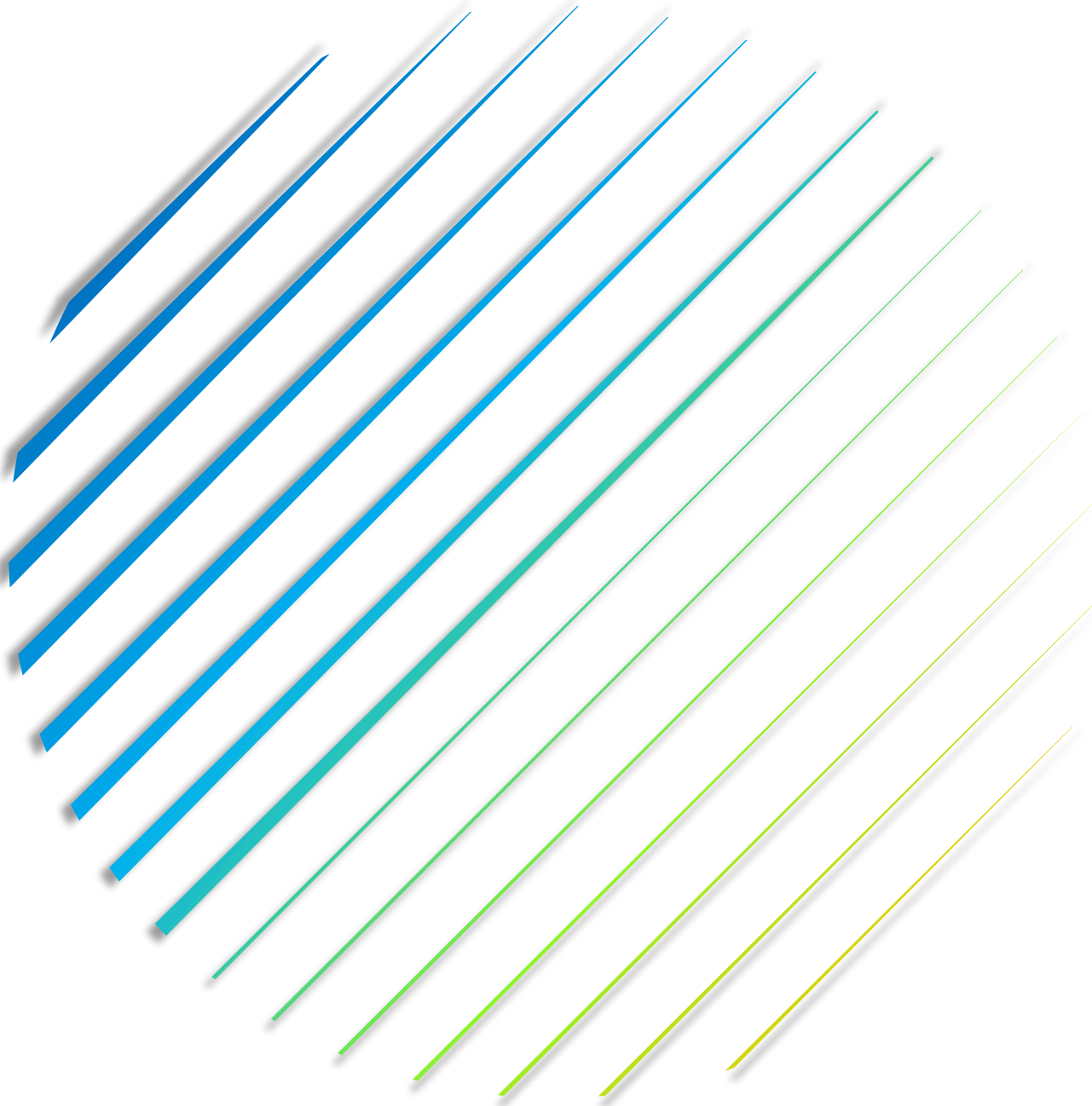


# LEASES

## POCKET GUIDE TO IFRS 16



APRIL 2022



## INTRODUCTION

IFRS 16 has replaced IAS 17 and the major reason is to improve comparability and transparency on balance sheet. IAS 17 allowed the classification based on risk and rewards under lease however, under IFRS 16, classification is based on who has the Right to use the asset. This new standard has marked the end of off-balance sheet treatment for leases which makes it easier for users of financial statements to make comparison.

This new accounting standard has a far-reaching impact on lessee's business process, systems and controls as more data is required to be gathered and processed than before. Companies will need to take a cross-functional approach to implementation, not just accounting.

The effective date of IFRS 16 is 1 January 2019. Its scope includes all leases including sub-leases except IAS 41 (biological asset lease), IFRIC 12 (Service Concessional arrangements), Intellectual property under IFRS 15, IAS 38 and lease for exploration of mineral oils etc.

## IDENTIFICATION OF A LEASE

Under IFRS 16, a contract is, or contains, a lease if the contract conveys the right to control the use of identified asset for a period in exchange for consideration.

Having the right to control the use of an identified asset means having the right to direct, and obtain all of the economic benefits from, the use of that asset. These rights must be in place for a period of time, which may also be determined by a specified amount of use.

For further reference of "Right to control" and "identified Asset", refer the below link

<https://ifrscommunity.com/knowledge-base/ifrs-16-identifying-a-lease/>



## RECOGNITION EXEMPTIONS

A lessee may elect to account for lease payments as an expense on a straight-line basis over the lease term or another systematic basis for the following two types of leases:

- Short term lease period of 12 months or less with no purchase options; and
- Lease with a low value underlying asset.

## LEASE TERM

IFRS 16 has defined lease term as non-cancellable period of lease; together with

- Periods covered by extension option if the lessee is reasonably certain to exercise that option; and
- Periods covered by termination option if the lessee is reasonably certain not to exercise that option.

Determining the lease term will require judgment which was often not needed

before for an operating lease as this did not change the expense recognition.

## LESSEE ACCOUNTING

Initially, the lessee shall recognize the right of use asset and lease liability at the commencement date.

Right of use asset shall be recognized at cost containing following elements:

- Amount of the lease liability;
- Lease payments made at or before the commencement date, less any lease incentives;
- Initial direct costs incurred; and
- Estimate of costs to be incurred to dismantle and remove an asset and restore the site based on the terms and conditions of the lease.

Under the cost model a right-of-use asset is measured at cost less accumulated depreciation and accumulated impairment.

Lease liability shall be recognized for the unpaid portion of lease liability. The lease liability is initially measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease if that can be readily determined. If that rate cannot be readily determined, the lessee shall use their incremental borrowing rate.

Lease liability also comprises of the following:

- Fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- Variable lease payments dependent on an index or rate;
- Residual value guarantees;
- Exercise price of a reasonably certain purchase options; and

- Lease termination penalties, if a lessee termination option was considered in setting the lease term.

Which shall be discounted at

- Interest rate implicit in the lease, if readily determinable; or
- Otherwise, incremental rate of borrowing.

The entity may apply cost model, revaluation model or fair value model for subsequent measurement of right of use asset. (Refer IFRS 16: 30 – 35).

Lease liability shall be accounted for interest cost, lease payment and remeasurement subsequently. (Refer IFRS 16: 40 – 46B)

## LESSOR ACCOUNTING

A lessor classifies a lease as either a finance lease or an operating lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. Otherwise, a lease is classified as an operating lease.

Examples of situations that would lead a lease to be classified as a finance lease are laid out in IFRS 16: 63.

If the lease is operating lease, the lessor shall continue to recognize the underlying asset, any direct cost is added to the cost of the asset and recognize lease income on straight line basis or, if more representative of the pattern in which benefit from use of the underlying asset is diminished, another systematic basis.

If the lease is finance lease, the lessor shall derecognize the underlying asset and recognize finance lease receivable with any gain / loss in profit or loss.

Initially, Finance lease payments are the sum of present value of future lease payments

and present value of any unguaranteed residual value accruing to the lessor, both discounted at interest rate implicit in the lease.

Finance income on lease receivable shall be recognized using effective interest method.

If the lessor is manufacturer or dealer, following accounting treatment as per IFRS 16 is followed:

The lease shall give rise to 2 types of income:

- Selling profit or loss, resulting from outright sale of the asset; and
- finance income over the lease term.

Sales revenue shall be recognized at lower of:

- Fair value of the underlying asset; and
- PV of lease payments discounted at market rate of interest.

Cost of sale is recognized at carrying amount of the asset less PV of unguaranteed residual value (if any).

Any costs incurred in connection with obtaining the lease is charged to P/L at the commencement date.

If artificially low rate of interest is charged by manufacturer / dealer lessor, selling profit is restricted to that which would apply if a market rate of interest were charged. This is done by discounting future lease payments using market rate of interest.

## SALE AND LEASEBACK TRANSACTIONS

As IFRS 16 has withdrawn the concepts of operating leases and finance leases from lessee accounting, the accounting requirements that the seller-lessee must apply to a sale and leaseback are more straight forward. In addition, IFRS 16

provides an overview of the accounting requirements for buyer-lessors too.

When a seller-lessee has undertaken a sale and lease back transaction with a buyer- lessor, both the seller-lessee and the buyer- lessor must first determine whether the transfer qualifies as a sale. This determination is based on the requirements for satisfying a performance obligation under IFRS 15 'Revenue from Contracts with Customers'.

If the transfer to buyer-lessor is a sale, then seller – lessee shall derecognize the underlying asset and apply lessee acting model. Similarly, buyer – lessor shall recognize the underlying asset and apply lessor acting model.

The accounting treatment is as follows:

1) Sale proceeds are less than fair value

- Recognize lease liability at PV of lease payments.
- Recognize right-of-use asset as proportion of carrying amount of asset retained by seller-lessee.
- Recognize gain/loss that relates to rights transferred to buyer-lessor.
- Recognize sale at fair value.
- Difference between sale proceed and fair value will be accounted for as prepayment of lease payments.

2) Sale proceeds are more than fair value

- Recognize lease liability at PV of lease payments.
- Recognize right-of-use asset as proportion of carrying amount of underlying asset retained by seller- lessee.

- Recognize gain/loss that relates to rights transferred to buyer-lessor.
- Recognize sale at fair value.
- Difference between sale proceed and fair value will be accounted for as additional financing provided by buyer-lessor to seller-lessee.

However, if the transfer does not qualify as a sale, the parties account for it as a financing transaction. This means that the seller lessee shall continue to recognize the asset and recognize financial liability as per IFRS 9 for any amount received from buyer lessee. Similarly, buyer-lessor shall not recognize the asset and recognize the amounts paid to seller-lessee as a financial asset under IFRS 9.

## COVID-19

Considering the COVID-19 pandemic, “Covid-19-Related Rent Concessions” was issued which amended IFRS 16 Leases. The amendment permitted lessees, as a practical expedient, not to assess whether particular rent concessions occurring as a direct consequence of the Covid-19 pandemic are lease modifications and instead to account for those rent concessions as if they are not lease modifications. In March 2021 the Board issued Covid-19-Related Rent Concessions beyond 30 June 2021, which extended the availability of the practical expedient by one year.

## INTEREST RATE BENCHMARK REFORM (IBOR)

If the future lease payments are changed as a result of change in Interest rate benchmark reform, i.e., market wide reform of IBOR, then lease modification will be required if following conditions are fulfilled:

- The modification is necessary as a direct consequence of IBOR; and
- The new basis for determining the lease payments is economically equivalent to the previous basis.

A lessee accounts for modifications required by the IBOR reform by updating the effective interest rate.

## PRESENTATION AND DISCLOSURES

For presentation and disclosures requirements please refer:

- IFRS 16: 47 to 60A for Lessee, and
- IFRS 16: 89 to 97 for lessors.



# Contacts

Want to know more?



**Rahat Kalim**  
Chief Technical Officer  
[Rahat.Kalim@projectaccountants.co.uk](mailto:Rahat.Kalim@projectaccountants.co.uk)



**Kiran Jethmalani**  
Associate Manager  
[Kiran.Jethmalani@projectaccountants.co.uk](mailto:Kiran.Jethmalani@projectaccountants.co.uk)

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Project Accountants Ltd. accepts no liability for any loss prompted to any person acting or refraining from action as a result of any material in this publication.

