Finit Solutions

IFRS-16

LEASES

OBJECTIVE

To specify the principles for recognition, measurement, presentation & disclosure of LEASES

WHAT IS LEASE?

A contract that conveys the right to use of an asset for a period of time (lease term) in exchange for consideration (lease payment).

SCOPE

IFRS 16 applies to all leases except for:

- Leases to explore for / use of minerals, oil, natural gas and similar
- Leases of biological assets (IAS 41)
- Intellectual property licenses (IFRS 15)
- Services concession arrangements (IFRIC 12)
- Rights under licensing agreements (IAS 38)

Lessor: Entity that provides the right to use an underlying asset for a period of time in exchange for consideration.

Lessee: Entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.

KEY TERMS

WHAT IS AN "IDENTIFIED ASSETS"?

- The first criterion to be assessed in identifying the lease is whether there is an identified asset.
- Typically, an asset will be explicitly identified in a contract. Alternatively, identified asset may be implicitly identified at the point at which it is made available for use by the customer.

Capacity Portion

Capacity portion of asset may be an identified asset if:

- It is physically distinct; or
- It represents substantially all of the capacity of asset.

Substitution Rights

If the supplier has a substantive right to substitute the asset throughout the period of use, the 'specified asset' criterion would not be met and the contract would not contain a lease.

Substantive Substitution Rights

A supplier's right to substitute an asset would be substantive if both the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use; and
- The supplier would benefit economically from the exercise of its right to substitute the asset.

IF it is not readily determinable whether a supplier has substantive substitution rights, a lessee must presume that any substitution right is not substantive.

Finit Solutions

IFRS-16

LEASES

KEY TERMS

WHAT IS A "RIGHT TO USE"?

Through out the period of use, the lessee must have the following rights to the identified asset:

Right to obtain substantially all economic benefits from the use of the assets throughout the period of use

AND

Right to direct the use of the asset i.e. how and for what purpose the asset is used throughout the period of use. Protective rights do not limit the right to direct the use

WHAT IS AN "LEASE PAYMENT"?

Payments made by a lessee to a lessor for the right to use of an underlying assets during the lease term.

It includes:

- Fixed payments (including in-substance fixed payments), less any lease incentives;
- Variable lease payments dependent on an index/rate;
- Exercise price of a purchase option if the lessee is reasonably certain to exercise that option; &
- Lease termination penalties, if a lessee termination option was considered in setting the lease term.

Lease payments also include:

- **FOR LESSEE,** amounts expected to be payable by the lessee under residual value guarantees.
- **FOR LESSOR,** any residual value guarantees provided to the lessor
  - by the lessee,
  - by a party related to the lessee, or
  - by a 3rd party unrelated to lessor that is financially capable of discharging the obligations under the guarantee.

WHAT IS AN "LEASE TERM"?

Non-cancellable period of the lease for which a lessee has the right to use an underlying asset, together with both:

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

Assess whether extension/termination option will be exercised by considering:

- Favorable terms and conditions of option compared to market;
- Significant leasehold improvements;
- Termination or relocation costs;
- Specialized asset or lack of available alternative assets.

VARIABLE LEASE PAYMENT

Do they depend on the index or rate?

Yes

- Include in the Lease Payment
- Change in index/rate will accounted for as remeasurement of lease

No

- Exclude from the Lease Payment
- Record in P/L in the period in which they arise

Finit Solutions

IFRS-16

LEASES

LEASE ACCOUNTING : LESSEE

INITIAL RECOGNITION AND MEASUREMENT

At the commencement date of lease, a lessee shall recognize right-of-use asset & lease liability

OPTIONAL EXEMPTIONS

A lessee can elect not to apply IFRS 16's recognition and requirements to:
- Short Term Lease; or
- Lease of Low Value Assets

Debit: RIGHT TO USE ASSET

Recognizes a right-of-use asset at cost, comprising:
- Amount of lease liability;
- Lease payments made at or before the commencement date, less any lease incentives;
- Initial direct costs (incurred by Lessee);
- Provision for dismantling costs.

Credit: LEASE LIABILITY

Recognizes a lease liability for the unpaid portion of lease payments, discounted at
- Interest rate implicit in the lease, if readily determinable; or
- Otherwise, incremental borrowing rate

SUBSEQUENT MEASUREMENT (LESSEE)

RIGHT TO USE ASSET

Subsequent to initial recognition, an entity may apply three potential models to account for right-of-use assets:

Cost Model (IAS 16)

- Under "cost model", lessee measures ROU asset at cost less accumulated depreciation and accumulated impairment losses.
- Depreciation period is the useful life of the asset if the lease transfers ownership of the underlying asset; otherwise earlier of the asset's useful life and lease term

Revaluation Model (IAS 16)

If a lessee applies "Revaluation model" to a class of asset, it may elect to apply that model to the same class of right-of-use assets.

Fair Value Model (IAS 40)

If a lessee applies "Fair value model" to its investment property, the lessee is required to apply that model to ROU assets that meet the definition of investment property in IAS 40.

LEASE LIABILITY

- After the commencement date, a lessee accounts for the lease liability by:
  - Increasing the carrying amount to reflect interest on lease liability;
  - Reducing the carrying amount to reflect lease payments made;
  - Re-measuring the carrying amount to reflect any reassessment and lease modifications.
- **Variable lease payments (that are not dependent on rate/index)** are not included in the initial measurement of the lease liability. Such payments are recognized in P/L in the period in which the event or condition that triggers such payments occur.

Finit Solutions

IFRS-16 **LEASES**

LEASE ACCOUNTING : LESSEE

CONNECTED CONCEPTS

Initial Direct Cost

Increment costs of obtaining a lease that would NOT have been incurred without the lease

- ✔ Legal fees (contract drafting)
- ✔ Commissions
- ✘ Internal costs
- ✘ Certain legal advice for selecting lease

Depreciation of ROU Asset

If it is certain that asset will be transferred to lessee	If it is NOT certain that asset will be transferred to lessee
Over useful life of the asset	Over lower of, ▪ Useful life of the asset; or ▪ Lease term.

OPTIONAL EXEMPTIONS

- A lessee can elect not to apply IFRS 16's recognition and requirements to:
  - Short Term Lease; or
  - Lease of Low Value Assets

Accounting for Exempt Lease

- The lessee shall recognise the lease payments as an expense on straight-line basis over the lease term (or another systematic basis).
- No balance sheet assets and liabilities (other than prepaid and accrued lease payments)
- Disclose expense relating to each exemption in the notes to the financial statements

1. SHORT-TERM LEASES

- Can be applied to leases with a lease term ≤ 12 months.
- Cannot be applied to leases containing a purchase option
- Apply the exemption by class of underlying asset. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations.

2. LEASES OF LOW VALUE ASSETS

- Can be applied to leases for low value items – i.e. assets with a value of USD 5,000 or less.
- Low value assessment applies:
  - To the value of underlying asset when new;
  - On an absolute basis: and
  - Irrespective of materiality.
- Apply the exemption on a lease-by-lease basis.
- Exemption cannot be applied
  - if the underlying asset is highly dependent or interrelated with other assets;
  - if lessee cannot benefit from using the underlying asset on its own or with other readily available resources;
  - to the head lease in a sublease arrangement; or
  - if the nature of the underlying asset, when new, is not typically low value

Finit Solutions

IFRS-16

LEASES

REMEASUREMENT OF LEASE

- Re-measurement of lease (i.e. lease liability and ROU asset) arises from revisions in estimates and judgements made on initial recognition of the lease.
- Re-measurement that arises from modification to the original contractual terms agreed between lessor and lessee, is addressed in another section.

- When there is a change in original assessment of lease term; or
- When there is a change in original assessment of exercise of purchase / termination options

Re-measure lease liability using revised estimate of lease term and cash flows and discounting at revised interest rate i.e. current rate.

- When there is a change in estimate of guarantee residual value; or
- When there is a change in future lease payment due to change in index/rate.

Re-measure lease liability using revised estimate of lease term and cash flows and discounting at original interest rate.

Re-measurement of lease liability is adjusted against the carrying value of ROU asset. Therefore, there is no immediate gain or loss. However, if reduction in carrying value of lease liability is greater than carrying value of ROU asset, the asset is reduced to 'zero' and excess reduction in lease liability is recognized in P/L.

LEASE MODIFICATIONS (LESSEE)

- A change in scope or consideration of a lease that was not part of the original terms and conditions of the lease. For e.g. adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term.
- Accounting for lease modification depends on whether modified terms increase or decrease the scope of lease, and whether the consideration for increase in scope is commensurate with a 'standalone price' for the new scope of the lease.

Does modification increases the scope of the lease by adding the right to use of one or more underlying assets?

No → **LEASE MODIFICATION = CHANGE IN EXISTINGLEASE**

Yes

Does the increase in consideration commensurate with the stand-alone price for the increase in scope?

No → **LEASE MODIFICATION = CHANGE IN EXISTINGLEASE**

Yes

LEASE MODIFICATION = SEPARATE LEASE

LEASE MODIFICATION = CHANGE IN EXISTINGLEASE

Decrease in scope

- Decrease ROU asset and lease liability by their relative scope compared to the original lease taking the difference to P&L
- Re-measure lease liability using revised discount rate with off-set to ROU asset

Other modification:
• Increase in scope;
• Change in consideration

- Re-measure lease liability using revised discount rate
- Re-measure ROU asset by same amount
- No P&L impact

Finit Solutions

IFRS-16

LEASES

PRENSENTATION AND DISCLOSURE : LESSEE

PRESENTATION

STATEMENT OF FINANCIAL POSITION

- ROU assets:
  - Present separately from other assets; or
  - Include within the same line item as underlying asset, with separate disclosure in notes.
- ROU assets that meet the definition of investment property shall be grouped with investment property.
- Lease liabilities:
  - Present separately from other liabilities; or
  - Disclose the line item in which they are included.

STATEMENT OF PROFIT AND LOSS

- Interest expense with other finance costs.
- Depreciation of right-of-use assets.

STATEMENT OF CASH FLOWS

- Principal payments of lease liabilities as financing activities.
- Interest payments in accordance with IAS 7's requirements for interest paid.
- Short-term, low-value and variable lease payments (not within lease liability) as operating activities.

QUALITATIVE DISCLOSURE REQUIREMENTS

- A summary of the nature of entity's leasing activities;
- Potential cash outflows the entity is exposed to that are not included in the lease liability, including:
  - Variable lease payments;
  - Extension options and termination options;
  - Residual value guarantees; and
  - Leases not yet commenced but committed by lessee.
- Restrictions or covenants imposed by leases; and
- Information about sale and leaseback transactions.

QUANTITATIVE DISCLOSURE REQUIREMENTS

IFRS 16 requires quantitative disclosures to be presented in a tabular format, unless another format is more appropriate.

STATEMENT OF FINANCIAL POSITION

- Additions to ROU assets.
- Carrying value of ROU assets at the end of reporting period by class.
- Maturity analysis of lease liabilities separately from other liabilities based on IFRS 7 requirements.

STATEMENT OF PROFIT AND LOSS

- Depreciation for assets by class.
- Interest expense on lease liabilities.
- Short-term leases expensed.
- Low-value leases expensed.
- Variable lease payments expensed.
- Income from subleasing.
- Gains or losses arising from sale and leaseback transactions.

STATEMENT OF CASH FLOWS

- Total cash outflow for leases

Finit Solutions

IFRS-16

LEASES

SUB-LEASE

HEAD LESSOR ⟷ HEAD LEASE ⟷ ORIGINAL LESSEE / INTERMEDIATE LESSOR ⟷ SUB LEASE ⟷ SUB LESSEE

CONCEPT OF SUB LEASE

- Sub lease is a transaction in which the underlying asset is re-leased by a lessee ('intermediate lessor') to a 3rd party, and the lease ('head lease') between the head lessor and lessee remains in effect.
- Intermediate lessor shall account for the head lease and sublease as two separate contracts, applying both lessee and lessor accounting requirements.
- For intermediate lessor, obligations that arise from head lease are generally not extinguished by the terms and conditions of sublease.
  Intermediate lessor shall classify the sub-lease as finance lease or operating lease w.r.t to the
- ROU-asset arising from head lease i.e. right-of-use asset is treated as underlying asset in sub-lease, not PPE that it leases from the head lessor.
- At commencement of sub-lease, if intermediate lessor cannot readily determine the rate implicit in sub-lease, then it uses the discount rate of head lease to account for sub-lease, adjusted for any initial direct costs associated with sub-lease.

Accounting by the Original Lessee / Intermediate Lessor

If Head Lease is accounted for under IFRS 16

If Sub lease is Operating Lease

- Keep recognizing the ROU-asset and lease liability of head lease.
- Recognize lease income from sublease on straight-line basis (or systematic basis) over the lease term.

If Sub lease is Finance Lease

- Derecognize ROU-asset of head lease transferred to sub-lessee and recognize net investment in the sublease with any difference in P/L.
- Keep recognizing the lease liability of head lease.
- During sublease, recognize both finance income on sublease and interest expense on head lease.

IF Head Lease is accounted for as exception from IFRS 16

- If the head lease is accounted for as a short-term lease, intermediate lessor shall classify the sublease as operating lease.
- If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

Finit Solutions

IFRS-16 LEASES

SALE AND LEASEBACK TRANSACTIONS

A company (seller-lessee) transfers an underlying asset to another company (the buyer-lessor) and leases that asset back from the buyer-lessor

Seller Lessee

Sells an asset

Lease back the same asset

Buyer Lessor

Accounting Treatment depends on whether the transfer of underlying asset from seller-lessee to buyer-lessor is a sale under IFRS 15?

whether the transfer of underlying asset from seller-lessee to buyer-lessor is a sale under IFRS 15?

Transfer to buyer-lessor is a sale

Seller-Lessee

- Derecognise the underlying asset
- Apply the lessee accounting model to the leaseback

Buyer-Lessor

- Recognise the underlying asset
- Apply the lessor accounting model to the leaseback

Transfer to buyer-lessor is not a sale

Seller-Lessee

- Continue to recognise the underlying asset
- Recognise financial liability under IFRS 9 for any amount received from buyer-lessor

Buyer-Lessor

- Do not recognise the underlying asset
- Recognise a financial asset under IFRS 9 for any amount paid to the seller-lessee

Accounting Treatment for Seller-Lessee where transfer of underlying asset from seller-lessee to buyer-lessor is a sale under IFRS 15

Lease back is accounted for under IFRS 16

- Recognize lease liability at PV of lease payments.
- Recognize ROU Asset as proportion of carrying amount of asset retained by seller-lessee:
- ROU Asset = Carrying amount of Asset x $\frac{\text{Present value of Lease Payment}}{\text{Fair value of Asset}}$
- Recognize sale at fair value
- Recognize gain/loss that relates to rights transferred to buyer-lessor

  Gain / (loss) (Fair value Carrying amount of Asset) x $\frac{\text{Fair value - PV of Lease Payment}}{\text{Fair value of Asset}}$
- **IF Sale proceed > Fair value,** difference between sale proceed & fair value will be accounted for as additional financing provided by buyer-lessor to seller-lessee
- **IF Sale proceed < Fair value,** difference between sale proceed & fair value will be accounted for as prepayment of lease payments.

Lease back is a/c for as
- **Short-term lease; or**
- **Low value asset**

- Recognize any gain/(loss) as a difference between sale proceed & carrying value of underlying asset
- Recognize lease payments as expense on straight-line basis (or systematic basis) over the lease term

Finit Solutions

IFRS-16 **LEASES**

Lessor Accounting

CLASSIFICATION OF LEASE

A lessor classifies a lease as either a finance lease or an operating lease.

Are substantial risk and rewards of ownership of the underlying asset is transferred to lessee? (Legal title may or may not be transferred)

YES → **Finance Lease**

NO → **Operating Lease**

Lessor Accounting: Classification of lease

Lease is finance lease if:

- Ownership transferred to lessee by the end of lease term;
- Option to purchase the asset at price < Fair value of asset at the end of lease;
- Lease term ≥ Major part of economic life of asset (75% or more);
- PV of lease payments ≥ Fair value of asset at the start of lease (90% or more); or
- Lease asset is of specialized nature;

Other indicators

- If lessee can cancel the lease, lessor's losses are to be borne by lessee;
- Gain / loss from fluctuation of residual value accrues to the lessee;
- Lessee can continue the lease for secondary period at rent < market rent

ACCOUTING TREATMENT

OPERATING LEASE

- Continue to recognize the underlying asset.
- Any indirect direct costs incurred in connection with obtaining the lease is added to the carrying amount of underlying asset.
- Recognize lease income over the lease term on a straight line basis (or other systematic basis).

FINANCE LEASE

- Derecognize the underlying asset and recognize finance lease receivable with any gain or loss in P/L as follow:

Finance lease receivable	xxxx	
Underlying asset		xxxx
Cash - Initial direct cost (if any)		xxxx
Gain on disposal (balancing)		xxxx

- Initially, lessor recognize finance lease receivable as follow:

– PV of future **lease payments @ interest rate implicit in lease	xxxx
– PV of any unguaranteed residual value accruing to the lessor @ interest rate implicit in lease	xxxx
– **Finance lease receivable (Net investment in finance lease)**	**xxxx**

Finit Solutions

IFRS-16

LEASES

Finance Lease by Manufacturer/ Dealer Lessor

A finance lease of an asset by a manufacturer / dealer lessor gives rise to two types of income:

FINANCE LEASE INCOME OVER THE LEASE TERM

- 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.

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

SELLING PROFIT OR LOSS

- **Sales revenue** is 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).

PRENSENTATION AND DISCLOSURE : LESSOR

QUANTITATIVE DISCLOSURE REQUIREMENTS

IFRS 16 requires quantitative disclosures to be presented in tabular format, unless another format is more appropriate.

FINANCE LEASES

- Selling profit or loss;
- Finance income on the net investment;
- Income from variable lease payments;
- Qualitative and quantitative explanation of changes inthe net investment; and
- Maturity analysis of lease payments receivable.

OPERATING LEASES

- Lease income, separately disclosing variable lease payments.
- Disclosure requirements of IAS 16 for leased assets, separating leased assets from non-leased assets.
- Other applicable disclosure requirements based on the nature of the underlying asset (e.g. IAS 36, 38, 40, 41).
- Maturity analysis of lease payments.

QUALITATIVE DISCLOSURE REQUIREMENTS

- IFRS 16 requires a lessor to disclose additional qualitative information about its leasing activities in order to provide users with a basis for assessing the impact on the financial statements from lease contracts.
- This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including:
  - Buy-back agreements;
  - Residual value guarantees;
  - Variable lease payments for excess use; &
  - Any other risk management strategies