IFRS 16 - Leases

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IFRS 16 - Leases

Agenda

- Brief history
- Key handbook sections
- Exemptions and expedients
- Identifying a lease
- Measurement
- Right of Use asset
- Modifications
- Presentation and Disclosure
- Transition
- Other

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Brief history

- 2009 – IASB and US standard setter issued a joint discussion paper on leases – why?
- Information reported about operating leases lacked transparency and did not meet the needs of users of financial statements

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Brief history (continued)

- 2010 – issued joint exposure draft
  - 786 comment letters
- 2013 – issued second joint exposure draft
  - 641 comment letters
- Today IFRS 16 – from Lessee’s perspective, capitalize all leases except short term and immaterial leases

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Key handbook sections

- BC19 – A lease is defined as a <u>contract</u>, or part of a contract, <u>that conveys the right to use an asset for a period of time in exchange for consideration</u>
- .2 – An entity <u>shall consider</u> the terms and conditions of contracts and all relevant facts and circumstances when applying this standard
- .3,.5 and appendix C.10 – scope, exemptions and practical expedients

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Key handbook sections (continued)

- **.9 – At inception of a *contract*, an entity shall assess whether the *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**
- .53 and Appendix B.48 – disclosures
- Appendix B.9 – right to control
- .B31 - flowchart

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Exemptions and expedients

- Leases to explore for or use of minerals, oil & gas and similar non-regenerative assets
- Leases of biological assets
- Service concession arrangements
- Licenses of intellectual property granted by lessor
- Rights held by a lessee under certain licensing arrangements
- Practical expedient for short term or immaterial leases (which should be disclosed in FS)

Identifying a lease

1) Definition

- 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 it conveys the <u>right to control</u> the use of an <u>identified asset</u> for a <u>period of time in exchange for consideration</u>

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Identifying a lease (continued)

2) Identifiable asset

- Asset can be specified explicitly or implicitly (embedded lease)
- There is an identified asset (lessor cannot substitute for their own benefit)

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Identifying a lease (continued)

3) Control

- Right to obtain substantially all of the economic benefits from using the asset
- Right to direct how to use the asset
- Protective rights (does not prevent the right to use)
- Decisions determined during and before the period of use

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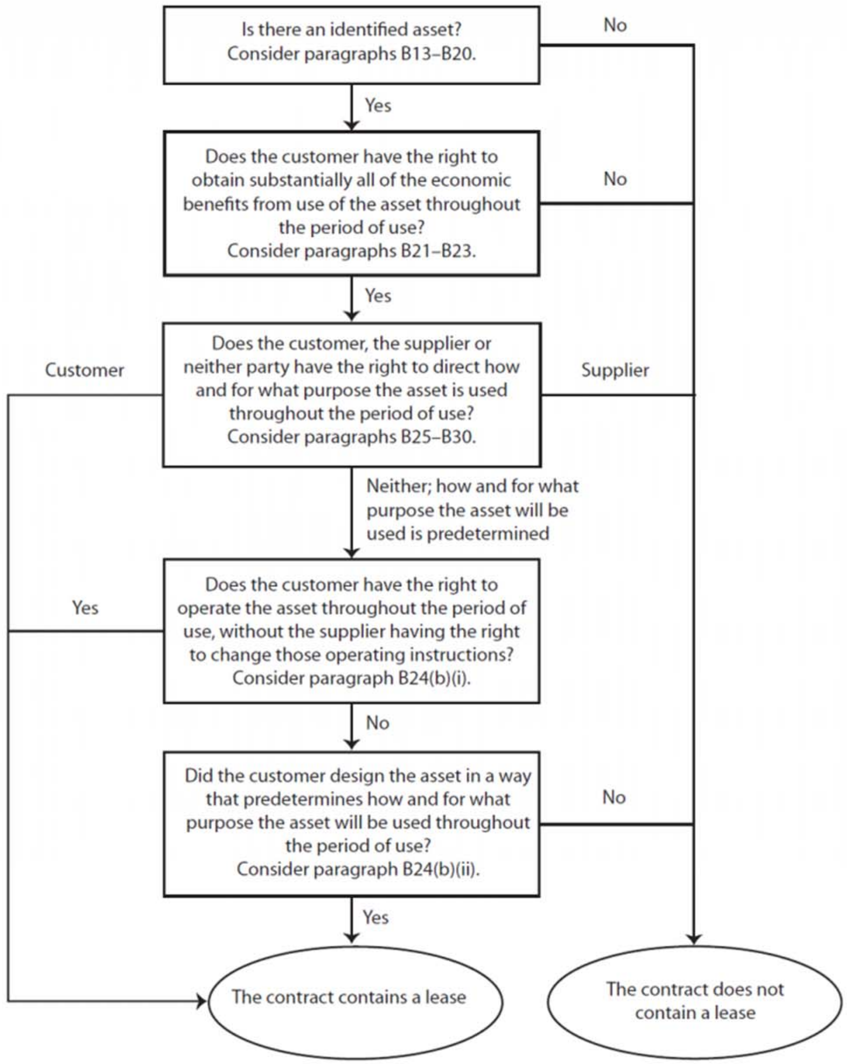
Decision tree



Initial measurement – lease liability

- Measurement
  1) Lease term
  2) Lease payments
  3) Determine discount rates
  4) Calculate present value of future lease payments

Lease liability – term

1) Non-cancellable period together with both:

- Option to extend if reasonably certain to exercise that option
- Option to terminate if reasonably certain not to exercise that option

Lease liability – payments

2) Payments comprise:

- Fixed payments and in-substance (unavoidable) payments
- Variable payments with linked index or rate
- Lease and non-lease components (practical expedient)
- Lease incentives (deduct)
- Purchase option (if exercise expected)
- Termination penalty (if exercise expected)
- Residual guarantees (amount expected to pay)

Lease liability – discount rate

3) Determine discount rate

- Use either:
  - Interest rate implicit in the lease, if readily determinable, otherwise,
  - Incremental borrowing rate for lessee
- Portfolio approach
  - Can use for leases with similar characteristics

Lease liability – PV of future payments

4) Calculate the present value (PV) of future lease payments

- PV based on term, payment amounts and discount rate

Lease: Office lease

Lease payments	$	100,000
Years		5
Incremental borrowing rate		10.00%

Year		1		2		3		4		5
Payment	$	100,000	$	100,000	$	100,000	$	100,000	$	100,000
Discount rate		10.00%		10.00%		10.00%		10.00%		10.00%
PV factor		0.9091		0.8264		0.7513		0.6830		0.6209
Present value	$	90,909	$	82,645	$	75,131	$	68,301	$	62,092
PV	$	379,078								

Lease example A

- The Company has entered into a contract to rent an office in downtown Vancouver for a period of 36 months with an option to renew for an additional 24 months. The monthly lease payments are $5,000 per month and include $500 per month of common area maintenance. The Company incurred $100,000 in leasehold improvements at the start of the lease.

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Lease example A – key terms

- The Company has entered into a **contract** to rent an office in downtown Vancouver for a period of of **36 months** with an option to **renew for an additional 24 months**. The monthly lease payments are **$5,000 per month** and include $**500 per month of common area maintenance**. The Company incurred **$100,000 in leasehold improvements** at the start of the lease.

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Lease example B

- The Company has entered into a contract to obtain exclusive right to use a specialized ore crusher for 24 months at their mine in the Northwest Territories. The lease payments are $10,000 per month with an additional $1 per tonne crushed. The lease is renewable for another 24 months at the end of the lease for a 5% increase in monthly lease payments.

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Lease example B – key terms

- The Company has entered into a **contract** to obtain exclusive **right to use** a **specialized** ore crusher for **24 months** at their mine in the **Northwest Territories**. The lease payments are **$10,000 per month** with an **additional $1 per tonne crushed.** The lease is **renewable** for another **24 months** at the end of the lease for a **5% increase in monthly lease payments**.

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Discount rate

- Measuring the liability
  - Initially measured at the present value of the lease payments payable over the lease term, discounted at the **rate implicit in the lease**
  - If not readily determined, use incremental borrowing rate.

Discount rate (continued)

- Challenges with using the “Rate Implicit in Lease”
  - Implicit rate is the discount rate at which: (i) the sum of the present value of the lease payments and residual value; equals (ii) the sum of the fair value of the underlying asset and any initial direct costs of the lessor
  - Lack of information makes it difficult to determine
    - Fair value of the underlying asset
    - Appraisals impractical
    - Lessors may not want to disclose

Discount rate (continued)

- Incremental borrowing rate
- Rate a lessee would have to pay to borrow (similar term / security) to obtain an asset of similar value … in a similar economic environment.
- NOT WACC
- Specific to
  - Lessee
  - Term and amount “borrowed”
  - The security underlying the asset
  - The economic environment

Discount rate (continued)

- Consider the following sensitivities:
  - The better credit rating = lower incremental borrowing rate
  - The more borrowed = higher incremental borrowing rate
  - The Better quality of security = lower incremental borrowing rate
  - The better economic environment = lower incremental borrowing rate

Discount rate (continued)

- Example
  - Company's general borrowing rate based on:
    - Non-Arm's length borrowing rates
    - High yield bonds (if no debt-type instruments made) adjusted for
      - Lease term
      - Security
      - Amount

Right of Use asset ("ROU")

- Initial recognition of ROU
  - ROU's value is initially linked to the calculated value of the financial liability with several additional adjustments
  - ROU asset comprised of:
    - Lease liability
    - Initial direct costs
    - Costs of removal and restoring
    - Payments made at or prior to commencement
    - Less lease incentives received

Other measurement considerations

- Subsequent measurement of lease liability

  Lease liability = initial value + interest on carrying value – lease payments + re-measurements

- Interest on carrying value:
  - Recognized in P&L, unless it is included in the carrying amount of an asset as required by another standard (e.g. production of inventory utilizing leased equipment)

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Other measurement considerations

- Subsequent measurement of ROU asset
  - Subsequent measurement of ROU assets is based on the entity's accounting policy choice:
    - Cost model under IAS 16 PP&E
    - Revaluation mode under IAS 16 PP&E
    - Fair value model for investment property under IAS 40

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Modifications

- Lease modifications arise from changes to the underlying contract agreed between the lessor and the lessee subsequent to the commencement of the lease

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Modifications (continued)

- Modifications – separate leases
  - A lease modification is accounted for as a separate lease if both conditions are met:
    - The modification increases the scope of the lease by adding the right to use one or more underlying assets; and
    - The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope

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Modifications (continued)

- Modifications – not separate leases - accounted for as follows:
  - Decrease in scope
    - Decrease ROU asset and lease liability by their relative scope compared to the original lease, taking the difference to profit or loss
    - Re-measure lease liability using revised discount rate with the offset to ROU asset

Re-measurement of leases

- Not the same as modifications
- Lease liabilities and ROU assets are re-measured when:
  - Change in original assessment of lease term or purchase/termination option
  - Change in estimate of residual guarantee and chance in index or rate affecting payments
- No P&L impact in either situation

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Presentation

- Statement of financial position
  - ROU: present in its own line or combine with PP&E with separate disclosure
  - Lease liabilities: present separately or include with other liabilities and disclose which line items they have been included
  - Short term vs long term classification

Presentation

- Statement of profit or loss
  - Interest expense with other finance costs
  - Amortization of ROU assets

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Presentation

- Statement of cash flows
  - Cash payments of lease liabilities as financing activities
  - Cash payments for interest in accordance with IAS 7’s requirement for interest paid
  - Short term, low value and variable payments within operating activities

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Disclosure

- Quantitative disclosure requirements:
  - Additions to ROU assets
  - Maturity analysis of lease liabilities separately from other liabilities based on IFRS 7 requirements
  - Short-term and low value leases that are expensed
  - Income from subleasing

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Disclosure

- Qualitative disclosure requirements:
  - Summary of the nature of the entity’s leasing activities
  - Potential cash outflows the entity is exposed to that are not included in the lease liability
  - Restrictions or covenants imposed by leases
  - Significant estimates used

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Transition

- Effective date: for periods beginning on or after January 1, 2019. Early adoption is permitted if the entity adopts IFRS 15.
- Two approaches in adopting IFRS 16:
  - Full retrospective approach
  - Modified retrospective approach

Transition

- Disclosures – modified retrospective approach
  - Disclosure requirements per IAS 8 (EPS impact and the amount of each adjustment to each FS line item) as well:
    - The weighted average lessee's incremental borrowing rate applied to lease liabilities in the statement of financial position at the date of the initial application
    - An explanation of the difference between:
      - Operating lease commitments disclosed under the previous lease standard IAS 17 at the end of the prior year, discounted using the incremental borrowing rate at the date of initial application; and
      - Lease liabilities recognized in the statement of financial position at the date of initial application
    - Which practical expedients were used, if any.

Other

- Watch out for:
  - Changes in lease terms or estimates
  - Embedded leases within service contracts
  - Separate impairment considerations of ROU assets
  - Subleases – intermediate lessor
    - Is sublease financing or operating?
    - If financing, de-recognition of part of asset but liability has different counterparties
- Right of way or easement
  - Need to assess whether there is an identified asset and whether the customer obtains substantially all of the economic benefits of the identified asset and has the right to direct the use of that asset throughout the period of use