IFRS Accounting Standards discussion fora: IFRS 16 *Leases*

2023

Addis Ababa, Ethiopia

Accounting and Audit Board of Ethiopia

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Aims

» Develop a more cohesive understanding of IFRS accounting and reporting for leases in Ethiopia

» Enhance capacity in Ethiopia to apply IFRS 16 *Leases* more consistently

Applicable version of IFRS Accounting Standards

Unless specified otherwise, the accounting requirements that are the subject matter of this discussion forum are IFRS Accounting Standards as issued by the International Accounting Standards Board that are applicable for annual period beginning on or after 1 January 2023 without early applying new and amended IFRS Accounting Standards that have a later mandatory application date.

Index of issues
IFRS 16 Leases

Issue 1: Operating and finance leases

Operating and finance leases
What do you think?

IFRS 16 *Leases* became effective for accounting periods starting on or after 1 January 2019. It replaced IAS 17 *Leases*.

How should lessees treat operating and finance leases?

Operating and finance leases
Summary of discussion

How should lessees treat operating and finance leases?

Discussants' consensus view

- IFRS 16 removed the distinction between operating and finance leases for lessees
- Applying IFRS 16.9 - .11, a lessee recognises all contracts that are, or that contain a lease, on-balance sheet[1] from lease commencement date:
  - A liability is recognised for outstanding lease payments (IFRS 16.26), and
  - A right of use asset is recognised (IFRS 16.23)
- The liability is subsequently accounted for similarly to a financial liability
- The asset is subsequently accounted for similarly to PPE

[1] Exceptions apply, for eg IFRS 16.5 exempts certain short-term leases and leases low value assets

Issue 2: Paid-up lease

Paid-up lease
What do you think?

IFRS 16 establishes the value of a right-of-use asset (the rights that are the subject of the lease) by reference to the cost of that asset. The cost of the ROU asset includes, but is not limited to, the future lease payments.

If payment of the lease is paid in advance in full then we will not have lease liability. How can this be treated?

Paid-up lease
Summary of discussion

If payment of the lease is paid in advance in full then we will not have lease liability. How can this be treated?

Discussants' consensus view

» The calculation of the right of use (ROU) asset is (IFRS 16.24):

Present value of future payments + Payments made before commencement + Initial direct costs + Costs of dismantling/ restoring asset = Right of use asset

» In situation described, the ROU asset is calculated applying the 'formula':

» Present value of future payments will be zero, and payments before commencement will capture most of the cost of the lease

Issue 3: Break clauses

Break clauses
What do you think?

Applying IFRS 16, the asset and liability are established by reference to the duration of the lease (the lease term). The lease term may in certain circumstances include option extension periods, or periods beyond a break clause.

A three-year lease of machinery with a one-year break clause. If the lessee does not pay within the break clause period, the lessor has the right to cancel and take back the leased asset. Is depreciation calculated including the break clause?

Break clauses
Summary of discussion

A three-year lease of machinery with a one-year break clause. If the lessee does not pay within the break clause period, the lessor has the right to cancel and take back the leased asset. Is depreciation calculated including the break clause?

Discussants' consensus view

- Per the fact set provided:
  - The lessor only obtains the right to cancel if the lessee does not pay
  - Thus control of the break clause appears to reside with lessee
    - If the lessee continues to pay,
    - The lessor has no right to cancel

Break clauses
Summary of discussion *continued*

Areas of significant judgment

Discussants' consensus view

- If lessee has control, it must assess if it is 'reasonably certain' not to break
- Lease term:
  - https://www.youtube.com/watch?v=pZnbuU7p0dU
- If the lessee is reasonably certain, then the following are based on the extended lease term:
  - Lease liability,
  - Right of use asset and
  - Consequential depreciation

Issue 4: Low-value leases

Low-value leases
What do you think?

IFRS 16 provides an exemption from applying the standard to low value leases and separately to short-term leases.

For leases under the size threshold where the lease period is more than one year, how is the lease accounted for on the income statement?

Low-value leases
Summary of discussion

For leases under the size threshold where the lease period is more than one year, how is the lease accounted for on the income statement?

Discussants' consensus view

- If the lease is material, or together with other leases similarly classified is material, then:
  - Determine the total cost of the lease, including lease incentives, lease premiums and direct cost
  - Allocate that total cost to income statement on a straight-line basis over the lease term, unless another systematic basis better represents the benefits
  - This approach is consistent with operationg lease accounting under IAS 17
- If not material, common practice is to account for as an expense on a cash basis

Issue 5: Lease versus service

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Lease versus service
What do you think?

IFRS 16 defines the accounting for a *lease* and provides extensive guidance on the definition of a *lease*.

Sometimes we control the leased asset and in other instances we only control the service of the asset. Can we consider this as operational lease of right-of-use asset?

Lease versus service
Summary of discussion

Sometimes we control the leased asset and in other instances we only control the service of the asset. Can we consider this as operational lease of right-of-use asset?

Discussants' consensus view

» A contract is a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration (IFRS 16.B9-B31)

Who controls the use of the asset?

Customer → Lease

Supplier → Service

Lease versus service
Summary of discussion *continued*

Sometimes we control the leased asset and in other instances we only control the service of the asset. Can we consider this as operational lease of right-of-use asset?

Discussants' consensus view

» If the lessee/customer does not control the asset then it is a service

» A service is accounted for by recognizing a liability and an expense when the service has been provided

» IFRS 16 has extensive guidance on judgement between services and leases (IFRS 16.B9 to B33, and illustrative examples 1 to 10)

» IFRS 16.15 allows an entire contract to be accounted for as a lease if the contract includes both a lease and a service (practical expedient)

Issue 6: Subleases

Subleases
What do you think?

Subleases occur when an entity leases an asset, for example office space in a building, and the leases out that asset in whole or part to a third party. In such cases, the entity is both a lessee and a lessor.

How can we treat sublease of a leased assets? We have leased a PPE from a lessor and we then sub-leased with almost similar terms and conditions with original lease.

Subleases
Summary of discussion

How can we treat sublease of a leased assets? We have leased a PPE from a lessor and we then sub-leased with almost similar terms and conditions with original lease.

Discussants' consensus view

- Account for head lease and sublease as two separate contracts
  - Apply the lessor guidance to the sublease
  - Continue applying lessee guidance to the underlying lease
- Classify a sublease with reference to the ROU asset arising from the head lease
- Should not offset lease assets and liabilities, or income and expenses, unless it meets existing IFRS guidance for offsetting

Issue 7: Assets where title is not transferred

Assets where title is not transferred
What do you think?

The IFRS conceptual framework establishes the concept of substance over form. Substance over form, in the context of assets, focusses on the entity that controls the asset to obtains economic benefit from that asset, irrespective of what is recorded in the legal title to the asset.[1]

Government or a public entity gain titles of certain assets even though commercial users pay the full purchase price of those assets. What is the accounting treatment applied by the commercial users?

[1] Note: The Conceptual Framework is not a Standard. Nothing in the Conceptual Framework overrides any Standard or any requirement in a Standard. *Conceptual framework SP1.2*

Assets where title is not transferred
Summary of discussion

Government or a public entity gains title of certain assets even though commercial users pay the full purchase price of those assets. What is the accounting treatment applied by the commercial users?

Discussants' consensus view

» Should the commercial users apply lessee accounting?

» A lease is a contract that conveys the right to control the use of an identified asset for a period of time in exchange for consideration

» If a contract conveys control of the underlying asset as opposed to right to control use, then it is typically an in-substance purchase[1]

» Distinction depends on rights retained by the public authority or its agents

[1] IFRS 16.BC140

Certain assets
Summary of discussion

What is the accounting treatment applied by the commercial users?

Discussants' consensus view

» If this contract is not a lease, then it may be a purchase[1]

» IAS 16.7 requires recognition of an asset if it is probably that future economic benefits associated with it will flow to the entity, and the cost can be reliably measured

» Commercial users have control over the asset, and will use that control to derive future benefits from transformer, they can estimate the price reliably

» Consequently, the asset would typically be recognised as PPE and depreciated over its useful life.

[1] IFRS 16.BC140

Issue 8: Incremental borrowing rate - bank

Incremental borrowing rate
What do you think?

A number of IFRS standards require an entity to calculate the incremental borrowing rate. This typically the case when the contractual interest rate is not available for example in certain leases.

Can we use the bank loan borrowing rate to discount future cash flows?[1]

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Incremental borrowing rate
Summary of discussion

Can we use the bank loan borrowing rate to discount future cash flows?

Discussant consensus view: It depends

- An incremental borrowing rate (IBR) is provided as a relief when the rate implicit in a contract cannot be readily determined
- It is a last resort
- The IBR is defined as the rate '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' (IFRS 16 *appendix A definitions*)
- A bank borrowing rate may meet this criteria but judgement is required

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Issue 9: Incremental borrowing rate – senior vs junior loans

Incremental borrowing rate
What do you think?

IFRS 16 defines the incremental borrowing rate as *'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.'*

We have foreign loans classified as senior and junior loans (interest rate varies from 2% to 8%). The maturity of the loans are 7 years for the junior and 10 to 12 years for the senior loans which is similar to most of the lease terms. In calculating the present value of the future lease payments which interest rate should we use as incremental borrowing rate?

Incremental borrowing rate
Summary of discussion

We have foreign loans classified as senior and junior loans. In calculating the present value of the future lease payments which interest rate should we use as incremental borrowing rate?

Discussant consensus view

- If the leased asset is a domestic asset (used in Ethiopia) then the rate must be localised:
  - Adjusted for currency conversion spread; or
  - Adjusted considering pricing of foreign currency forwards
- If a lease contract allows the lessor to repossess the asset in the event of a default - this is more equivalent to a senior loan
- However, this depends on contract terms, asset type and Ethiopian law