FRS 116: LEASES

Diving into the Complex

By
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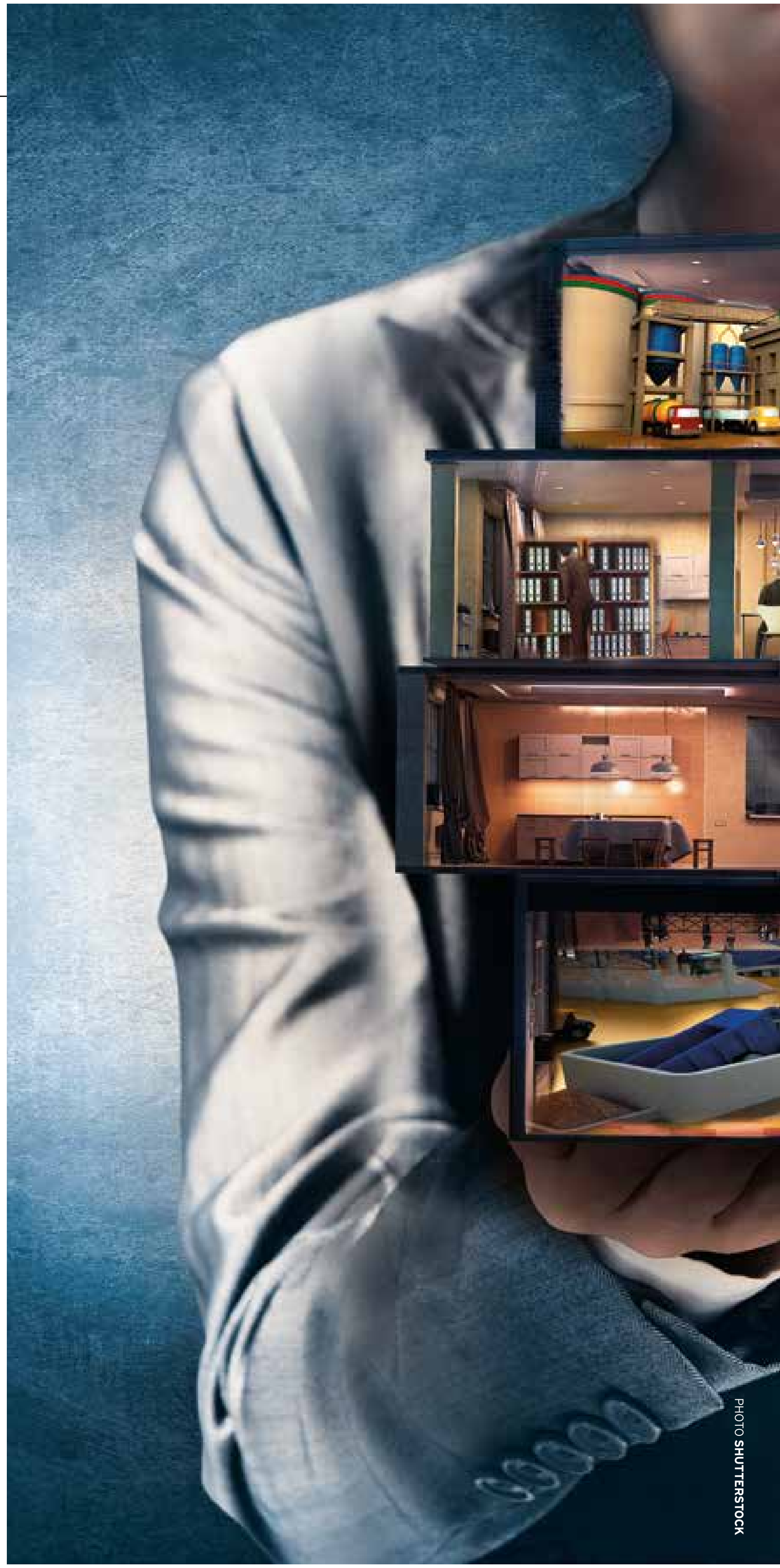
We are now one third of the way into the implementation period of FRS 116: Leases, following the Accounting Standards Council (ASC)'s issuance of the Standard on 30 June 2016. On 15 December 2016, ASC Chairman Kevin Kwok issued a reminder letter to Directors and Chief Financial Officers, encouraging them to take the necessary steps to ensure a smooth and timely transition to three major Financial Reporting Standards – FRS 109: Financial Instruments, FRS 115: Revenue from Contracts with Customers, and FRS 116: Leases. He urged companies to undertake in-depth analyses to determine the full implications of the Standards to their financial reporting, bearing in mind that these Standards carry potential implications beyond financial reporting – such as financial covenants and regulatory requirements, income taxes, employee compensation, information technology systems and business processes. ASC highlighted that FRS 116 is expected to have widespread implications across different industries and improve



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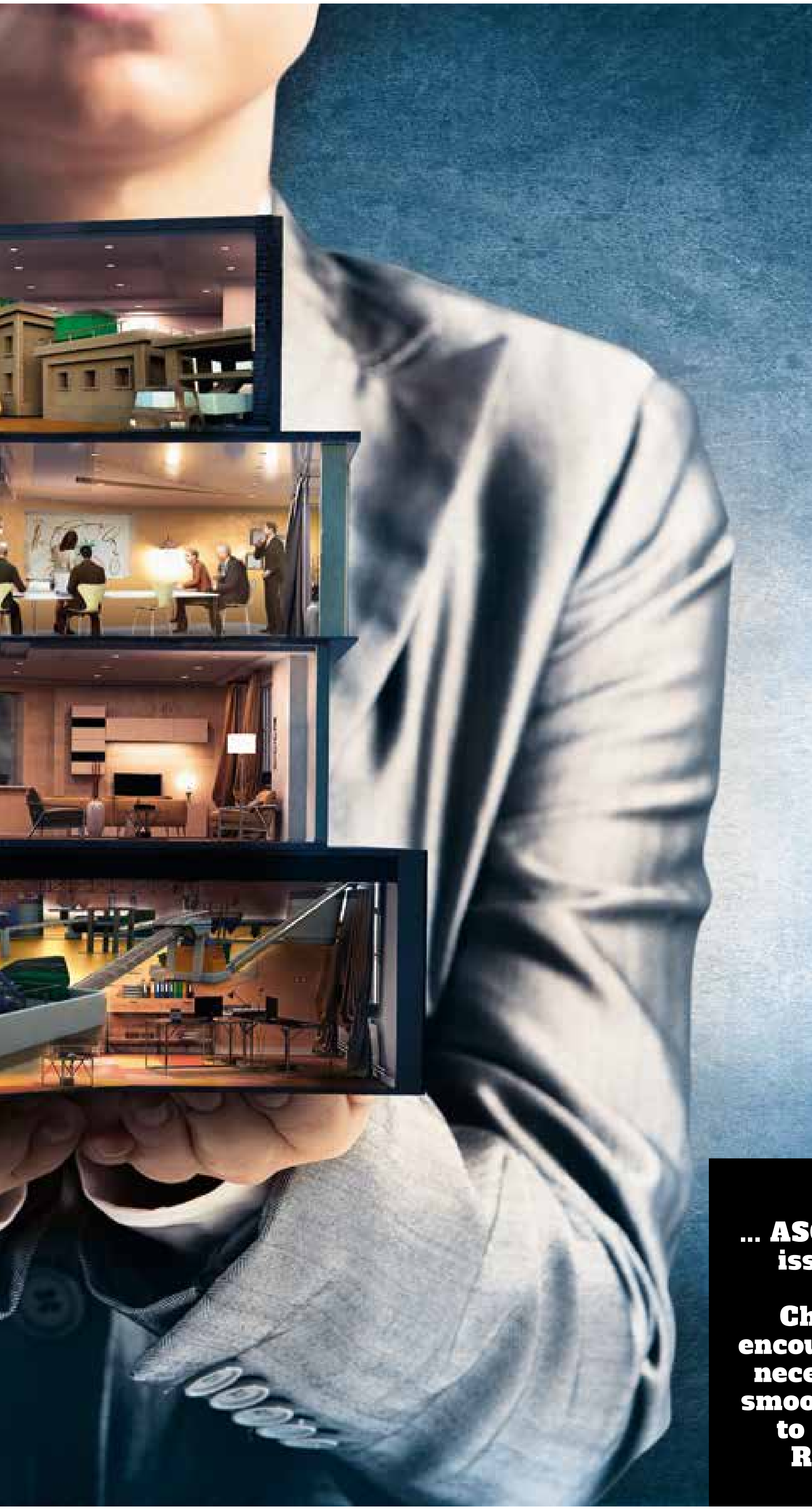

transparency about lessees' financial leverage and capital employed. The accounting changes would potentially affect key financial metrics, such as gearing, liquidity and return on capital, and may have further implications for lessees' tax obligations and compliance with financial covenants and/or regulatory requirements, although their economic positions may have remained unchanged.

In my previous three articles (published in the March, August and September 2016 issues of ***IS Chartered Accountant*** journal), I have focused on the genesis of the right-of-use accounting model, guidance on determining whether a contract contains a lease (ISCA Leases Roadmap), the implications to financial metrics, financial debt covenants and consequences that may go beyond the entity's accounting department, simplifications under FRS 116 to address concerns about costs and complexity, materiality considerations in scoping determinations, and, last but not least, an examination of commercial and business challenges faced by companies when implementing the new leases standard. In this article, I will be expounding on several accounting complexities when applying the Standard's requirements, providing insights into areas requiring more thinking and preparation time.

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ACCOUNTING COMPLEXITIES IN APPLYING FRS 116

Contrary to the above sub-title, the leases accounting concepts under FRS 116 are relatively straightforward and easy to understand even though it took the accountancy profession a decade to finalise them. Before taking the plunge into the "complexities", let me first explain the key requirements of lessee accounting under FRS 116.

FRS 116 defines a lease as a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. FRS 116 requires entities, at inception of a contract, to assess whether a contract is, or contains, a lease. A 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. For *all* contracts assessed to be or to contain a lease, a lessee shall recognise a right-of-use asset and a lease liability. Former operating leases are to be capitalised, and henceforth, there will be no more accounting distinctions made between finance leases and operating leases from the perspective of the lessee. All leases[1] are to be accounted for similarly to today's finance leases.

A lease contract creates, for the lessee, a right to use an underlying asset during the lease term, and an obligation to make payments to the lessor for providing the right to use that asset. The lessee's control of the right to use the underlying asset is demonstrated through the lessee's ability to determine how to utilise the underlying asset and thus, how the reporting entity generates future economic benefits from the right-of-use. Accordingly, the lessee's right to use an underlying asset meets the definition of an asset under the Conceptual Framework. The lessee's control of the right-of-use arises from past events – commitment to the lease contract and the underlying asset being made available for use. The lessee's right-of-use is unconditional unless the lessee breaches the contract. The lessee's obligation to make lease payments meets the definition of a liability under the Conceptual Framework, inasmuch as the lessee has a present obligation to make lease payments once the underlying asset has been made available to the lessee. Again, the obligation arises from past events – commitment to the lease contract

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and the underlying asset being made available for use. The International Accounting Standards Board (IASB) concluded that all leases provide finance to lessees and thus create assets and "debt-like" liabilities. FRS 116's single lessee expense recognition model requires the recognition of interest expense on those debt-like liabilities separately from depreciation expense of lease assets. Hence, there is the unavoidable front loading of total leases expenses. As for lessor accounting, only selected elements of prior guidance are changed under FRS 116 – accounting for subleases, the definition of a lease, initial direct costs and lessor disclosures.

Notwithstanding its conceptual simplicity, certain requirements are difficult to apply and require judgements and rigorous evaluations. Below are just four of the more complex requirements of the Standard; this is by no means an exhaustive list.

#1 Is a capacity portion of an asset an identified asset?

The issue here is whether a contract for the right to use only a portion of an asset qualifies as a lease contract. This brings us to "Roadblock 1 – Is there an identified asset? If NO, the journey ends. If YES, proceed to Roadblock 1A" of the ISCA Leases Roadmap.[2]

A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from the use of the asset (FRS116.B20). IASB concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example, if it is a 20% capacity portion of a pipeline). In this instance, the customer is unlikely to have the right to control the use of its portion because decisions about the use of the asset are typically made at the larger asset level and may be constrained by decisions of others also having rights to portions of the asset's capacity.

Nonetheless, "physically distinct" and "substantially all of the capacity of the asset" concepts can be complex to apply in some situations, requiring accounting judgements.

#2 Are the supplier's asset substitution rights substantive?

The issue here is whether a supplier (lessor) has the substantive right to substitute the asset throughout the period of use. This brings us to "Roadblock 1A – Does the supplier have substantive asset substitution rights? If YES, the journey ends. If NO,

[1] Except for leases which lessees have elected to exclude under the "short-term leases and leases of low-value assets" recognition exemptions; the election for short-term leases shall be made by class of underlying asset to which the right-of-use relates, whereas the election for low-value assets can be made on a lease-by-lease basis.

[2] ISCA Leases Roadmap was published in the March 2016 issue of ***IS Chartered Accountant*** journal.

proceed to Roadblock 2" of the ISCA Leases Roadmap.

A substitution right is substantive if the supplier has the practical ability to substitute the asset and would benefit economically from doing so. FRS 116.B14-B19 provides application guidance to help determine the circumstances in which substitution rights are substantive. The intention of the application guidance is to differentiate between (i) substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset, and (ii) substitution rights that do not change the substance or character of the contract because it is not likely, or practically or economically feasible, for the supplier to exercise those rights. The requirement that a substitution right must benefit the supplier economically in order to be substantive is a new concept. The requirement is that economic benefits associated with substituting the asset must be expected to exceed the costs associated with substituting the asset.

FRS 116 states that if a customer cannot readily determine whether a supplier has a substantive asset substitution right, then the customer should presume that any such substitution right is not substantive. IFRS 16.BC115 clarifies that "it is intended that a customer should assess whether substitution rights are substantive if it is reasonably able to do so – if substitution rights are substantive, then the IASB thinks that this would be relatively clear from the facts and circumstances. However, the requirement is also intended to clarify that a customer is not expected to exert undue effort in order to provide evidence that a substitution right is not substantive".

It is noted that the terms "cannot readily determine", "reasonably able to do so" and "undue effort" are subjective and an entity would still be expected to exercise reasonable effort to consider facts and circumstances at inception of the contract when evaluating whether a supplier's substitution right is substantive. This may be a complex exercise and the efforts required would be multiplied by the number of different contracts an entity has with different suppliers.

#3 Who makes decisions about how and for what purpose an asset is used?

The issue here is whether the customer or the supplier has the decision-making rights to direct the use of the underlying asset stipulated in the contract. If the supplier holds the decision-making rights, the supplier has control over the underlying asset and only provides a service to the customer, in which case the contract is a service contract and not a lease contract. This brings us to "Roadblock 2B(i) – Does the customer have the right to direct how and for what purpose the asset is used throughout the period of use? If YES, the contract contains a lease. If NO, consider Roadblock 2B(ii)" of the ISCA Leases Roadmap.

In IASB's view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than are other decisions to be made about use, including decisions about operating and maintaining the asset. This is because decisions about how and for what purpose an asset is used determine how, and what, economic benefits will be derived from its use. Decisions regarding operating an asset are generally about implementing the decisions about how and for what purpose an asset is used and are dependent upon, and subordinate to, those decisions. The IASB observed that considering decisions about how and for what purpose an asset is used can be viewed as similar to considering the decisions made by a board of directors when assessing control of the entity. Decisions made by a board of directors about the operating and

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financing activities of an entity are generally the decisions that matter in that control assessment, rather than the actions of individuals in implementing those decisions.

An entity is to consider the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. FRS 116.B26 provides examples of relevant decision-making rights – right to change what type of

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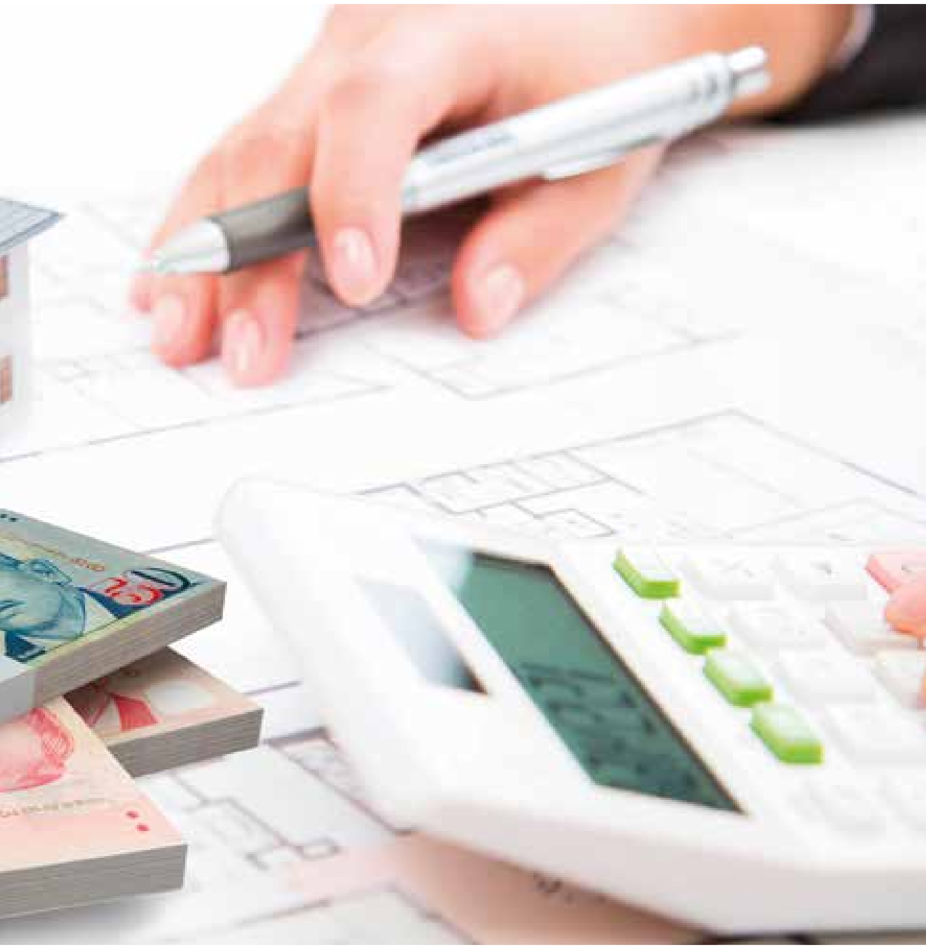

output is produced, when the output is produced, where the output is produced and how much of the output is produced. Decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

Depending on the terms and conditions of the contracts, assessment of decision-making rights can be a complex exercise requiring accounting judgements.

#4 Are variable lease payments in-substance fixed payments?

Variable lease payments are excluded from the measurement of lease liability except for variable lease payments that depend on an index or a rate. Variable lease payments that are linked to the lessee performance derived from the underlying asset are not included in the lease payments unless they meet the definition of in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but which in substance, are unavoidable. FRS 116 requires a lessee to include in-substance fixed lease payments in the measurement of lease liabilities because those payments are unavoidable and, thus, are economically indistinguishable from fixed lease payments.

FRS 116 does not contain any specific guidance on in-substance fixed payments but indicates that lease payments are in-substance fixed if there is no genuine variability. FRS 116 includes four examples of the types of payments that are considered to be in-substance fixed payments to help in applying the requirement, as follows:

(i) Payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring;

(ii) Payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved;

(iii) There is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case, an entity shall consider the realistic set of payments to be the lease payments, and

(iv) There is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In this case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to the lease payments.

In view that the Standard includes only limited guidance on how to interpret in-substance fixed payments, unravelling any contingent payments "disguised" as variable lease payments will be a complex exercise requiring significant accounting judgements.

CLOSING REMARKS

Contrary to the perception of some, FRS 116 does contain a number of nuances and complexities which requires detailed considerations, accounting judgement and early preparation. Accountants are accordingly cautioned to not underestimate the amount of preparation time that will be required if appropriate decisions are to be reached. ISCA

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