# IFRS 16: LEASES

## Ready for the Demands of Today

BY
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It is finally curtains down for lease accounting, after a spellbinding seven-year saga debuting with the 2009 joint Discussion Paper *Leases: Preliminary Views* (2009 DP); followed by the 2010 and 2013 joint Exposure Drafts *Leases* (2010 ED, and 2013 ED); 1,427 comment letters and countless outreaches. The "right-of-use" accounting model is finally given its due acceptance more than a half century after it was first conceived by John H. Myers in 1962.

For a lessee, assessing whether it has, through a lease, acquired substantially all risks and rewards incidental to ownership of an asset will become passé. Instead, an entity needs to carefully consider the existence of any lease in all its contracts that might contain a lease, in the light of the enhanced concept of rights to use, because all such leases identified (except for short-term leases and leases of low-value assets) are required to be recognised on the lessee's balance sheet. IFRS 16, however, does provide a practical expedient whereby an



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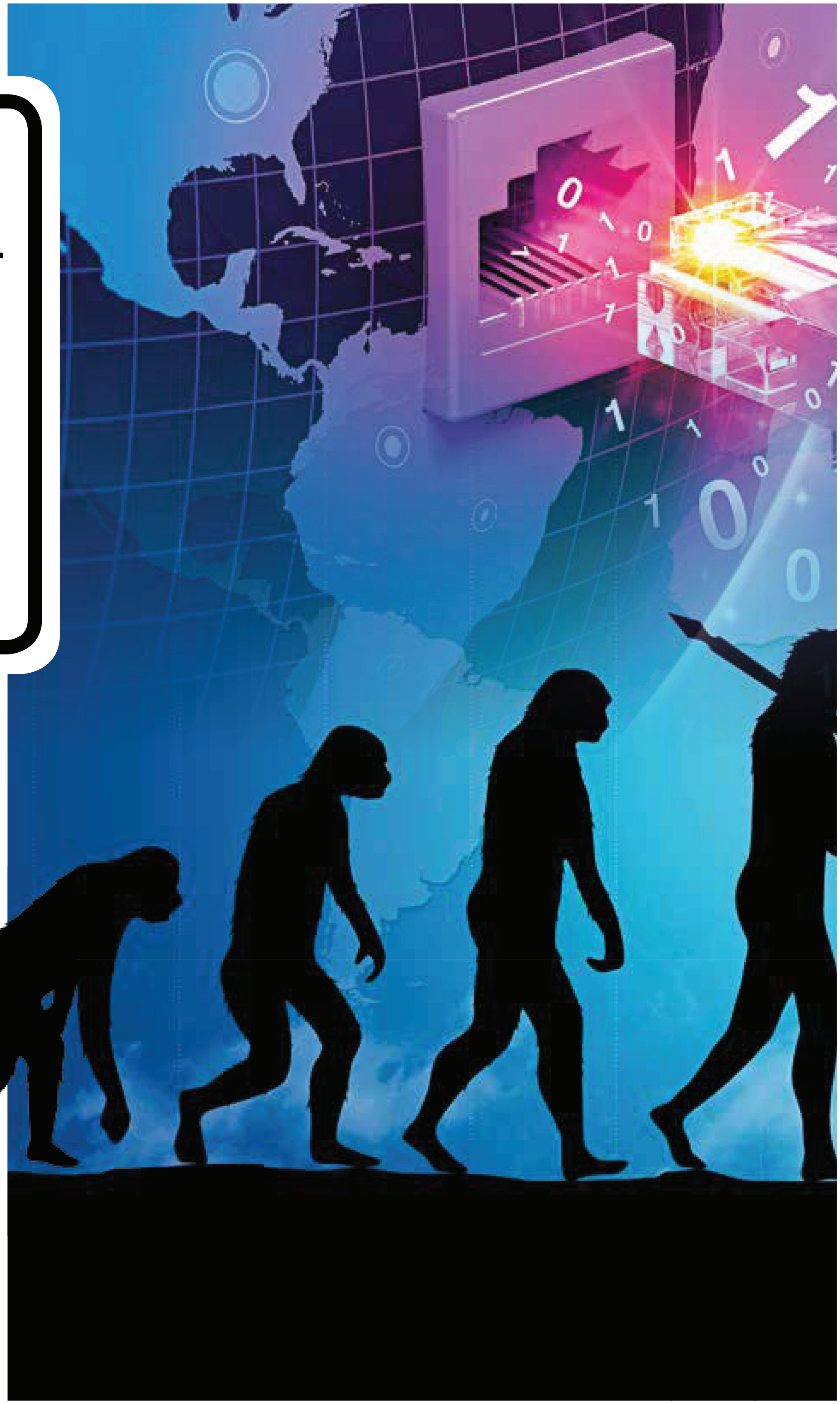
entity is not required to reassess existing contracts (regarding whether a contract is or contains a lease) at the date of initial application, which will be 1 January 2019 unless it is adopted earlier. The entity can elect to apply the requirements for identifying a lease only to contracts entered into (or changed) on or after the date of initial application, thus avoiding the burden of retrospective application.

## LESSEE: RIGHT-OF-USE ACCOUNTING MODEL

The right-of-use accounting model requires a lessee to recognise a right-of-use asset and a lease liability on the balance sheet at the commencement date of the lease, for all leases with a term of more than 12 months, and for which the underlying asset is not of low value. This is a significant conceptual breakthrough from IAS 17 *Leases*, and a milestone step for the accounting profession. It is a conceptual breakthrough because we have progressed from the "substantially all risks and rewards" framework to the "controls" framework, resulting in the recognition of all leases on the balance sheet. It is a milestone step because we now recognise and present a new right-of-use asset separately from other assets, and more significantly, because this will curb the use of operating leases as a mechanism for off-balance sheet financing.



**It requires the company to consider whether any such arrangement gives it the "right to control the use of an asset" for a period of time, even when the period is much shorter than the useful life of the asset.**

This right-of-use concept was first coined by John H. Myers in the US Accounting Principles Board's 1962 Accounting Research Study (ARS) No. 4 *Reporting of Leases in Financial Statements*. Myers introduced a new property rights model under which, instead of considering how closely leasing an asset corresponds to purchasing the asset under an ownership and mortgage-borrowing arrangement (purchase model), an entity should consider a lease as a mechanism for conveying rights to use property, even if those rights are not perfectly aligned with, or even close to, ownership rights. Under the property rights model, Myers recommended that all leases be recognised on the balance sheet at the discounted present value of cash flows that were to be paid for the property rights.

Notwithstanding the intellectual appeal of Myers' concept, the preference for the purchase model prevailed for the next 54 years until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it is finally adopted in IFRS 16. His property rights model was considered 13 years later in the FASB 1975 ED *Accounting for Leases*, but was not adopted over the purchase model.

## DETERMINING WHETHER A CONTRACT CONTAINS A LEASE

Determining whether a contract contains a lease can be challenging because the line between a lease contract and a service contract can sometimes be blurred. This may not have mattered much under IAS 17, because off-balance sheet operating leases were to be accounted for similarly to service contracts, with the entity reporting periodic rental expense. At the core of IFRS 16 is the requirement for entities to account for operating leases in a manner similar to finance leases. IFRS 16 eliminates the classification of leases as either operating leases or finance leases for a lessee. Instead, all leases are treated in a similar way to finance leases under IAS 17.

Chua Kim Chiu, Chairman of ISCA's Financial Reporting Committee, has the following comments, "The old lease accounting standard requires a company renting premises or equipment for its own use to consider whether the arrangement is economically similar to purchasing the asset with borrowing. If so, the company treats it as a finance lease and has to report it as an asset and a borrowing on its balance sheet. All other leases are operating leases that are kept off-balance sheet.

The new standard extends this concept – it requires the company to consider whether any such arrangement gives it the "right to control the use of an asset" for a period of time, even when the period is much shorter than the useful life of the asset. If so, the company has to report it similarly on the balance sheet.


Most companies understand that going forward, they will bring more off-balance sheet operating leases into their balance sheets and show higher gearing ratios and asset bases. What is not so apparent is how this will affect their profit or loss.

Under the old standard, the company reports monthly rental expense based on the same amount paid each month. Going forward, each rental payment is split into an interest expense component (from an implicit interest rate) and a principal repayment component. The interest expense is higher at the beginning of the lease period and declines as the borrowing is progressively paid down.

Correspondingly, the principal component rises progressively over time. In place of the principal component within the rental, the company reports straight-line depreciation as an expense. As a result, the company's total expense (interest plus depreciation) is higher at the beginning and declines progressively towards the end of the lease period."

IFRS 16 allocates an entire segment, 22 paragraphs of application guidance and 10 illustrative examples to the matter of "identifying a lease". IAS 17 contains no such guidance, although it is helped by IFRIC Interpretation 4 *Determining Whether an Arrangement Contains a Lease* (IFRIC 4), which provides guidance for determining whether such arrangements are, or contain, leases that should be accounted for in accordance with IAS 17. It requires a determination based on substance and an assessment of whether the arrangement is dependent on the use of a specific asset(s) and whether the arrangement conveys a right to use the asset.

Although superficially similar to IFRIC 4, IFRS 16 provides detailed guidance and introduces new concepts which can be complex to apply in practice, requiring the exercise of substantial judgement.

The following is an IFRS 16 Leases Roadmap to help determine whether a contract contains a lease.

## IFRS 16 LEASES ROADMAP

**ROADBLOCK 1** Is there an identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 1A.**

This requirement is substantially the same as the requirement in IFRIC 4. The first step is to determine the existence of an identified asset for the customer (lessee) to control. To have a lease, a specific leased asset must be identified, either explicitly or implicitly. Hence, even in a situation

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where the asset is not explicitly specified in a contract, an asset can be implicitly identified if the supplier can fulfil the contract only by use of a particular asset.

IFRS 16 Illustrative Example 3B, “Fibre-optic cable”, illustrates a scenario where there is no identified asset. The contract provides for the customer to have a right to use a specified amount of capacity within a cable for the transportation of data. The contract does not, however, specify any distinct fibres within the cable which the customer would have a right to control. Consequently, the customer does not have the right to use an identified asset and the arrangement is not a lease.

**ROADBLOCK 1A** Does the supplier have substantive asset substitution rights? If YES, the journey ends. If NO, proceed to **Roadblock 2.**

The next roadblock to negotiate after an asset overcomes Roadblock 1 is whether the supplier has an asset substitution right. If a supplier has a substantive right to substitute the asset throughout the period of use, the supplier (and not the customer) effectively controls the use of an asset. This means the supplier uses the asset to provide a service rather than leases out an asset. Hence, to have a lease, the supplier cannot have substantive substitution rights. IFRIC 4 does allude to the “substantive substitution rights” concept, now entrenched in IFRS 16, but does not dive very deeply into the subject.

For the substitution right to be substantive, the supplier must have the practical ability to substitute the asset and be able to benefit economically from doing so. This ensures that only in-substance substitution rights are considered when assessing whether a contract contains a lease. However, if the supplier has a right or obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier’s substitution right is not substantive because the supplier does not have


the practical ability to substitute alternative assets throughout the period of use. Also, the supplier's right or obligation to substitute the asset for repairs and maintenance, or technical upgrades, does not preclude the customer from having the right to use an identified asset.

An entity's evaluation of whether a supplier's asset substitution right is substantive depends on the facts and circumstances at the inception of the contract and are to exclude consideration of future events that, at inception of the contract, are not considered likely to occur.

In addressing a concern that in some cases, it would be difficult or impossible for a customer to determine whether a supplier's asset substitution right is substantive, IFRS 16 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. Hence, a customer is not expected to exert undue effort in order to provide evidence that a substitution right is substantive. Put another way, the default position is that the supplier's asset substitution right is not substantive unless the customer can readily evidence it. This makes it harder for a customer to argue that an asset substitution right is substantive in order to avoid lease accounting under IFRS 16.

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IFRS 16 Illustrative Example 1B, "Rail cars", requires the supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. It illustrates an arrangement whereby the supplier has substantive substitution rights. The supplier has a large pool of similar rail cars which can be used to fulfil the requirements of the contract. The rail cars are stored in the supplier's premises when not in use.

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The supplier has the practical ability to substitute each car throughout the period of use because the supplier has a large pool of similar cars which are stored at the supplier's premises. The supplier can also benefit economically from substituting each car because they can maximise the utilisation of the cars for other customers with similar contracts. Accordingly, the customer does not direct the use (see Roadblock 2B) nor have the right to obtain substantially all of the economic benefits from the use (see Roadblock 2A) of an identified car. In such circumstances, the arrangement is a service contract, not a lease.

**ROADBLOCK 2** Does the customer have the right to control the use of the identified asset? If YES, the contract contains a lease.

Once Roadblock 1 and Roadblock 1A have been surmounted and it has been determined that there is an identified asset with no substantive asset substitution rights by the supplier, the journey continues to Roadblock 2.

Roadblock 2 goes to the heart of the matter, that is, whether the customer has the right to control the use of the identified asset. To overcome Roadblock 2, both the hurdles in Roadblock 2A and Roadblock 2B below must be overcome.

IFRIC 4 also requires an arrangement to convey the right to control the use of the underlying asset, but the conditions to meet this requirement, set forth in paragraph 9 of IFRIC 4, are minuscule in comparison to the requirements in Roadblock 2A and Roadblock 2B.

**ROADBLOCK 2A** Does the customer have the right to obtain "substantially all" of the economic benefits from the use of the identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 2B.**

This requires the entity to consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset. Here, "substantially all" does not mean a substantial time period of the asset's useful life but a substantial part of the asset's total usefulness (that is, the economic benefits the asset can deliver). For example, if a customer has the right to use a specified car for two years (although the car has five more years of useful life), "substantially all" would refer to the economic benefit obtainable by the customer in comparison to the total economic benefit the car can deliver during the contract period.

**ROADBLOCK 2B** Does the customer have the right to direct the use of the identified asset? If NO, the journey ends. If YES, the contract contains a lease.

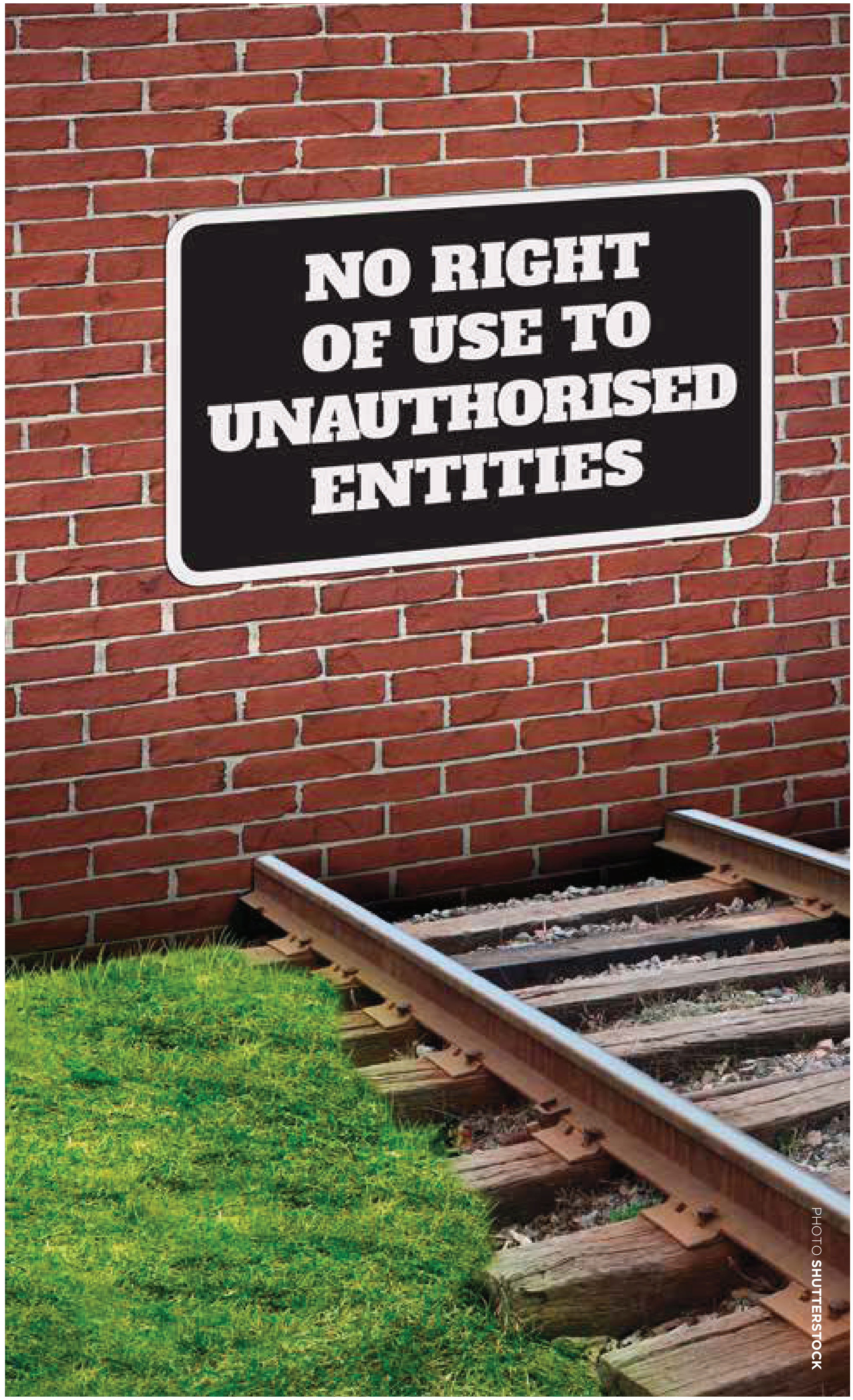
To control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from the use of an asset throughout the period of use (a "benefits" element/**Roadblock 2A**) but also the ability to direct the use of that asset (a "power" element/**Roadblock 2B**).

This is to say that a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from the use of the asset throughout the period of use. These decision-making rights differentiate a lease from a contract for purchasing supplies or services. This is also consistent with the concept of control in IFRS 10 and IFRS 15, and with IASB's proposals regarding control in the Exposure Draft *Conceptual Framework for Financial Reporting*. IFRS 10's and IFRS 15's definition of control also requires both a "benefits" element and a "power" element.

An entity which overcomes either one of the sub-hurdles in **Roadblock 2B(i)** or **Roadblock 2B(ii)** would satisfy **Roadblock 2B**.

**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).**

In assessing this "power" element, decision-making rights of both the entity/customer and supplier are considered, and an entity considers who/which party has the rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from the use of the asset. Protective rights and rights that are limited to operating/maintaining the asset do not grant decision-making rights and hence do not satisfy this requirement. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined. (Refer to **Roadblock 2B(ii)**.)

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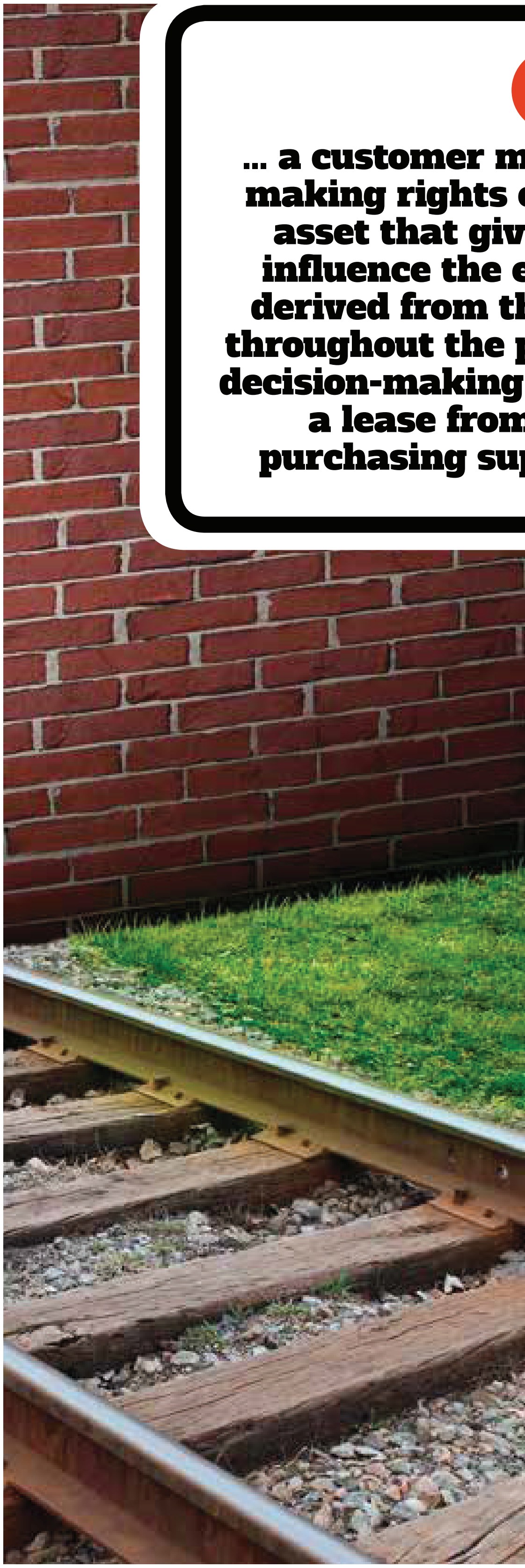

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**ROADBLOCK 2B(ii)** Are the relevant decisions about how and for what purpose the asset is used predetermined? If YES, (i) does the customer have the right to operate the identified asset throughout the period of use without the supplier having the right to change those operating instructions, or (ii) did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use? If YES to either (i) or (ii), the customer can still direct the use of the asset and hence, the contract contains a lease.

"Predetermined" is a new concept introduced by IFRS 16 where relevant decisions about how and for what purpose the asset is used are made before the inception of the lease. This could happen when both the customer and the supplier cannot make decisions about how and for what purpose an asset is used during the period of use. An example would be where decisions about how and for what purpose an asset is used are agreed between the customer and supplier in negotiating the contract and cannot be changed after the commencement date, or are predetermined by the design of the asset. In such a situation, IFRS 16 clarifies that a customer can still direct the use of an asset if it has the right to operate the asset, or if it has designed the asset in a way that predetermines how and for what purpose the asset will be used.

This concept can require substantial use of judgement and would frustrate attempts to structure contracts with the intention to avoid lease accounting under IFRS 16.

## CLOSING REMARKS

This article has addressed the new lease accounting for lessees, the right-of-use accounting model, and the determination of whether a contract contains a lease. Other critical areas of IFRS 16 not addressed in this article include accounting issues for lessors, variable lease payments, in-substance fixed payments, sale and leaseback transactions, transition, disclosures, impact analysis and implementation challenges, to name just a few. These deserve and will receive in-depth scrutiny and separate mention in later analyses. However, the most challenging issues are those facing lessees.

While 1 January 2019 might seem some way down the road, the journey has begun and the clock is now ticking. It is time to pull out the contracts that might contain a lease, scrutinise their terms, negotiate the roadblocks explained in this article and determine if there is a lease or a service contract at the end of the road. Although retrospective application of IFRS 16 is not required, by using hindsight applied to extant leases, reporting entities can gain the needed insights to become capable of applying the standard to new leases from the beginning of the mandatory application date (or earlier, if elected). Waiting until then to understand the myriad provisions of IFRS 16 is not a strategy for success. ISCA

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