IFRS 16 LEASES

IFRS 16 Leases replaced IAS 17 Leases effective **1st January 2019**. Under the new standard, lessees have to show all leases on the statement of financial position instead of hiding them in the notes to the financial statements.

Definition:

A lease is a contract or part of a contract that conveys the right to use an asset for a period of time in exchange for consideration.

IFRS 16 states that a customer has the right to direct the use of an identified asset if either:

i. They obtain substantially all of the economic benefits from the use of the asset
ii. The customer has the right to direct how and for what purpose the asset is used throughout its period of use

ACCOUNTING FOR LEASES BY LESSEES

IFRS 16 abolished the distinction between an operating lease and a finance lease in the financial statements of lessees. All leases in the books of the lessee are accounted for in the same way.

INITIAL RECOGNITION & MEASUREMENT BY THE LESSEE

At the commencement of a lease, the lessee accounts for two elements:

1. **Right of use asset (ROUA)**

The Right of use asset comprises of the following items:

Item	Amount
Any initial direct costs incurred by the lessee e.g. commission to brokers and legal fees	XXX
Any payments made to the lessor at, or before, the commencement date of the lease	XXX
Less: Any lease incentives received by the lessee	(XXX)
Lease liability	XXX
An estimate of any costs to be incurred by the lessee in dismantling and removing the underlying asset, or restoring the site on which it is located (IAS 37)	XXX
Right of use asset	**XXX**

2. Lease liability.

This comprises of all payments outstanding/not paid at the commencement date discounted to present value using the interest rate implicit in the lease or incremental borrowing rate.

SUBSEQUENT MEASUREMENT

1. Right-of-use asset.

Subsequently, the lessee shall measure the ROUA using the cost model under IAS 16 Property, Plant and Equipment i.e. depreciate the asset over the shorter of the lease term and the useful life of the asset, unless title over the asset passes/transfers at the end of the useful life to the lessee, in which case useful life is used.

The lessee can also apply IAS 40 Investment Property (if the right-of –use asset is an investment property and fair value model is applied), or using revaluation model under IAS 16 (if right-of-use asset relates to the class of PPE accounted for by revaluation model).

2. Lease liability.

The lease liability will be amortised over the lease term and split between the finance costs (interest) and reduction in the lease liability.

If there is a change in the lease term, lease payments, discount rate or anything else, then the lease liability must be re-measured to reflect all the changes.

RECOGNITION EXEMPTIONS

IFRS 16 permits **two exemptions**:

1. Leases with the lease term of 12 months or less with no purchase option
2. Leases where underlying asset has a low value when new, for example tablets and personal computers, small items of office furniture and telephones.

For the above leases, lease payments will be recognised on a straight line basis over the lease term.

ACCOUNTING FOR LEASES IN THE LESSOR'S BOOKS

Here lessors continue to classify leases between finance and operating lease.
A finance lease is a lease that substantially transfers all risks and rewards incidental to ownership of the underlying asset to the lessee.
An operating lease is a lease other than a finance lease.

Examples of situations that indicate that a lease is a finance lease

- The lease transfers ownership of the asset by the end of the lease term
- The lessee has the option to purchase the asset at a price that is lower than its fair value at the date the option becomes exercisable
- The lease term is for the major part of the economic life of the asset even if title is not transferred

- At inception of the lease, the present value of the lease payments amounts to substantially all of the fair value of the leased asset
- The leased assets are of such a specialized nature that only the lessee can use them without major modifications.

Accounting for finance lease by the lessor

Initial measurement

At the commencement of the lease term, lessor derecognizes the underlying asset and recognizes a lease receivable in the statement of financial position. The lease receivable equals to the payments not received at the commencement date discounted to present value plus the initial direct costs.

DR Lease Receivable	XXX
CR PPE (Underlying asset)	XXX

Subsequent Measurement

The lessor should recognize finance income in the profit/loss:

1. A finance income on the lease receivable:

DR Lease receivable	XXX
CR Profit or loss – Finance income	XXX

2. A reduction of the lease receivable by the cash received:

Debit Bank account (Cash)	XXX
Credit Lease receivable	XXX

Accounting for operating lease by lessors

The Lessor keeps recognizing the leased asset in his statement of financial position.

Lease income from operating leases is recognized as an income on a straight-line basis over the lease term.

EXAMPLE ONE: LESSEE ACCOUNTING

PM Limited (Lessee) entered into a five year lease for a machine on 1st January 2018 with ABC Limited (Lessor). Lease payments were Shs. 60,000,000 per annum, payable at the end of each year. To obtain the lease, the lessee incurred initial direct costs of Shs. 30,000,000. The lessor agreed to reimburse the lessee Shs. 7,500,000 in regard to part the real estate commission incurred by the lessee. The interest rate implicit in the lease is 5%.

Required.

i. Show how the transaction will be accounted for initially in the books of PM Limited.
ii. Compute the amounts that PM Limited will recognize for Interest expense, Non-Current Liability and current liability in the years 2018, 2019 and 2020.

EXAMPLE 2:

Assume the lease payments were made in advance.

Initial direct costs = Shs 30,000,000
Lease payments payable in advance = Shs 60,000,000
Lease term = 5 years
Interest rate = 5%

Solution:

If lease payments are in advance, then the lease payment for year one is supposed to be paid at the commencement date i.e. in this case 1st January 2018.

Initial recognition and measurement

Right of use asset

Initial direct costs	30,000,000
Lease payment for year one	60,000,000
Less: Re-imbursement	(7,500,000)

Lease liability 212,757,030
Right of use asset 295,257,030

Lease liability:
This will be obtained by discounting the remaining four lease payments, since the payment for year one is assumed to have already been made.

Present value = Annuity factor for 4 years x Annual lease payment

Annuity factor = $\frac{1 - (1 + r)^{-n}}{r}$

-

$= \frac{1 - (1+0.05)^{-4}}{0.05}$

= 3.545950504
Present value = 60,000,000 x 3.545950504
= **212,757,030**

Subsequent measurement

The Right of use asset will be accounted for using the cost model of IAS 16.

The lease liability is amortised over the lease term.

Amortisation schedule (Payments in advance)

Year	Lease liability @ start (A)	Lease payment (B)	Subtotal (A – B) = C	Interest @ 5% (D)	Lease liability @ end (C + D)
2018	212,757,030	-	212,757,030	10,637,852	223,394,882
2019	223,394,882	(60,000,000)	163,394,882	8,169,744	171,564,626
2020	171,564,626	(60,000,000)	111,564,626	5,578,231	117,142,857
2021	117,142,857	(60,000,000)	57,142,857	2,857,143	60,000,000
2022	60,000,000	(60,000,000)	-		

Example 3: November 2019 Qn. 4

JLO limited is a company in the mining sector located in Hoima district. Due to the nature of the capital intensity, it finances operations through leases. The following are the different lease agreements made by JLO Ltd.

On 1 May, 2018, JLO entered into a 15 year lease contract with Feng. International Company to obtain an earth mover, making rental payments of Shs 20,480,000 per year. Before the commencement date, JLO paid Shs 10 million to secure the lease and also incurred direct initial cost of Shs 5 million. The interest cost implicit in the lease is 5% with a present value of lease payments of Shs 256 million. The machine had a useful life of 20 years and the title would be transferred to JLO at the end of the lease term.

As a way of increasing accessibility to information by its employees, the company, on 1 November, 2018 entered into a lease arrangement to secure tablets for the staff paying lease rentals of Shs 13.5 million per year for two years.

Required:

In accordance with IFRS 16: Leases.

(a) advise the management of JLO limited on how to account for the above transactions, clearly showing extracts to be included in the financial statements for the year ended 30 April, 2019. **(13 marks)**

(b) explain the conditions under which an underlying asset can qualify to be a low value asset. **(3 marks)**

Answers:

- ✓ The assets nature is that when new, the asset is typically a low value.
- ✓ The lessee can benefit from the use of the underlying asset on its own or together with other resources that are readily available to the lessee

- ✓ The underlying asset is not highly dependent on, or highly interrelated with other assets.

(c) explain the impact of the recognition criteria on the statement of financial position of JLO Limited. **(4 marks)**

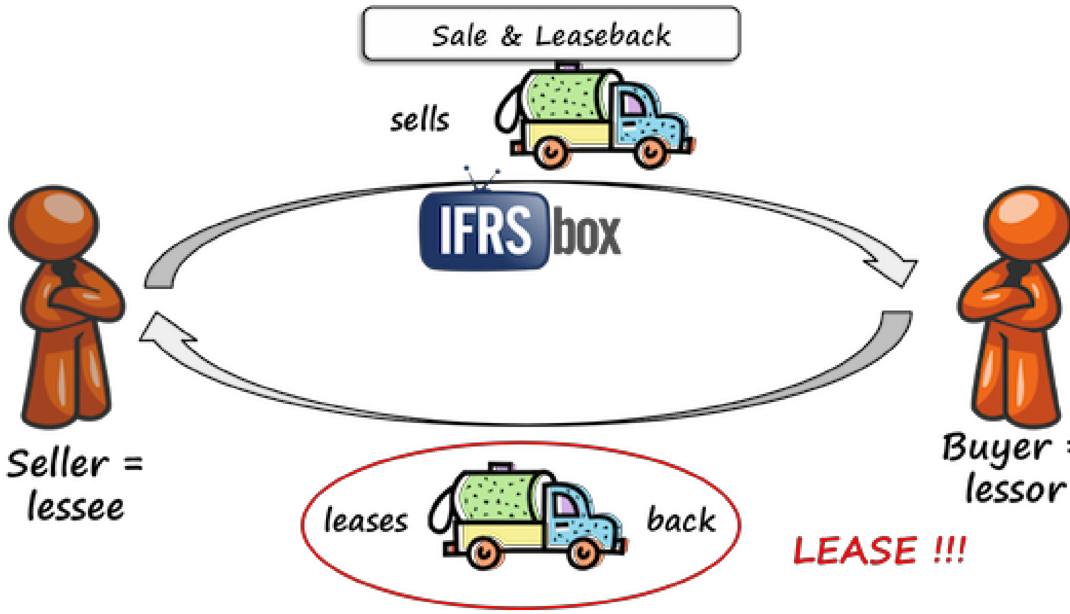
Answers:

The impact of IFRS 16 on the financial statements

- ✓ It leads to the recognition of more leased assets and liabilities
- ✓ It leads to increased levels of gearing due to the increased liability shown in the financial statements
- ✓ Profits are likely to reduce especially in the first years where the depreciation and the finance costs are likely to be higher than the rental repayments.
- ✓ It limits the creative accounting that was likely with the old standard IAS 17 especially with operating leases.

SALE AND LEASEBACK TRANSACTIONS

A sale and leaseback transaction involves the sale of an asset and the leasing the same asset back. In this case the seller becomes the lessee and the buyer becomes the lessor.



The accounting treatment of sale and leaseback transactions depends on the whether the transfer of an asset is a sale under IFRS 15 Revenue from contracts with customers or whether it is not a sale.

1. **If a transfer is a sale:**

The seller (lessee) derecognises the underlying asset and accounts for the right-of-use asset at the proportion of the previous carrying amount related to the right-of-use retained (under the leaseback). The seller/lessee also computes a gain or loss only to the extent related to the rights transferred. The buyer (lessor) accounts for a purchase of an asset under applicable standards and for the lease under IFRS 16.

$$\text{ROUA} = \frac{\text{Carrying amount of asset}}{\text{Fair value of asset}} \times \text{Amount of lease liability}$$

$$\text{Gain on sale} = \frac{\text{Fair value of Asset} - \text{Amount of Lease Liability}}{\text{Fair value of Asset}} \times \text{Total Gain}$$

2. **If a transfer is NOT a sale:**

The seller (lessee) keeps recognizing transferred asset in their books and accounts for the cash received as for a financial liability under IFRS 9 Financial Instruments. The buyer recognizes a financial asset under IFRS 9 amounting to the cash paid.

Example: Sale and Lease back

Katumba Limited requires funds to finance a new rebranding exercise. Its only way of raising finance is through the sale and leaseback of its head office building for a period of 10 years. The annual lease payments are of Shs 10 million payable at the end of each year. The carrying amount of the building is Shs 84 million while its fair value is Shs 100 million. The interest rate implicit in the lease is 5%.

Required:

Advise Katumba Limited on how to account for the sale and leaseback in its financial statements if the transfer of this building was an actual sale and meeting the revenue recognition requirements of IFRS 15 Revenue from contracts with customers.

Solution:

Carrying amount = 84 million
Fair value = 100 million
Lease term = 10 years
Lease payments = 10 million @ yearend
Since the transfer of the building is an actual sale, then the seller/lessee derecognizes the asset from their books. The seller/lessee will then recognise a right of use asset and a gain on sale of the building.

Right of use asset = $\frac{\text{Carrying amount of asset}}{\text{Fair value of asset}}$ X Lease liability

= 84M/100M X 77,217,340
= 64,862,567
Lease liability = Present value of future lease payments

Present value = Annuity factor x Annual lease payment

Annuity factor = $\frac{1-(1+r)^{-n}}{R}$

$= \frac{1-(1+0.05)^{-10}}{0.05}$

= 7.721734

Present value = 7.721734 x 10,000,000

= 77,217,340

Gain to be recognised by the lessee

$= \frac{\text{Fair value of asset} - \text{Lease liability}}{\text{Fair value of asset}} \times \text{Total gain}$

Total gain = Fair value – Carrying amount

= 100M – 84M

= 16 Million

$= \frac{100{,}000{,}000 - 77{,}217{,}340}{100{,}000{,}000} \times 16{,}000{,}000$

= 3,645,226

DR Cash/Bank	100,000,000
DR Right of use asset	64,862,657
CR Underlying asset (Building)	84,000,000
CR Lease liability	77,217,340
CR Profit/loss (Gain on sale)	3,645,226