IFRS 16 – PROBLEM AREAS

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INTRODUCTION

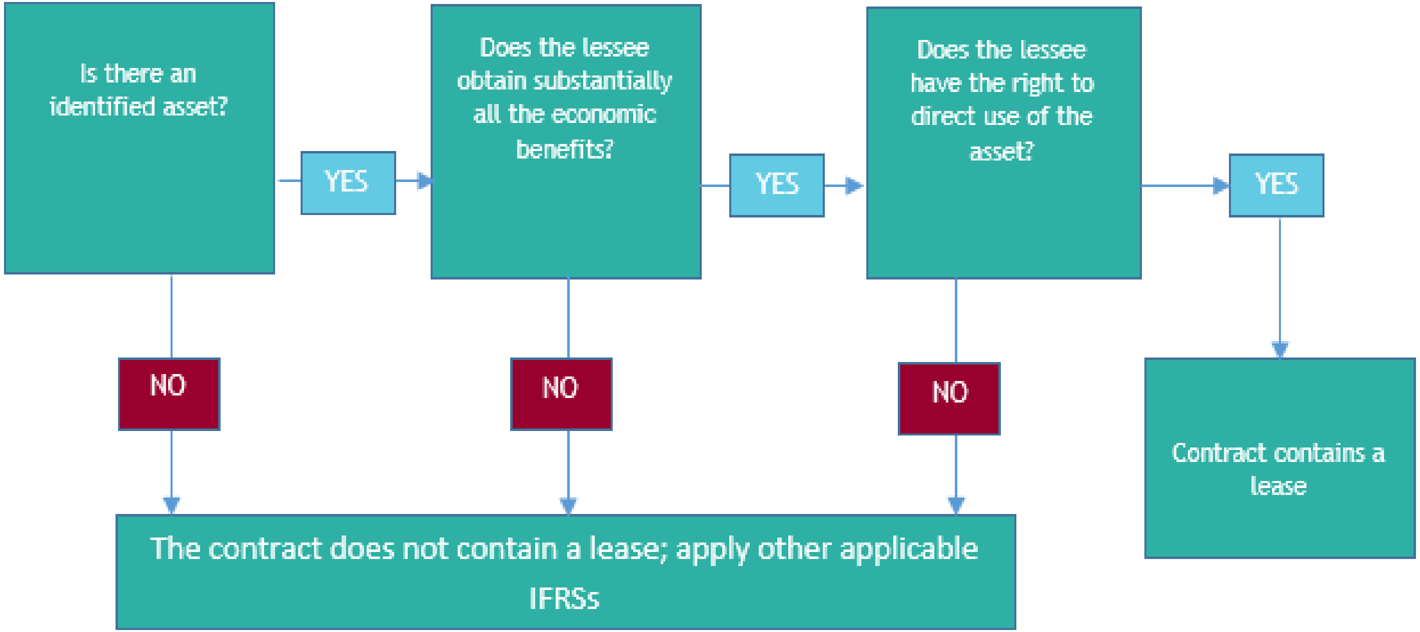
OUTLINE OF THIS WEBINAR

- Identifying a Lease
- Determining the Lease Term
- Measurement Issues

IDENTIFYING A LEASE

IDENTIFYING A LEASE

Applying the definition of a lease



IDENTIFYING A LEASE

Criteria 1 - Is there an identified asset?

- Typically, an asset will be explicitly identified in a contract
- Alternatively, an asset is implicitly identified at the point at which it is made available for use by the customer
- However, even if a contract specifies a particular asset, a customer does not have the right to use that asset if the supplier has a **substantive right** to substitute the asset throughout the period of use

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IDENTIFYING A LEASE

Criteria 1 - Is there an identified asset?

- A supplier's right would be substantive if both the following conditions are met:
  - The supplier has the practical ability to substitute alternative assets throughout the period of use; AND
  - The supplier would benefit economically from the exercise of its right to substitute the asset

In situations where the lessor has the right to substitute an asset, we should assess whether the lessor has a compelling reason to exercise the right

If not, the substitution right may only be protective

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IDENTIFYING A LEASE

#1: Substantive substitution rights for part of the lease term (1/2)

Guidance:

- IFRS 16.B15
  - *'If the supplier has a right or an 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'*

Fact patterns:

- ABC Co. (lessee) enters into a 4 year rail car lease agreement on 30 June 20x1
  - Scenario A: Rail Co. (lessor) has substantive substitution rights for the remainder of the lease term beginning on 1 July 20x3
  - Scenario B: Rail Co. can substitute the rail car throughout the term of the lease on the occurrence of a specific event
  - Scenario C: Rail Co. can substitute the rail car at 1 July 20x3 only

Question:

- What it the term of the lease and are the substitution rights substantive?

IDENTIFYING A LEASE

#1: Substantive substitution rights for part of the lease term (2/2)

Answer:

- Scenario A: Since substitution right is not for the entire period of the lease, it is not substantive and the lease term is the period of the contract of 4 years
- Scenario B: Since the substitution right is only on the occurrence of an event, it is not substantive and the lease term is the period of the contract of 4 years
- Scenario C: Since the substitution right is only on a particular date, it is not substantive and the lease term is the period of the contract of 4 years

IDENTIFYING A LEASE

#2: Allocation of consideration to lease components and non-lease components (1/3)

Guidance:

- IFRS 16.B15
  - *'Suitable methods for estimating the stand-alone selling price of a good or service include, but are not limited to, the following:*

    (c) Residual approach—an entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract. However, an entity may use a residual approach to estimate, in accordance with paragraph 78, the stand-alone selling price of a good or service only if one of the following criteria is met:

    (i) the entity sells the same good or service to different customers (at or near the same time) for a broad range of amounts (ie the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence); or

    (ii) the entity has not yet established a price for that good or service and the good or service has not previously been sold on a stand-alone basis (ie the selling price is uncertain).'

IDENTIFYING A LEASE

#2: Allocation of consideration to lease components and non-lease components (2/3)

Fact patterns:

- ABC Co. (lessee) enters into a 4 year building lease agreement
  - Breakdown of amount of lease payment relating to cleaning services not included in the lease agreement
  - ABC elects to separate lease and non-lease components

Question:

- Can ABC Co. use the ‘residual approach’ to determine the stand-alone value for the components?

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IDENTIFYING A LEASE

#2: Allocation of consideration to lease components and non-lease components (3/3)

Answer:

- If the criteria in IFRS 16.B15 are met, ABC Co. is allowed to use the ‘residual approach; however, given the requirements it is unlikely they will be able to.

DETERMINING THE LEASE TERM

DETERMINING THE LEASE TERM

The lease term comprises

- The non-cancellable period of the lease

AND

- Periods covered by an option to **extend** the lease if the lessee is reasonably certain to exercise that option

AND

- Periods covered by an option to **terminate** the lease if the lessee is reasonably certain not to exercise that option

DETERMINING THE LEASE TERM

A lease is not enforceable if

The lessee has the right to terminate the lease without permission from the lessor and with only an insignificant penalty

AND

The lessor has the right to terminate the lease without permission from the lessee and with only an insignificant penalty

To assess if there is an 'insignificant penalty' the analysis needs to include both what is explicitly stated in the contract, as well as other kinds of economic penalties that may not be included in the contract. Termination clauses must have economic substance to be considered.

DETERMINING THE LEASE TERM

#3: Lease Term (1/2)

Background

- Lessee A enters into a 14-year lease for a property
- The lease contract includes a termination clause every 2 years. This can ONLY be exercised by Lessee A
- The lease contract does not require Lessee A to make a termination payment to the lessor if it exercises the termination option
- Lessee A is reasonably certain that it will not exercise the termination option for 10 years

Required

What is the lease term?

DETERMINING THE LEASE TERM

#3: Lease Term (2/2)

Answer

- Lease term = 10 years (enforceable by lessee)
  - Lessee A does not expect to exercise termination option for a period of 10 years
  - IFRS 16.B34 is N/A here (i.e. lease is only not enforceable if both parties can terminate the lease)

DETERMINING THE LEASE TERM

#4: Lease Term (1/4)

Background

- Lessee B enters into a 14-year lease for a property
- The lease contract includes a termination clause every 2 years. This clause can be exercised by BOTH Lessee B and the lessor
- The lease contract does not require either Lessee B or the lessor to make a termination payment if either party exercise a termination clause
- Lessee B has installed expensive leasehold improvements that have an expected useful life of approximately 10 years
- Lessor would incur significant costs in finding a new tenant

Required

What factors should Lessee B consider when determining the lease term?

DETERMINING THE LEASE TERM

#4: Lease Term (2/4)

Answer

Step 1 - Determine if the lease is enforceable under IFRS 16.B34

- Must consider if either party has <u>more than an insignificant penalty </u>for terminating. Types of penalties include:
  - Cash penalty
  - Having to relocate premises
  - Undertaking leasehold improvements (not used for full useful life)
  - Finding a new tenant
- If Lessee B considers there is no significant penalty of any type (for either party), lease term = 2 years. Lessee B would be unlikely to conclude this is the case.

DETERMINING THE LEASE TERM

#4: Lease Term (3/4)

Answer (continued)

Step 2 - If there is a significant penalty, contract is enforceable and lease term needs to be determined

- In this fact pattern, it is likely that there is a significant penalty for Lessee B up until the end of year 10 because of remaining useful life of its leasehold improvements. There is also a significant penalty for Lessor because it would incur significant costs to find a new tenant
- Lessee B is likely to assess the lease term as 10 years, being the length of time its leasehold improvements are expected to be used (i.e. period it would be reasonably certain NOT to exercise termination option).

DETERMINING THE LEASE TERM

#4: Lease Term (4/4)

Challenges in applying B34 in practice

- What constitutes ‘more than insignificant penalty’ is highly judgemental
- How do you know what lessor costs to find a new tenant will be?
- Lessee need to consider changing circumstances within its control when reassessing lease term (IFRS 16.20)

DETERMINING THE LEASE TERM

#5: Lease Term (1/3)

Background

- Lessee C enters into a 10-year lease for a property
- After the initial 10-year period, the lease continues until EITHER party terminates the lease (with 3 month's notice)
- The lease contract does not require either Lessee C, or the lessor, to make a termination payment if either party exercises its termination clause

Required

What factors should Lessee C consider when determining the lease term?

DETERMINING THE LEASE TERM

#5: Lease Term (2/3)

Answer

Step 1 – consider if requirements of IFRS 16.B34 apply because BOTH lessee and lessor have option of terminating lease after non-cancellable period of 10 years

- Must consider if either party has more than insignificant penalty for terminating. Types of penalties include:
  - Cash penalty
  - Having to relocate premises
  - Undertaking leasehold improvements (not used for full useful life)
  - Finding a new tenant
- If either Lessee C or the lessor would suffer some form of economic loss for terminating the contract, then there is a ‘more than an insignificant penalty’ and the lease contract is considered to be enforceable. Lessee C would need to consider the lease term in the same way as it did in Part 1 above

DETERMINING THE LEASE TERM

#5: Lease Term (3/3)

Answer (continued)

Step 2 – If there is more than a significant penalty, contract is enforceable and lease term needs to be determined in the same way as PART 1 (above)

- This may be extremely difficult to assess in practice, and when deciding on the lease term, the lessee would need to consider any factors, such as:
  - Past practice
  - Reasonable expectations of its lease term
- Wider economic factors, however, Lessee C considers that all types of penalties would be insignificant for terminating the lease after the 10-year period, then the lease term would be 10 years

DETERMINING THE LEASE TERM

#6: Lease Term (1/2)

Background

- Lessee D enters into a 10-year lease for a property
- After the initial 10-year period, the lease includes a rolling 12 month extension option. There is no end date to the number of potential extension options
- The lease therefore continues until EITHER party decides not to extend the lease
- If either party decides not to extend the lease after the initial 10-year period, no termination payments are required to be made
- Assume:
    - The lease contract is enforceable for the 10-year initial lease period
    - At the end of year 10, the Lessee D extends the lease for an additional 12 months, and
    - Lessee D had only included the initial 10-year period in its initial estimate of the lease term

Required

At the end of Year 10, can Lessee D apply the IFRS 16 short-term lease exemption to the lease for an additional 12 months

DETERMINING THE LEASE TERM

#6: Lease Term (2/2)

Answer

- No. Lessee D must revise the lease term (refer to IFRS 16.20-21 for information on reassessment of the lease term)
- The short-term lease exemption is not supposed to be used in these circumstances. It was only intended as a cost-saving measure to get the simple, and clearly short-term leases off balance sheet, e.g. car hires, Christmas period pop-up shops, etc

LEASE TERM

#7: Leases with non-consecutive or intermittent periods of use (1/3)

Guidance:

- Definition of lease term:
  - *'The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:*
    - *(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and*
    - *(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.'*

- Definition of period of use:
  - *'The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).'*

LEASE TERM

#7: Leases with non-consecutive or intermittent periods of use (2/3)

Scenarios:

- Scenario 1 - Holiday Co. enters into a two-year lease agreement
  - Months available for use are November, December and January
  - Same store location to be provided for each year
- Scenario 2 - Sports Team Co. enters into a 15-year stadium lease agreement
  - Available for use for 30 non-consecutive home games per year

Discussion question:

- Would these leases with lease terms greater than 12 months be considered a short-term lease?

LEASE TERM

#7: Leases with non-consecutive or intermittent periods of use (3/3)

Answer:

- Scenario 1
  - Lease term 2 years
  - Period of use 6 months
  - Short-term lease

- Scenario 2
  - Lease term 15 years
  - Period of use 450 days
  - Long-term lease

LEASE TERM

#8: IFRS 16 paragraph B34 penalty (1/3)

Guidance:

- IFRS 16.B34
  - *‘In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.’*

- IASB staff webcast Lease Term Q&A, October 2017

LEASE TERM

#8: IFRS 16 paragraph B34 penalty (2/3)

Fact pattern:

- ABC Co. enters into a 10-year warehouse lease
- Both the lessor and ABC Co. have the right to terminate the contract with no contractual penalties
- ABC Co. has significant leasehold improvements in the warehouse
- Warehouse is located in a remote location where ABC Co. would have limited replacement options

Question:

- Are economic penalties considered in the determination of ‘more than an insignificant penalty’ in accordance with IFRS 16.B34?

LEASE TERM

#8: IFRS 16 paragraph B34 penalty (3/3)

Answer:

- Yes, significant economic penalties are considered in terms of IFRS 16.B34
- Some additional examples of economic penalties would be (this list is not all inclusive):
  - Damage to market reputation
  - Damage to customer relationships
  - Importance of the asset to the operation of the entities business

LESSEE ACCOUNTING MEASUREMENT ISSUES

MEASUREMENT

#9: Restoration obligations included in initial measurement of right-of-use asset (1/6)

Guidance:

- IFRS 16.24
  - *'The cost of the right-of-use asset shall comprise:*
    - *(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.'*
- IAS 16.16(c)
  - *'The cost of an item of property, plant and equipment comprises:*
    - *(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.*

MEASUREMENT

#9: Restoration obligations included in initial measurement of right-of-use asset (2/6)

Guidance (continued):

- IFRS 16.BC148
  - *'…initial measurement of a right-of-use asset at cost is consistent with the measurement of many other non-financial assets, such as assets within the scope of IAS 16 and IAS 38. Measuring right-of-use assets on a basis similar to that used to measure the underlying asset maintains the comparability of amounts reported for leased and owned assets, which contributes to the usefulness of the information provided to users of financial statements'*

MEASUREMENT

#9: Restoration obligations included in initial measurement of right-of-use asset (3/6)

Scenario A:

- ABC Co. enters into a 7 year building lease
  - Required to return building at the end of the lease in same condition as at lease commencement
  - Installs leasehold improvements
  - Removal of leasehold improvements estimated to cost 3,000

Question:

- How is the restoration obligation accounted for?

MEASUREMENT

#9: Restoration obligations included in initial measurement of right-of-use asset (4/6)

Answer:

- ABC Co. records a provision of 3,000 when the leasehold improvements are installed and capitalises the 3,000 to the cost of the asset
- 3,000 is subsequently depreciated over the term of the lease
- In the event of any changes in the estimate, a corresponding adjustment is recorded to the cost of the asset

MEASUREMENT

#9: Restoration obligations included in initial measurement of right-of-use asset (5/6)

Scenario B:

- (Same facts as scenario A) ABC Co. enters into a 7 year building lease
  - Required to return building at the end of the lease in same condition as at lease commencement
  - Installs leasehold improvements
  - Removal of leasehold improvements estimated to cost 5,000
  - Building incurs minor damage as a result of normal ‘wear and tear’
  - Repairing the minor damage is estimated to cost 500 for each year ABC Co. is a tenant in the building with a total cost of 3,500 (500 * 7)

Question:

- How is the ‘wear and tear’ be accounted for?

MEASUREMENT

#9: Restoration obligations included in initial measurement of right-of-use asset (6/6)

Answer:

- ABC Co. records a provision of 500 each year and an expense of 500 for minor damages that have occurred during that year
- Treatment is consistent with IAS 16
  - IFRS 16.BC148 notes the Boards intention for the treatment to be similar to IAS 16 (see IAS 16.16(c))

MEASUREMENT
#10: Lease liability for an interest-only lease (1/2)

Fact pattern:

- ABC Co. enters into a 7-year lease
  - Notional capital of the lease is 10,000
  - Annual payment of LIBOR multiplied by the notional capital amount (LIBOR x 10,000)
  - Notional amount due at termination date of lease
  - LIBOR at lease commencement is 3% (assume remains constant for this example)

Question:

- What amount is included in the lease liability on lease commencement for the lease payments?

MEASUREMENT

#10: Lease liability for an interest-only lease (2/2)

Answer:

- At lease commencement the following payments are included in the lease liability:

Year	Payment
1	300
2	300
3	300
4	300
5	300
6	300
7	10,300

MEASUREMENT

#11: In-substance fixed lease payments (1/3)

Guidance:

- IFRS 16.27
  - *'At the commencement date, the lease payments included ….:*
    - *(a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;'*
- IFRS 16.B42
  - *'Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, if:*

    (a) payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance. Examples of those types of payments include:

      (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.

MEASUREMENT

#11: In-substance fixed lease payments (2/3)

Fact pattern:

- Cleaning Co., a cleaning equipment and supplies company, enters into a 3 year industrial cleaning equipment lease with Supplies Co.
  - Lease payments for the cleaning equipment are nil
  - As part of the arrangement ABC is not required to purchase cleaning bags so there is no minimum purchase required, however, if ABC does purchase cleaning bags they need to be purchased from Cleaning Co.
  - Based on past experience Cleaning Co. has used 1,000 bags per year
  - Cleaning Co. expects that it is highly probably it will use at least 800 bags per year

Question:

- Does the lease agreement contain in-substance fixed payments?

MEASUREMENT
#11: In-substance fixed lease payments (3/3)

Answer:

- No
- Variable lease payments based on use of the underlying asset are excluded from the measurement of the lease payment
- High probability is not a factor in the conclusion

MEASUREMENT
#12: Subsidiary incremental borrowing rate (1/2)

Guidance:

- IFRS 16.26
  - *'…The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.'*

Background:

- Implicit rate in the lease is not readily determinable by lessee
- Subsidiary does not have its own treasury function
- All funding for the group is managed centrally by the parent

Questions:

1) Can the subsidiary use the parent's incremental borrowing rate?
2) Can the subsidiary use the parent's internal rate for transfer pricing?

MEASUREMENT

#12: Subsidiary incremental borrowing rate (2/2)

Answer:

- No to both questions
- IFRS 16.26 states the lessee is required to use its own incremental borrowing rate
- In the April meeting of the Board they considered that having a centralised treasury function is irrelevant
- Need to consider other factors that could influence the pricing offered by the lessor to the subsidiary (i.e. currency exchange rates, tax, local regulations, etc.)

MEASUREMENT

#13: Subsequent measurement - reassessment of the lease liability (1/3)

Guidance:

- IFRS 16.42(b) states:
  - *'A lessee shall remeasure the lease liability by discounting the revised lease payments, if either: …*

    (b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.'

MEASUREMENT

#13: Subsequent measurement - reassessment of the lease liability (2/3)

Fact pattern for a lease:

- 31 December year end
- Initial non-cancellable term of 3 years ending 31 December 20x1
- Option to extend for 2 years
- Rent review upon extension
- Rent change retroactive to day one of the extension period (1 January 20x2)
  - Note that it can take a period of time to perform the rent review (i.e. greater than 12 months)
- Lessee is able to reliably estimate the revised rent on 31 December 20x1

Discussion question:

- Should a liability be recorded for the retrospective payment at 31 December 20x1 prior to the conclusion of the rent review?

MEASUREMENT
#13: Subsequent measurement - reassessment of the lease liability (3/3)

Answer:

- No liability is recognised at 31 December 20x1
- Since the lease is in the scope of IFRS 16, IFRS 16.42(b) applies in determining the timing of recording the retrospective payment.
- The timing of recording the payment is dependent on the terms of the lease agreement with regards to when the payment is made.

RE-CAP

RE-CAP OF THIS WEBINAR

- Identifying a Lease
- Determining the Lease Term
- Measurement Issues

DO YOU NEED ASSISTANCE?

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QUESTIONS

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