The Institute of Chartered Accountants of Nigeria (ICAN)

Kaduna & District Society

Implementation and Challenges of adopting IFRS 16 - Leases

By

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Contents

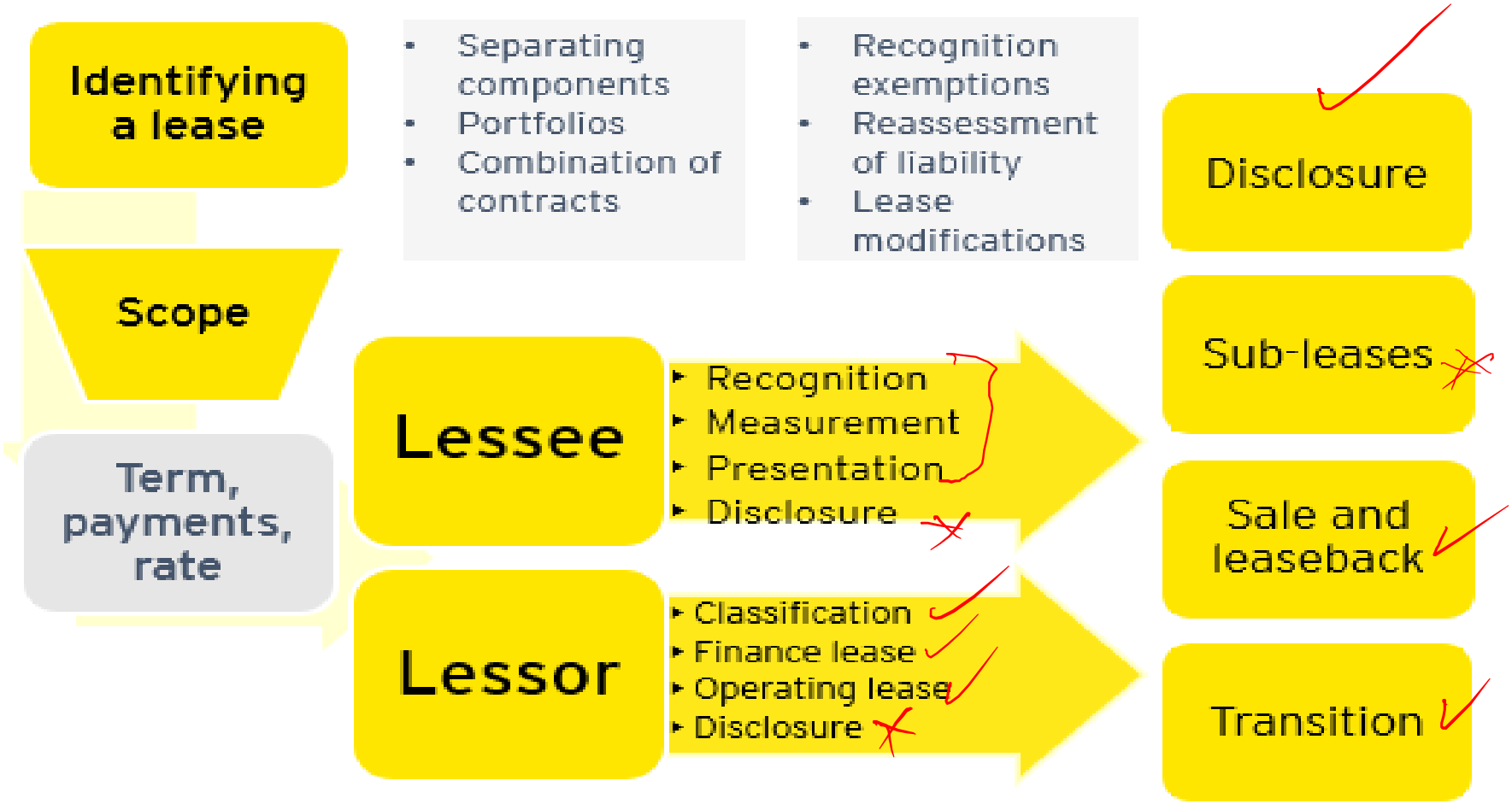
INTRODUCTION

SCOPE AND SCOPE EXCEPTIONS

- IFRS 16 was issued in January 2016 and became effective for annual periods beginning on or after 1 January 2019
- IFRS 16 applies to all leases including lease of right of use asset in a sublease except for the followings:
  a) Lease to explore for or use minerals, oil, natural gas and similar non regenerative resources
  b) Leases of biological assets within the scope of IAS 41 Agriculture held by a lessee
  c) Service Concession arrangements within the scope of IFRIC 12 Service Concession Arrangements.
  d) Licences of intellectual property granted by a lessor within the scope of IFRS 15
  e) Rights held by a lessee under licensing agreements within the scope of IAS 38 for such items as motion pictures, picture films, video recordings, plays manuscripts, patents and copyrights.

- A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in (e) above.

IFRS 16 – THE "BIG PICTURE"



DEFINITIONS OF TERMS

Lease – 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.

Lessee - An entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.

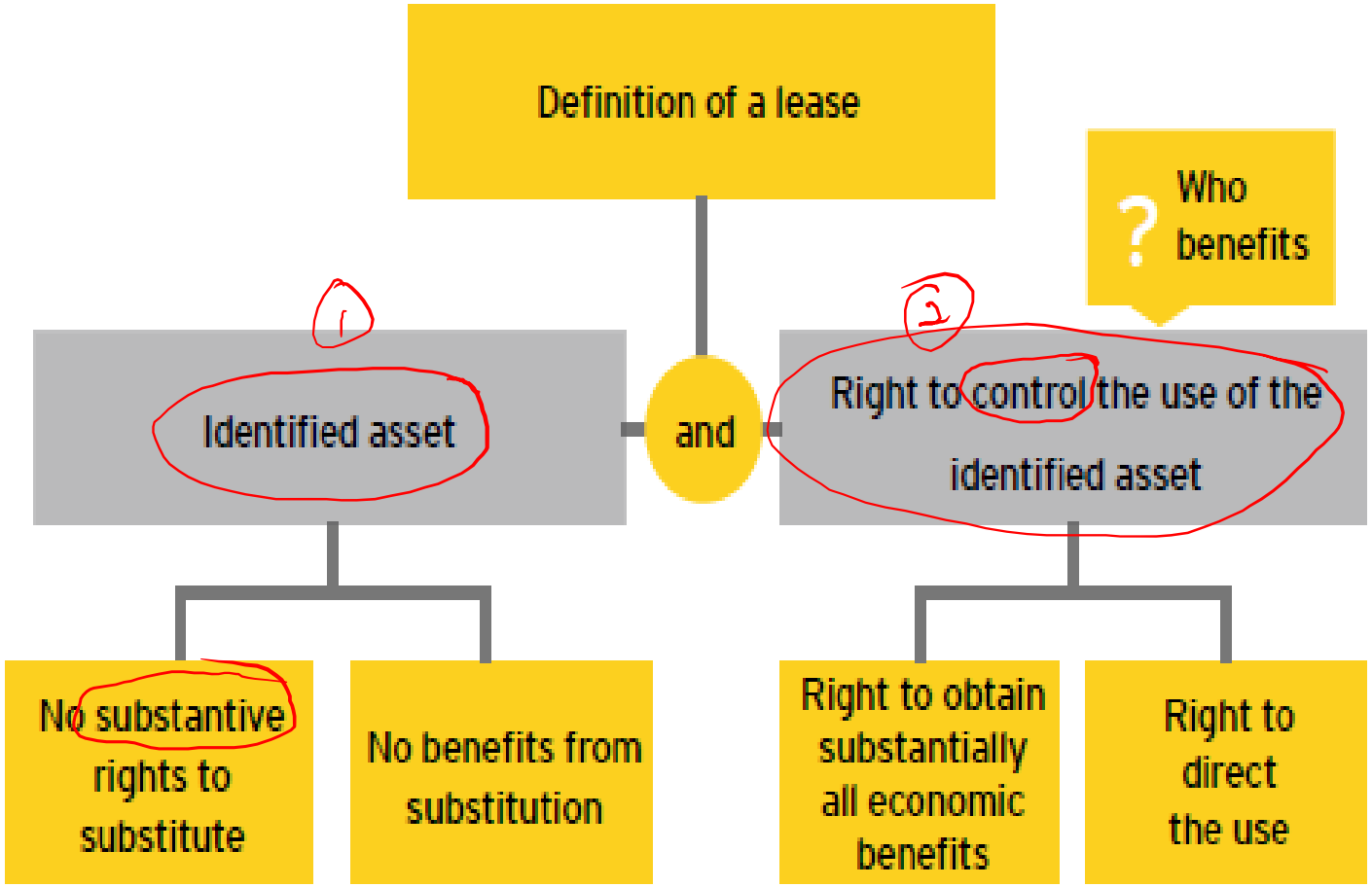
Lessor - An entity that provides the right to use an underlying asset for a period of time in exchange for consideration

Underlying asset – An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

Right-of-use asset – An asset that represents a lessee's right to use an underlying asset for the lease term.

IDENTIFYING A LEASE

IDENTIFYING A LEASE



IDENTIFYING A LEASE (CONTD.)

Right to control the use of the identified asset

Right to obtain **substantially** all the economic benefits

AND

Right to direct the use throughout the period of use

Customer has the right to direct how and for what purpose the asset is used

OR

Relevant decisions about how and for what purpose the asset is used are predetermined AND

- The customer has the right to operate the asset, without the supplier having the right to change those operating instructions; OR
- The customer designed the asset in a way that predetermines how and for what purpose the asset is used

IDENTIFIED ASSET

- An asset is typically identified by being explicitly specified in a contract.
- However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.
- A capacity portion of an asset is an identified asset if it is physically distinct (e.g. floor of a building).
- A capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a fibre optic cable) is not an identified asset, unless:

  ~~100%~~ 95%

  a) It represents substantially all of the capacity of the asset; and thereby
  b) Provides the customer with the right to obtain substantially all of the economic benefits from the use of the asset.

IDENTIFYING A LEASE – ILLUSTRATION 1

Customer X enters into a 12-year contract with Supplier Y for the right to use three fibres within a fibre optic cable between New York and London. The contract identifies three of the cable's 20 fibres for use by Customer X. The three fibres are dedicated solely to Customer X's data for the duration of the contract term. Assume that Supplier Y does not have a substantive substitution right.

Required:
Does the contract contain identified assets?

Analysis
The three fibres are identified assets because they are physically distinct and explicitly specified in the contract.

IDENTIFYING A LEASE – ILLUSTRATION 2

Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y's pipeline. The contract provides that Customer X will have the right to use 95% of the pipeline's capacity throughout the term of the arrangement.

Required:
Does the contract contain identified assets?

Analysis
The capacity portion of the pipeline is an identified asset. While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the pipeline.

IDENTIFYING A LEASE – ILLUSTRATION 3

Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y's pipeline. The contract provides that Customer X will have the right to use 60% of the pipeline's capacity throughout the term of the arrangement.

Required:
Does the contract contain identified assets?

Analysis
The capacity portion of the pipeline is not an identified asset because 60% of the pipeline's capacity is less than substantially all of the capacity of the pipeline. Customer X does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

SUBSTANTIVE SUBSTITUTION RIGHT

- Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.

- A supplier's right to substitute an asset is substantive only if both of the following conditions exist:
  a) The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and
  b) The supplier would benefit economically from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

- 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.

IDENTIFYING A LEASE – ILLUSTRATION 4

An electronic data storage provider – Datacom Limited provides services, through a centralised data centre to a customer – Heavyweight Limited that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single, accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

Required:
Does the contract give Heavyweight the right to direct the use of an identified asset?

Analysis
The customer, Heavyweight Limited, does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

"Under IFRS 16, how a lessee account for a lease depends on whether the lease is a finance or operating lease".

LESSEE ACCOUNTING

LESSEE ACCOUNTING

At the **commencement date** of the lease, IFRS 16 requires that the lessee recognises a lease liability and a right-of-use asset.

Recognition Exemptions

The measurement requirements of IFRS 16 apply to all leases, unless a lessee makes use of optional exemptions as follows:

- Short-term leases (those having a term of 12 months or less)
- Leases of low value assets

Dr ROU asset X

Cr Lease liab X

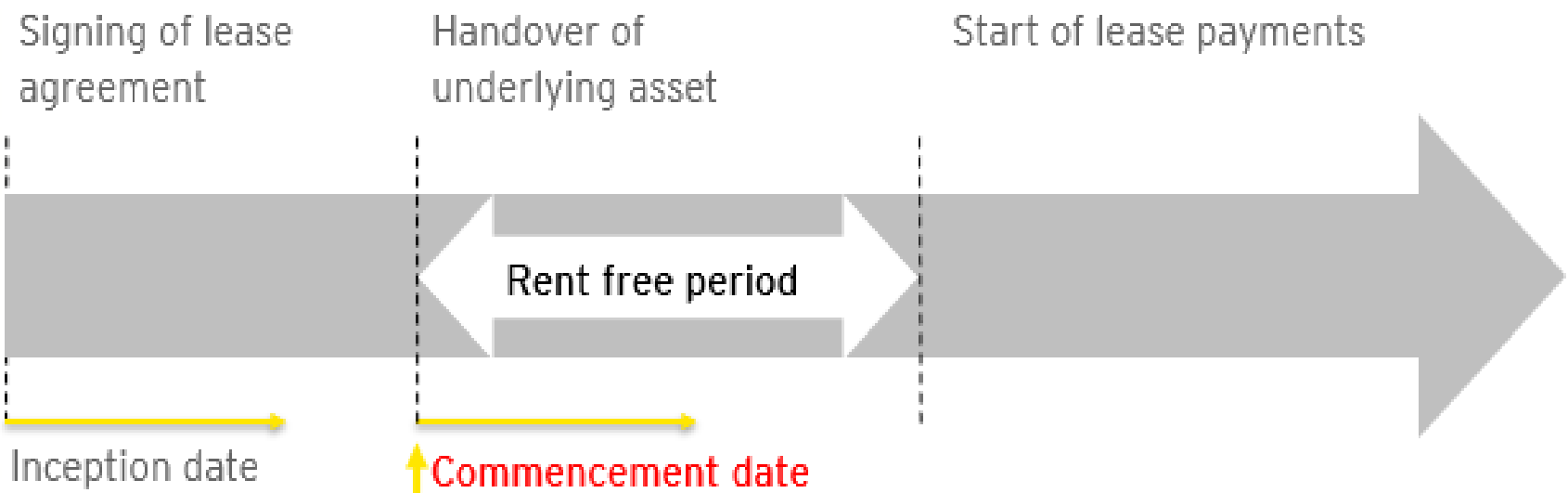
LEASE LIABILITY

Lease liability = Present value of lease rentals + Present value of expected payments at end of lease

Key inputs

- Lease term (1)
- Lease payments (2)
- Discount rate (3)

COMMENCEMENT DATE VS INCEPTION DATE



„The **lease term** begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor."
(IFRS 16.B36)

LESSEE TERM

To calculate the initial value of the **lease liability** and **right-of-use (ROU) asset**, the lessee must consider the length of the lease term. IFRS 16 says that the lease term comprises:

Lease term =

Non-cancellable period

2 yrs.

+

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

3 yrs

+

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

NON-CANCELLABLE PERIOD, LEASE TERM AND ENFORCEABLE PERIOD

Enforceable period				
Lease term			No contract, no lease	
Non-cancellable period				
Initial lease term, Lessee has no option to terminate (e.g. 5 years)	Option to extend, Lessee is reasonably certain to exercise the option (e.g. 3 years)	Option to extend, Lessee is not reasonably certain to exercise the option (e.g. 2 years)	Any option to continue the lease is not enforceable (e.g. 20 years)	**Time**

LEASE PAYMENTS

At the commencement date, a lessee measures the lease liability at the present value of the lease payments that are not paid at that date.

Lease payments				
1 Fixed payments and "in-substance" fixed payments	2 Purchase options* (exercise price)	Residual value guarantees – amounts expected to be payable (lessees only) 3	Termination option penalties* 4	Variable lease payments that depend on an index or rate# 5

* Include only if reasonably certain of exercise

#Reassess when the contractual payments change and not when the index or rate changes

Variable lease payments that do **not** depend on an index or rate (e.g., performance- or usage-based payments) would be excluded from lease payments unless they are in-substance fixed and expensed as incurred

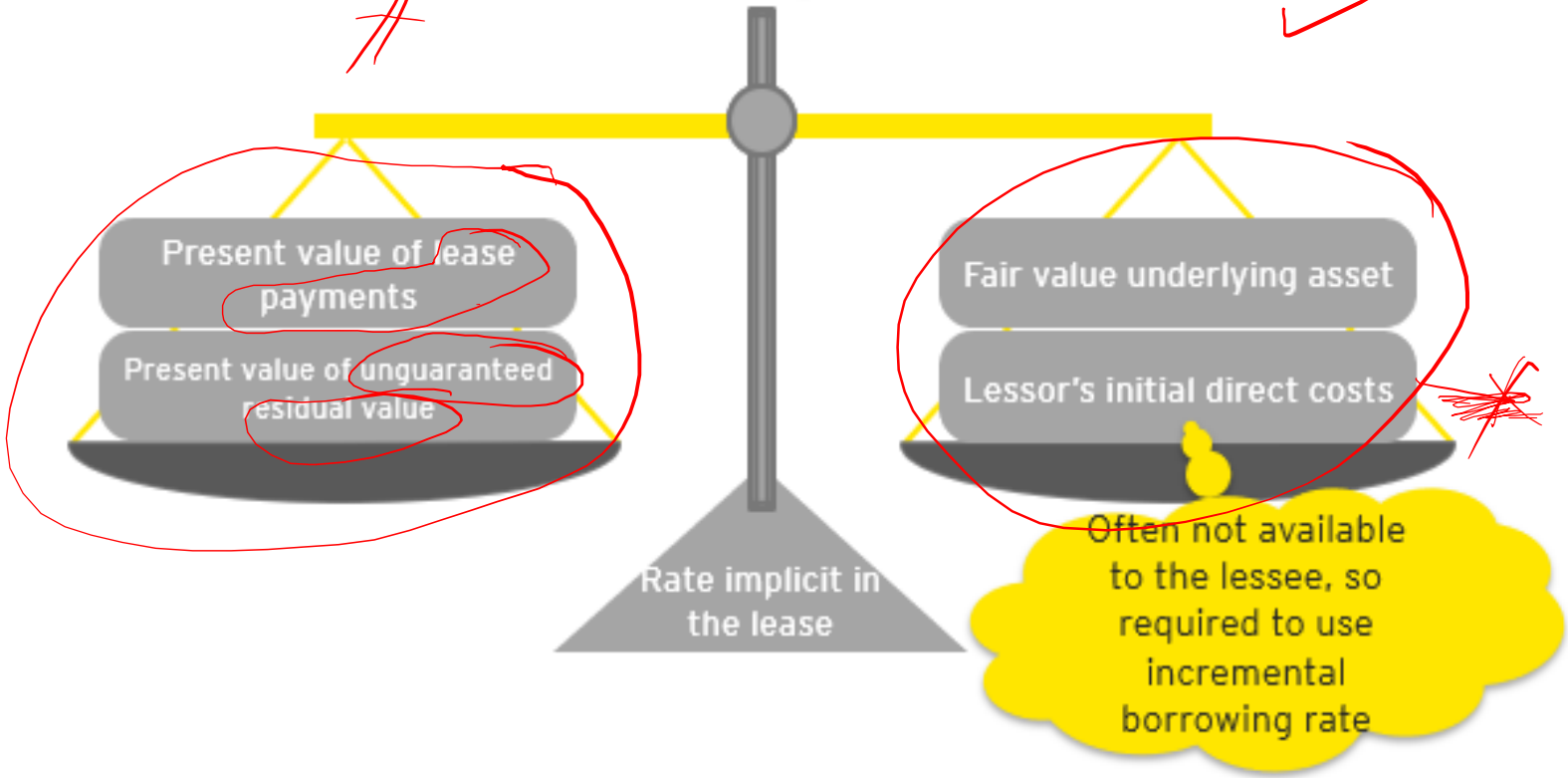
A **residual value guarantee** is a guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount

DISCOUNT RATE

The rate implicit in the lease, if readily available

BUT if not available

The lessee's incremental borrowing rate



RIGHT OF USE (ROU) ASSET – INITIAL MEASUREMENT

At the commencement date of the lease, a lessee recognizes a right-of-use asset at **cost**, comprising:

a) The amount of the initial lease liability recognised;

b) Any lease payments made at or before the commencement date, less any lease incentives; 1000

c) Any initial direct costs incurred; and

Dr cash 1000
Cr ROU asset 1000

d) An estimated of costs to be incurred to dismantle and remove an asset and restore the site based on the terms and conditions of the lease.

SUBSEQUENT MEASUREMENT

Lease liability	▸ Increase the carrying amount to reflect interest on the lease liability ▸ Reduce the carrying amount to reflect the lease payments made ▸ Remeasuring the carrying amount to reflect any reassessment, lease modifications or revised in-substance fixed lease payments.
ROU asset (cost model)	▸ Depreciated in accordance with IAS 16 *Property, Plant & Equipment*. ▸ Depreciation period is the shorter of lease term and useful life (if the lease does not transfer ownership of the underlying asset). ▸ If the lease transfers ownership, depreciation period is the useful life of the underlying asset ▸ Impairment testing under IAS 36 *Impairment* applies.
ROU asset (alternative models)	▸ Revaluation model under IAS 16 may be elected for PPE. ▸ If the lessee uses fair value model under IAS 40 to its investment properties (IP), it must use same model for ROU asset that meets the definition of IP

QUESTION 1

2yrs + 1yr = 3yrs.

On 1 January 2017, Derick Limited entered into a two year lease for a lorry. The contract contains an option to extend the lease term for a further year. Derick believes that it is reasonably certain to exercise this option. Lorries have a useful economic life of ten years.

Lease payments are N10,000 per year for the initial term and N15,000 per year for the option period. All payments are due at the end of the year. To obtain the lease, Derick incurs initial direct costs of N3,000. The lessor reimburses N1,000 of these costs.

Y1 — 10000
Y2 — 10000
Y3 — 15000

The interest rate implicit in the lease is not readily determinable. Derrick incremental borrowing rate is 5%.

3yrs. - lease term

lease payments.

Discount 5%.

Required:

a) Calculate the initial carrying amount of the lease liability and the right-of-use asset and provide the double entries needed to record these amounts in Derick's financial records.

b) Explain, with suitable calculation, the subsequent measurement of the right-of-use asset and lease liability at 31 December 2017.

SEPARATING LEASE AND NON-LEASE COMPONENTS

- A contract may contain both lease and a non-lease components.
- The non-lease contract may be an **executory contract** to the lessee.
- The consideration in the contract should be allocated to each component on the basis of stand-alone price of each component.
- The relative stand-alone price of lease and non-lease components should be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component or similar, component separately.
- As a practical expedient, a lessee may elect, **by class of underlying asset**, not to separate non-lease components from lease components, thus accounting for both as a lease.
- The practical expedient would increase the lease liability recorded at the inception of the lease, which may negatively impact perception of the entity's financial position.
- **Note** – For an item that does not relate to transfer of goods service (e.g. payment for admin), no consideration should be allocated to such item.
  - ✓ Amounts payable for such should be allocated to lease and non-lease components

LEASE AND NON-LEASE COMPONENTS – ILLUSTRATION 5

Assess the following scenarios and identify the lease and non-lease components.

A lessee enters into a three-year lease of equipment, with fixed annual payments of N12,000. The contract itemises the fixed annual payments as follows: N9,000 for rent, N2,500 for maintenance and N500 of administrative tasks.

Analysis:

The contract contains two components - one lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee. Therefore, the total consideration in the contract of N36,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

QUESTION 2

On 1 January 2017, Calacuta Limited entered into a contract to lease a crane for three years. The lessor agrees to maintain the crane during the three year period. The total contract cost is N180,000 (i.e. N60,000 x 3). Calacuta must pay N60,000 each year with the payments commencing on 31 December 2017. Calacuta accounts for non-lease components separately from lease.

If contracted separately, it has been determined that the standalone price for the lease of the crane is N160,000 and the standalone price for the maintenance series is N40,000.

Calacuta can borrow at a rate of 5% per annum.

Required:
Explain how the above will be accounted for by Calacuta in the year ended 31 December 2017.

SHORT TERM LEASES AND LEASE OF LOW VALUE ASSETS

- IFRS 16 allows a lessee to elect not to apply the previously discussed measurement methods to:
  a) Short-term leases - Those having a term of 12 months or less, including the effect of extension options and does not contain a purchase option.
  b) Leases for which the underlying asset is of low value (e.g. telephones, laptop computers, and small items of office furniture).

- A lessee must assess the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased.

- At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, of US$5,000.

[₦387 × $5,000] = ₦1,935,000

- The election for short term leases is by class of asset.

- The election for low value leases can be made on a lease-by-lease basis.

SHORT TERM LEASES AND LEASE OF LOW VALUE ASSETS

- An underlying asset qualifies as low value only if two conditions apply.
  a) The lessee can benefit from using the underlying asset on its own or together with other resources that are readily available to the lessee
  b) The underlying asset is not highly dependent on, or highly interrelated with other assets.

Accounting

- If the election offered to the lessee by IFRS 16 is taken in respect of short-term lease and lease of low value assets, the lease payments associated with those leases should be recognised as an expense on either:
  - ✓ Straight-line basis over the lease term; or
  - ✓ Another systematic basis, provided that basis is more representative of the pattern of the lessee's benefits.

PRESENTATION IN THE BOOKS OF THE LESSEE

Statement of financial Position

Right-of-use assets:

- Present on the face of the statement of financial position either:
  a) Separately from other assets; or
  b) Together with other assets as if they were owned but disclose the line item where they are included in the notes.

- The requirement in (a) does not apply to right-of-use-assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.

Lease liabilities:

- Present either separately from other liabilities or together with other liabilities but disclose the line item in which they are included.

PRESENTATION IN THE BOOKS OF THE LESSEE (CONTD.)

Statement of profit or loss

- Depreciation expense on the ROU asset presented in the appropriate expense category
- Interest expense on the lease liability is presented as a component of finance cost.

Statement of cash flows

- Principal payments on the lease liability is presented as a financing activity
- Payment of interest on lease liability is presented in accordance with the guidance of IAS 7
- Short-term and low-value asset leases and variable lease payments that are not included in the measurement of lease liabilities are classified within operating activities.

LESSOR ACCOUNTING

LESSOR ACCOUNTING – INTRODUCTION

- A lessor must classify its leases as **finance leases** or **operating leases.**
- Lessor classifies a lease as a **finance lease** if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.
- A lease is classified as an **operating lease** if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.
- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.

LESSOR ACCOUNTING – FINANCE OR OPERATING LEASE?

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;
- The lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable.
- The lease term is for the major part of the economic life of the underlying asset
- At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and
- The underlying asset is of such a specialised nature that only the lessee can use it without major modifications.
- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

QUESTION 3

Dulifeed Limited is a lessor and is drawing up a lease agreement for a building.

The building has a remaining useful economic life of 50 years. The lease term, which would commence on 1 January 2010 is for 30 years.

Dulifeed would receive 40% of the asset's value upfront from the lessee. At the end of each of the 30 years, Dulifeed will receive 6% of the asset's fair value as at 1 January 2010.

Legal title at the end of the lease remains with Dulifeed, but the lessee can continue to lease the asset indefinitely at a rental that is substantially below its market value. If the lessee cancels the lease, it must make a payment to Dulifeed to recover its remaining investment.

Required:
Based on IFRS 16, should the lease be classified as an operating lease or finance lease in the books of Dulifeed?

LESSOR ACCOUNTING – INITIAL RECOGNITION AND MEASUREMENT

At the **commencement date**, a lessor must recognise assets held under a finance lease in its SFP and present them as a receivable at an amount equal to the *net investment in the lease*

~~₦~~10m		~~₦9~~m		~~₦1~~m
Lease receivable (Net investment in the lease)	=	**Present value of lease payments**	+	**Present value of unguaranteed residual value**

Lease Receivable ₦10m
Or Prin (profit) ₦2m
Or MV ₦8m

Lease payments				
Fixed payments less lease incentives payable	Variable lease payments that depend on an index or rate	Residual value guarantees provided by the lessee or party related to the lessee or a 3rd party unrelated to the lessor	Exercise price of purchase options (if lessee is reasonably certain to exercise)	Termination penalties if the lease terms reflect that lessee is likely to exercise the option to terminate

Cost ₦10m
Dep. (2m)
NBV ₦8m

- Lease term - Same guidance as for lessees
- Discount rate - Interest rate implicit in the lease
- **Unguaranteed residual value** is the portion of the residual value of the underlying asset, the realisation of which a lessor is not assured or is guaranteed solely by a party related to the lessor

DISCOUNT RATE AND INITIAL DIRECT COST

- The lessor **must** use the interest rate implicit in the lease to measure the net investment in the lease.
-
- Initial direct Initial direct costs (other than those incurred by manufacturer or dealer lessors) are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term.

- The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

QUESTION 4

On 31 December 2011, River Limited leases a machine to Fish Limited on a three year finance lease and will receive N10,000 per year in arrears. Fish has been guaranteed by the lessee that the machine will have a market value at the end of the lease term of N2,000.

The interest rate implicit in the lease is 10%.

Required:
Calculate River's net investment in the lease at 31 December 2011.

FINANCE AND OPERATING LEASE – SUBSEQUENT MEASUREMENT

Finance Lease	Operating Lease
Statement of Financial Position	
▸ Derecognise the underlying asset ▸ Recognise a finance lease receivable	▸ Continue to present the underlying asset ▸ Add any initial direct costs incurred
Statement of Profit or Loss	
▸ Recognise finance income on the receivable based on effective interest method	▸ Recognise lease income over the lease term (typically straight-line) ▸ Expense costs related to underlying asset (eg depreciation)

QUESTION 5

Landmark hires out industrial plant on long-term operating leases. On 1 January 2019, it entered into a seven-year lease on a mobile crane. The terms of the lease are N175,000 payable on 1 January 2019, followed by six rentals of N70,000 payable on 1 January 2020 to 2025. The crane will be returned to Landmark on 31 December 2025. The crane originally cost N880,000 and has a 25 year useful life with no residual value.

Required:
Discuss the accounting treatment of the above in the year ended 31 December 2019.

SALE AND LEASEBACK TRANSACTIONS

- A seller-lessee and a buyer-lessor use the definition of a sale from IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction.

- If the transfer of the underlying asset satisfies the requirements of IFRS 15 to be accounted for as a sale, the transaction will be accounted for as a sale and a lease by both the lessee and the lessor.

- If not, the transaction will be accounted for as a financing arrangement by both the seller-lessee and the buyer-lessor.

SALE AND LEASEBACK SUMMARY

Determine whether the transfer of the asset is a sale

- Apply IFRS 15
- Presence of a leaseback does not preclude a sale

Transfer of the asset is a sale	Transfer of the asset is not a sale
Seller-lessees: ▸ Derecognise the underlying asset ▸ Recognise the sale at fair value ▸ Measure the ROU asset at the retained portion of the previous carrying amount of the underlying asset ▸ Recognise only the gain/loss that relates to the rights transferred to buyer-lessor ▸ Recognise a lease liability	Seller-lessees: ▸ Continue to recognise the transferred asset ▸ Recognise a financial liability equal to transfer proceeds (apply IFRS 9 *Financial Instruments* for subsequent accounting)
Buyer-lessors: ▸ Recognise the transferred asset ▸ Apply lessor accounting to the leaseback	Buyer-lessors: ▸ Do not recognise transferred asset ▸ Recognise a financial asset under equal to transfer proceeds (then apply IFRS 9)

QUESTION 6

On 1 January 2011, Door Limited sells an item of machinery to Window Limited for its fair value of N3 million. The asset had a carrying amount of N1.2 million prior to the sale. This sale represents the satisfaction of a performance obligation, in accordance with IFRS 15 – Revenue from Contracts with Customers. Door enters into a contract with Window for the right to use the asset for the next five years. Annual payments of N500,000 are due at the end of each year. The interest rate implicit in the lease is 10%. .

The present value of the annual lease payments is N1.9 million. The remaining useful economic life of the machine is much greater than the lease term.

Required:
Explain how the transaction will be accounted for on 1 January 2011 by both Door and Window.

SALE AND LEASEBACK TRANSACTIONS NOT AT FAIR VALUE

- If the sales proceeds or lease payments are not at fair value, IFRS 16 requires as follows:
  - ✓ Below market terms (e.g. when the sales proceeds are less than the asset's fair value) are treated as a prepayment of lease payments.
  - ✓ Above market terms (e.g. when the sales proceeds exceed the asset's fair value) are treated as additional financing.

IAS 17 TO IFRS 16 – TRANSITION IMPACT

Lessee operating lease (IAS 17 classification)	Lessee finance lease	Lessor operating lease	Lessor finance lease
Full retrospective	Full retrospective	No adjustment	
Modified retrospective with practical expedients*	Modified retrospective		
High	Medium	Low	

CHALLENGES OF ADOPTING IFRS 16 IN NIGERIA

- Deriving components of determining incremental borrowing rate.
- Non-availability of lease agreements
- Issues around legal interpretation of non-cancellable lease period in Nigeria.
- Difficulty in getting required data
- Diverse interpretation and application of the standard on incremental lease payment for future cash flows in determining lease liability
- Judgement around renewal period for the lease in determining the lease term
- Inadequate training for finance staff on IFRS 16 and other updates on the standard.
- Requirement for new account codes

TOPICS EXCLUDED

- Lease modification
- Reassessment of lease liability
- Accounting for lease payments that depend on index or rates
- Accounting for sub-lease

Thank You

QUESTIONS