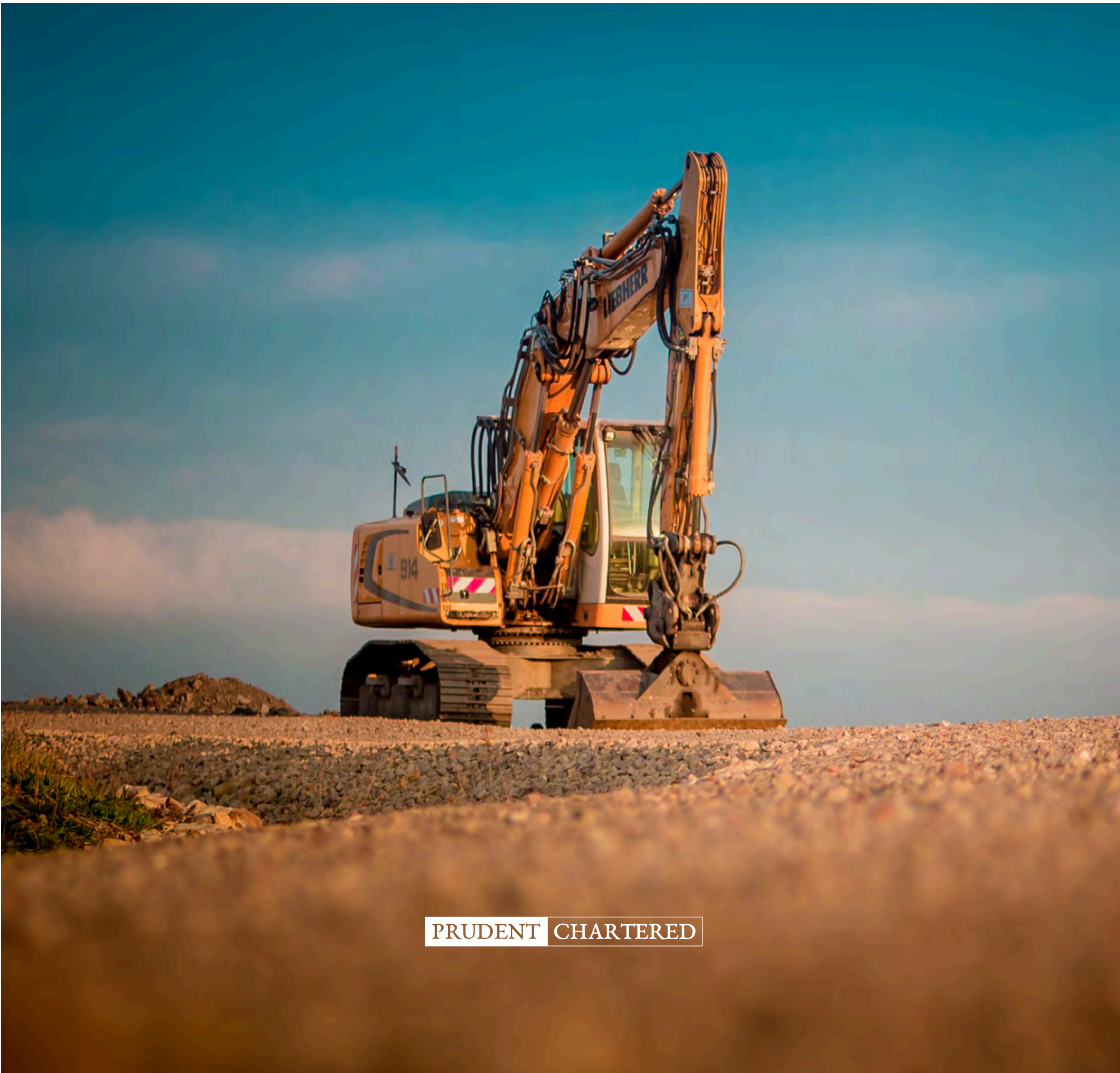
IN BRIEF

IFRS 16 *Leases*:

A Lessee's Perspective



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IFRS 16 *Leases*: A Lessee's Perspective

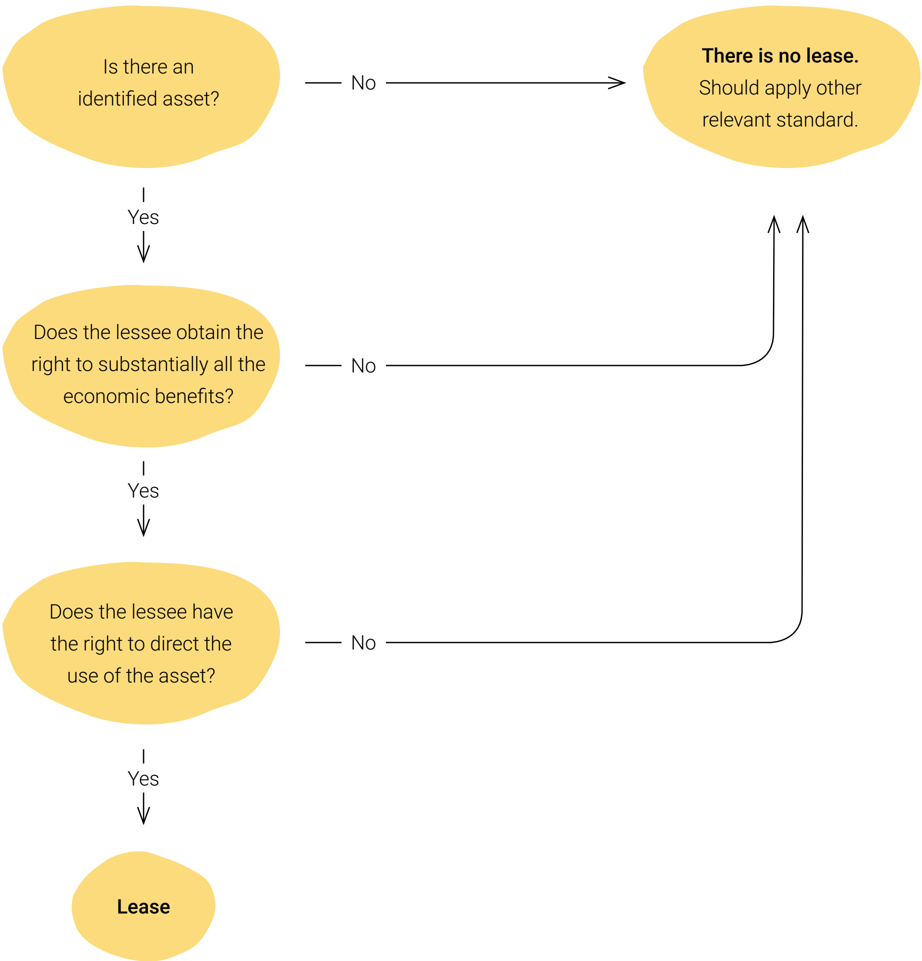
1. Introduction

As the financial statements for the year ended 2019 are currently being prepared and audited, practitioners should already be aware of the new accounting standard IFRS 16 *Leases* that is effective from 1 January 2019. Under the new standard, the most significant impact will be on the treatment of leases by the lessee. The purpose of this publication is to summarise the important changes introduced in IFRS 16 from the perspective of the lessee including the impact on the financial statements.

Under the previous lease standard IAS 17 *Leases*, lessee is required to classify the lease as a finance lease or an operating lease. If the lease is classified as an operating lease, the lessee must record the lease payments as an expense in Income Statement and neither asset nor liability is reported on the entity's balance sheet (they were 'off balance sheet leases'). Under IFRS 16, lessee is not required to distinguish between finance or operating lease and all leases are reported in the balance sheet providing enhanced disclosure to the users of the financial statements.

2. What is a lease?

Under the new standard, the definition of the lease has been slightly changed. As per IFRS 16, a contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. In applying the definition of a lease, there are certain criteria that must be met, as shown below:



In the context of the Maldives, the most common example of leases includes leases of land, offices, godowns, apartments and shops. These leases may have been accounted as operating leases under IAS 17 and thus adopting IFRS 16 in relation to these leases would result in a change in accounting treatment and presentation.

3. Exemptions

There are certain types of leases where a lessee can elect not apply the recognition and measurement requirements of IFRS 16. These exemptions are for the following two types of leases:

- Short Term Leases: A lease, at the commencement date, that has a lease term of 12 months or less and which does not contain a purchase option to buy the leased asset at the end of the lease;
- Low Value Leases: A lease of an asset, with a value of USD 5,000 or less when new, regardless of the age of the asset being leased. This exemption can be applied even if these leases are material to the lessee.

The election for short term leases must be made and consistently applied to all underlying assets in the same class. However, for low value leases, this election can be made on a lease-by-lease basis. Lessees can elect a simplified approach for short term or low value leases by recognising the lease rentals as an expense over the lease term rather than recognising a 'right of use asset' and a lease liability.

4. Accounting for Leases

4.1 Initial Recognition

At the commencement date of the lease, the lessee must recognise a Right-of-Use asset (ROU Asset) and a lease liability. As per the standard, the commencement date is the date on which a lessor makes an underlying asset available for use by a lessee. Therefore, a date on which an agreement is made would not necessarily trigger the recognition of the asset and the liability if the underlying asset is to be made available for use by the lessee on a later date.

4.2 Lease Liability

The lease liability is the present value of lease payments over the lease term. The lease payments must include the components shown in the illustration below. It must be discounted using the interest rate implicit in the lease. However, if the interest rate implicit in the lease cannot be readily determined, the lessee must use the lessee's incremental borrowing rate.

Lease liability

=

Fixed payments *less* Lease Incentive receivable* + Certain variable payments* + Residual value guarantee* + Excercise price of purchase options* + Termination penalties*

* Discounted payments

4.3 Interest rate implicit in the lease

As per IFRS 16, interest rate implicit in the lease is the rate of interest that causes the present value of the lease payments and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and any initial direct costs of the lessor.

When the lessor does not disclose the implicit rate in the contract, the determination of the implicit rate requires information such as fair value of the underlying asset, unguaranteed residual value, and initial direct costs from the lessor. Due to the nature of the information required from the lessor by the lessee, the lessor might not wish to disclose the information required. Therefore, in most cases the lessee will not be able to compute the interest rate implicit in the lease and as such would have to use the incremental borrowing rate in computing the lease liability.

Lessee's incremental borrowing rate is defined in IFRS 16 as "The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of use asset in a similar economic environment". In the Maldivian context the incremental borrowing rate can be the lending rate of the banks or financial institutions charged to acquire an asset of similar value for a similar period, with similar collateral.

4.4 Right-of-Use Asset (ROU Asset)

The Right-of-Use asset (ROU Asset) must comprise the components shown in the illustration below. The Initial direct costs included in the computation of the ROU Asset are the Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained.

Right of Use Asset

=

Lease liability + Initial direct costs + Payments made at or before commencement date + Cost of removal and restoring* - Lease incentives received

* Discounted payments

4.5 Subsequent Measurement - ROU Asset

After the initial recognition of the ROU Asset, the ROU Asset should be measured using the cost model in IAS 16 *Property, Plant and Equipment* by depreciating the asset over the shorter of the lease term or useful life of the asset, while also accounting for any impairment losses (IAS 36) and adjusting for any remeasurements. Where the lease transfers ownership of the underlying asset to the lessee at the end of the lease term or includes a purchase option which lessee is likely to exercise, the asset should be depreciated over the life of the underlying asset.

However, the lessee can follow one of the following measurement models where more appropriate:

- Fair Value Model in IAS 40: If the lessee applies the fair value model in IAS 40 *Investment Property* and ROU asset meets the definition of an Investment Property
- Revaluation Model in IAS 16: If the ROU Asset relates to a class of asset accounted under the revaluation model.

4.6 Subsequent Measurement - Lease Liability

After initial measurement, the lease liability must be subsequently measured by:

- including the Interest on the lease liability,
- deducting the lease payments made to the lessor, and
- adjusting any differences due to remeasurement of the lease liability to reflect any reassessment or lease modifications*

* Remeasurement of a lease due to lease modifications are required where certain conditions are met.

5. How it applies in practice

A lessee enters into an agreement to lease a land in an island for 10 years. The agreement was signed on 1 January 2019 and on the same day, the land was handed over to the lessee. Lease payments are MVR 600,000 per annum payable at the beginning of each year. To obtain the lease, the lessee incurred initial direct costs of MVR 25,000 as legal fee which was paid in cash on 1 January 2019. The interest rate implicit in the lease is 6%. Here's how the lease should be accounted in the lessee's books.

5.1 Recognizing the Lease Liability and ROU Asset

At the commencement of the lease (i.e. 1 January 2019) the lease liability and ROU must be computed. The lease liability would be the present value of the lease payments for the remaining 9 years calculated using the discount rate of 6%. As the rent is paid in advance on 1 January each year, the rent for 2019 would not be included in the computation of the lease liability as this would have been paid on 1 January 2019. The present value will be MVR 4,081,015.

After computing the lease liability, the ROU asset must be calculated as follows:

	MVR
Lease liability	4,081,015
Payments made at commencement	600,000
Direct Cost	25,000
Amount initially recognised as ROU asset	**4,706,015**

This will be recorded as follows:

Account	Dr MVR	Cr MVR
Right-of-Use Asset (ROU Asset)	4,706,015	
Lease Liability		4,081,015
Bank/Cash		600,000[1]
Bank/Cash		25,000[2]

[1] Payments made at commencement

[2] Initial direct cost

5.2 Subsequent Measurement of ROU Asset

The ROU asset would be depreciated over the lease term, which is 10 years. Therefore, the depreciation amount would be MVR 470,601.50 per year. Depreciation entry should be as follows:

Account	Dr MVR	Cr MVR
Depreciation Expense	470,601.50	
Accumulated depreciation of right-of-use asset		470,601.50

Financial Year	Year	ROU Asset b/f	Depreciation expense	ROU Asset c/f
		A	B	C=(A-B)
2019	1	4,706,015.00	470,601.50	4,235,413.50
2020	2	4,235,413.50	470,601.50	3,764,812.00
2021	3	3,764,812.00	470,601.50	3,294,210.50
2022	4	3,294,210.50	470,601.50	2,823,609.00
2023	5	2,823,609.00	470,601.50	2,353,007.50
2024	6	2,353,007.50	470,601.50	1,882,406.00
2025	7	1,882,406.00	470,601.50	1,411,804.50
2026	8	1,411,804.50	470,601.50	941,203.00
2027	9	941,203.00	470,601.50	470,601.50
2028	10	470,601.50	470,601.50	

5.3 Subsequent Measurement of Lease Liability

Amortised table should be prepared as shown below and the relevant entries should be passed.

Financial Year	Year	Lease liability b/f	Lease payment	Interest	Lease liability c/f
		A	B	C=(A-B)*Interest%	D=(A-B+C)
2019	1	4,081,015		244,861.00	4,325,876
2020	2	4,325,876	600,000	223,553.00	3,949,429
2021	3	3,949,429	600,000	200,966.00	3,550,395
2022	4	3,550,395	600,000	177,024.00	3,127,419
2023	5	3,127,419	600,000	151,645.00	2,679,064
2024	6	2,679,064	600,000	124,744.00	2,203,808
2025	7	2,203,808	600,000	96,228.00	1,700,036
2026	8	1,700,036	600,000	66,002.00	1,166,038
2027	9	1,166,038	600,000	33,962.00	600,000
2028	10	600,000	600,000		

Note: In cases where the lease payments are payable monthly, the amortisation table must be prepared on a monthly basis and thereby computing the interest expense monthly.

Year 1

Recognise the Interest on the Lease Liability:

Account	Dr MVR	Cr MVR
Interest Expense	244,861	
Lease Liability		244,861

At the end of each year the lease amount payable in the following year should be shown as a current liability. At the end of Year 1 the lease liability will be shown in the balance sheet as follows:

Balance Sheet Extract

Current Liability	
Lease Liability	MVR 376,447 (4,325,876 - 3,949,429)
Long term Liability	
Lease Liability	MVR 3,949,429
Total of the above:	MVR 4,325,876 (which is the Year 1 end balance in the amortisation table)

6. Transitional Accounting

There are two methods allowed in the application of IFRS 16 by the lessee in the transitional period, which are explained below. The election made must be applied consistently for all leases.

6.1 Retrospective Approach

Under this approach, an entity will prepare the Financial Statements by recognizing the Lease Liability and ROU Asset as if the standard has always been applied. Therefore, the entity will retrospectively restate the prior reporting period, in line with IAS 8 *Accounting Policies, changes in accounting estimates and errors.*

6.2 Modified Retrospective Approach

Under this approach an entity will apply the new standard from the first day of the reporting period in which the standard is initially applied. This would mean that comparatives will not be restated and as required under IAS 17 all operating lease expenses will be expensed. The cumulative effects of the initial application of the standard in the year 2019 will be shown as an adjustment to Retained Earnings as at 1 January 2019.

There are two methods by which the Modified Retrospective Approach can be applied.

a) Modified Retrospective Method 1:

In this approach, lease liability should be calculated at the initial application date using the lessee's current incremental borrowing rate. The ROU Asset will be the same as the lease liability amount. However, if there are any prepaid or accrued lease payments recognised in the previous year balance sheet under IAS 17, this amount should be adjusted in determining the ROU asset.

b) Modified Retrospective Method 2:

In this approach, ROU asset must be computed on a retrospective basis considering IFRS 16 have always been applied. But the ROU asset should be computed by using the prevailing incremental borrowing rate as at the date of initial application. After that, the amount should be amortized up to the beginning of the date of the initial application and recognised as the ROU in the financial statement. In this approach, Lease liability will be the same as computed in method 1. Any differences in ROU asset and Lease liability should be adjusted to retained earnings.

6.3 Comparison of the both approaches

Transitional Approach	Current Year	Comparatives	Comparability
Retrospective Approach	IFRS 16	IFRS 16	Yes
Modified Retrospective Approach	IFRS 16	IAS 17	No

7. Rent Concessions related to COVID-19

As a result of the COVID-19 pandemic, lessees have been offered, or are expected to be offered, rent concessions in the form of rent holidays, deferment of rent payments and/or lower lease payments by lessors as a means of providing some relief. Under IFRS 16, any change in the lease should be assessed for lease modification and if the conditions are met, it should be accounted for as required under the lease modification treatment. Due to the concerns of lessees in assessing and accounting for the lease modification in this difficult time, International Accounting Standards Board (IASB) has proposed some changes to IFRS 16 and issued an exposure draft *Covid-19-Related Rent Concessions* (ED/2020/2) on 24 April 2020. The amendment proposes to permit lessees not to assess whether particular COVID-19-related rent concessions are lease modifications if specified conditions in the amendment are met. Instead, lessees can account for those rent concessions as if they were not lease modifications. The exposure draft proposes no change for lessors.

The IASB have finalised the proposal in the exposure draft with some modifications during the meeting held on 15 May 2020. The IASB expects to issue the amendment on or around 28 May 2020.

As the proposed amendment applies to rent concession occurring as a direct consequence of Covid-19 pandemic, it would not impact the financial statements ending 31 December 2019 or an earlier date. For more details on accounting aspects with respect to COVID-19, refer to our previous article on "The Impact of Coronavirus on Financial Reporting".

8. What about Entities following IFRS for SMEs?

As *IFRS for SMEs* has not been changed after the issuance of IFRS 16, entities that prepare financial statements under *IFRS for SMEs* still have to follow the rules in the current standard and thus will have no changes in accounting for lease.

9. Summary

IFRS 16 has a major change in accounting for leases by lessee as all the leases (excluding the ones that fall in the exemption) are now required to be recognised as an asset and a liability. Further, instead of a lease expense, the lessee must recognise interest cost and depreciation of the ROU asset in the profit and loss account. Even though the yearly amounts expensed in the profit and loss account under IFRS 16 will be different than in the amount expensed under IAS 17 the net effect will be the same when the whole lease term is considered. In addition, the presentation requirements in IFRS 16 will affect almost all financial ratios such as EBITDA, Current Ratio, Asset Turnover, Gearing Ratio, interest cover, etc. The entities with material off balance sheet lease commitments will be significantly affected. Further, recognition of interest on these leases will also have an impact on the tax liability of businesses as these interests are subject to Thin Capitalisation Rules under the Income Tax Act.

Further information

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THE FIRM

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