ICAEW KNOW-HOW
AUDIT AND ASSURANCE FACULTY

IFRS 16 LEASES

GUIDE

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Financial Reporting Faculty outlines some of the key requirements of IFRS 16 *Leases* for lessees and lessors. Key differences when reporting leases under FRS 102 are also described.

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1. How, in a nutshell, does the lessee accounting model work?

IFRS 16 sets out a single lessee accounting model that requires assets and liabilities arising from almost all major lease arrangements to be recognised on-balance sheet.

It describes a 'right of use' model under which lessees will recognise an asset reflecting their right to use the leased asset for the lease term and a lease liability reflecting their obligation to make lease payments. Both the asset and the liability are recognised on-balance sheet at the commencement of the lease.

2. What is the definition of a lease?

IFRS 16 defines a lease as a contract that ‘conveys the right to control the use of an identified asset for a period of time in exchange for consideration’.

To assess whether a contract is or contains a lease, an entity must assess whether, throughout the period of use, the customer has both:

- The right to obtain substantially all the economic benefits from use of the identified asset; and
- The right to direct the use of the identified asset.

3. How is the lease liability measured and subsequently accounted for?

The lease liability is initially calculated at the present value of the lease payments, discounted at the rate the lessor charges the lessee or, if this cannot be readily determined, the lessee’s incremental borrowing rate. In subsequent years the reported liability is increased by the unwinding of the discount and reduced by lease payments made to the lessor.

4. How is the right-of-use asset measured and subsequently accounted for?

The value of the right-of-use asset is initially calculated as:

- the amount of the initial measurement of the lease liability, as described above;
- any lease payments made to the lessor before the commencement date, less any lease incentives received;
- any initial direct costs incurred by the lessee; and
- an estimate of any costs of dismantling, removing or restoring the underlying asset or restoring the site on which it is located when appropriate.

This asset will then be amortised over the life of the lease and tested for impairment when appropriate. A lessee can choose to revalue such assets.

5. Does this apply to all leases?

No. While this approach applies to most major leases, there are important exemptions for leases with a term of less than 12 months and for low value leases. Certain leases are also beyond the scope of the standard, for example leases of biological assets within the scope of IAS 41 *Agriculture*.

6. How do lessors account for leases?

IFRS 16’s definition of a lease applies to both lessees and lessors, however a lessor classifies its leases as finance or operating leases. If substantially all the risks and rewards incidental to ownership are transferred to the lessee, the lease is accounted for as a finance lease ie, it will be recognised as a lease receivable and the underlying asset derecognised; finance income attributable to the lease receivable will be recognised in profit or loss. A lease not accounted for as a finance lease is accounted for as an operating lease ie, the underlying asset will continue to be recognised on balance sheet together with any associated depreciation and impairment; any rental income will be recognised in profit or loss.

Intermediate lessors, however, face more complex accounting requirements as they must account for the head lease and the sub-lease as two separate contracts.

7. Does IFRS 16 apply to service contracts?

No. IFRS 16 does not apply to service contracts; nor does it change the way in which services are accounted for. This is a challenging area for those preparing financial statements as a lease and related services – such as maintenance of the asset – are often combined in a single contract. In such circumstances, the lessee will normally need to separate the contract into its lease and non-lease components. However, there is a practical expedient which permits an entity to elect to not separate non-lease components.

8. In summary, what are the disclosure requirements for lessees?

There are significant disclosure requirements with the objective of helping users better understand an entity's leasing activities and their impact on its financial position, financial performance and cash flows. A lessee is required to disclose information on lease depreciation, lease interest expense, additions to and carrying value of right-of use assets and lease cash outflows. Additional disclosures may be required depending upon sub-leasing arrangements, sale and leaseback transactions, variable lease payments and investment properties.

9. What is a lease modification and how does IFRS 16 deal with these?

Lease modifications are a change in scope or consideration for the lease that was not part of the original terms and conditions. Under IFRS 16, this results in a reassessment of the right-of-use asset and lease liability based on revised lease payments and discount rate.

10. Is there any accounting relief available for lease modifications related to Covid-19?

Should a leasing arrangement change as a direct result of the Covid-19 pandemic there is a practical expedient available which allows a simpler solution. Rather than treating this as a lease modification, it allows a straightforward reduction to the liability and a credit to the profit or loss in the period to which it relates. There are further conditions attached to this practical expedient as well as additional disclosure requirements described in *Amendment to IFRS 16 – Covid-19-Related Rent Concessions*.

11. Who is most affected by IFRS 16?

The impact varies from sector to sector and from entity to entity. It is likely to be most pronounced in those business sectors – such as transport, retail, real estate, financial services, mining and construction – where it is common for entities to have a significant number of material leases. Entities with significant leased premises are particularly affected.

12. What are the key differences between IFRS 16 and accounting for leases under FRS 102?

The most significant difference is the increased number of both lease assets and lease liabilities recognised on lessees' balance sheets. This results in significant differences to some key financial metrics such as gearing.

There is also a difference on the numbers reported in profit or loss. The typical straight-line operating lease expense in FRS 102 is replaced with a depreciation charge on the lease asset and an interest expense on the lease liability.

The difference in lease accounting does not, of course, cause a change in total cash flows, excluding any tax implications, because there is no difference in the economics. There may, however, be differences in how cash flows appear in the cash flow statement. Many entities reporting under FRS 102 classify cash outflows associated with operating leases as operating cash flows, whereas under IFRS 16 principal payments of lease liabilities appear as cashflows from financing activities.

13. Will FRS 102 be updated for IFRS 16?

The FRC has started the next periodic review of FRS 102 and has stated that the review will consider recent developments in financial reporting (such as changes in IFRS). Harmonisation of FRS 102 with IFRS is a long-term aim and this periodic review may be the point at which the FRC decide to incorporate the principles of IFRS 16. Further evidence-gathering and analysis needs to be undertaken by the FRC before they determine the appropriate timetable and approach to reflect the principles into FRS 102. The effective date for any changes to FRS 102 is expected to be 1 January 2024.

14. Are there any additional ICAEW resources available to help companies apply IFRS 16?

The Financial Reporting Faculty has produced a range of resources to guide members on all aspects of IFRS 16. This guidance, including webinars, can be found at icaew.com/ifrs16. A factsheet on IFRS 16 *Leases* is available to Financial Reporting Faculty subscribers, which provides further information and practical tips. The faculty will continue to review the need for further information for ICAEW members.

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