A BASIC GUIDE TO IFRS 16 LEASES

LEASE
TRACKER

What is IFRS 16?

IFRS 16, which became effective on January 1, 2019, introduced a comprehensive model for lease accounting. It requires lessees to recognise most leases on their balance sheets. Key aspects include:

1. **Lease Liability and Right-of-Use Asset**: Under IFRS 16, a lessee must recognise a lease liability representing its obligation to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term.
2. **Measurement**: The lease liability is initially measured at the present value of lease payments to be paid at the commencement date, discounted using the interest rate implicit in the lease, if that rate can be readily determined. If not, the lessee's incremental borrowing rate is used. The right-of-use asset is initially measured at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, initial direct costs, and an estimate of restoration costs.
3. **Subsequent Measurement**: The right-of-use asset is depreciated, typically on a straight-line basis, and the lease liability is increased by the interest expense and decreased by lease payments made.
4. **Impact on Balance Sheet**: This approach results in higher assets and liabilities on the balance sheet compared to previous standards, affecting key financial ratios such as leverage and return on assets.

Straight-Line Lease Recognition (Pre-IFRS 16)

Before IFRS 16, many leases were classified as operating leases under **IAS 17** and were recognised on a straight-line basis in the income statement. This method is now largely obsolete for lessees but is useful for understanding historical comparisons:

1. **Operating Leases**: Under IAS 17, operating leases were recognised off-balance sheet. Lease payments were recognised as an expense on a straight-line basis over the lease term, even if the payments were not made on such a basis.
2. **Straight-Line Method**: This method involved spreading the total lease expense evenly over the lease term. For example, if lease payments were R10,000 in the first year, R15,000 in the second, and R20,000 in the third, the total lease expense would be recognised at R15,000 per year.
3. **Impact on Balance Sheet**: A creditor for the straight-line expense versus actual lease payment.

Key Differences

1. **Balance Sheet Recognition**: IFRS 16 requires leases to be recognised on the balance sheet, significantly affecting financial statements and ratios, while the straight-line method under IAS 17 did not.
2. **Lease Expenses**: IFRS 16 leads to front-loaded lease expenses due to interest expense on the lease liability, whereas the straight-line method spread expenses evenly. Depreciation on the Right-of-Use Asset is recognised on a straight-line method over the useful life of the asset.
3. **Transparency**: IFRS 16 increases transparency and comparability by bringing leases onto the balance sheet.

In summary, IFRS 16's approach fundamentally changes lease accounting by recognising leases on the balance sheet and providing a more accurate representation of a company's financial position and obligations. The straight-line method under the previous standard offered simplicity but lacked the transparency and comprehensiveness of IFRS 16.

Determining the discount rate

Determining the appropriate discount rate under IFRS 16 is crucial as it impacts the measurement of lease liabilities and right-of-use assets. Here are the key steps and considerations for determining the discount rate:

Key Steps:

1. **Identify the Interest Rate Implicit in the Lease (IRIL)**:
   - The interest rate implicit in the lease is the rate 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.
   - If the IRIL can be readily determined from the lease agreement, it should be used.
2. **Use the Lessee's Incremental Borrowing Rate (IBR)**:
   - If the IRIL cannot be readily determined, the lessee should use its incremental borrowing rate.
   - The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow, over a similar term and with similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

Considerations for Determining the Incremental Borrowing Rate (IBR):

1. **Economic Environment**:
   - Consider the economic environment in which the lessee operates. This includes the country, currency, and prevailing economic conditions.
2. **Term of the Lease**:
   - The rate should match the term of the lease. Short-term leases typically have different rates compared to long-term leases.
3. **Security**:
   - The rate should reflect the nature and quality of the security offered. Leases secured against high-value assets might attract lower rates compared to unsecured leases.
4. **Lessee's Credit Risk**:
   - The lessee’s own credit rating and risk profile must be considered. Higher credit risk typically results in higher borrowing rates.
5. **Current Borrowing Rates**:
   - Review current market borrowing rates for similar financing arrangements. This can include obtaining rates from financial institutions or using internal finance rates if the lessee has recent borrowing experience.

Practical Steps to Determine IBR:

1. **Gather Market Data**:
   - Collect information on current borrowing rates from banks, financial institutions, or public financial data sources for similar terms and conditions.
2. **Adjust for Lease-Specific Factors**:
   - Adjust the market rates for lease-specific factors such as the term, security, and lessee’s credit risk.
3. **Consult with Financial Advisors**:
   - In complex scenarios, consulting with financial advisors or using internal treasury department expertise can help ensure accuracy.

Example Calculation:

1. **Market Rate for Similar Borrowing**: Assume a lessee can borrow at 5% for a similar term and security.
2. **Adjust for Lease Term**: If the lease term is shorter than the typical borrowing term, adjust the rate upwards, say to 5.2%.
3. **Adjust for Credit Risk**: If the lessee has a slightly higher credit risk compared to market participants, adjust the rate to 5.5%.

The resulting rate of 5.5% would be the lessee's incremental borrowing rate to use for discounting lease liabilities.

Summary:

To determine the appropriate discount rate under IFRS 16, first seek the interest rate implicit in the lease. If unavailable, use the lessee’s incremental borrowing rate, considering factors such as the economic environment, lease term, security, and the lessee’s credit risk. This ensures the lease liabilities and right-of-use assets are accurately measured.

Lease Options and Modifications

When dealing with leases that include options for continuation, such as renewal or extension options, lessees must consider several factors under IFRS 16 to determine whether these options should be accounted for as part of the initial lease term or as lease modifications. Here are the key considerations:

Determining the Lease Term:

1. **Non-cancellable Period**: Start with the non-cancellable period of the lease.
2. **Optional Periods**: Include periods covered by options to extend or terminate the lease if the lessee is reasonably certain to exercise the extension option or not to exercise the termination option.

Considerations for Lease Continuation (Including Optional Periods):

1. **Economic Incentives**:
    - Evaluate economic incentives that might make the lessee reasonably certain to exercise the renewal option. These could include:
        - Favourable lease terms compared to market rates.
        - Significant leasehold improvements that would have to be abandoned if the lease is not renewed.
        - Costs associated with relocating or finding a new lease.
2. **Strategic Importance**:
    - Consider the strategic importance of the leased asset. For example, if the asset is crucial for business operations, the lessee may be more likely to continue the lease.
3. **Contractual Terms**:
    - Review the terms of the lease contract to understand any penalties or costs associated with non-renewal or termination.
4. **Historical Behaviour**:
    - Look at the lessee’s historical behaviour regarding lease renewals and terminations. Past actions can provide insight into future decisions.

5. **Plans and Intentions**:
   - Consider the lessee’s plans and intentions for the leased asset. Management’s stated plans for the asset can be a strong indicator.

Lease Modifications:

If there is a change in the lease term (e.g., an extension or renewal not initially included in the lease term), it is considered a lease modification. Here are the key considerations:

1. **Reassessment of Lease Liability**:
   - When a lease modification occurs, the lease liability must be remeasured using a revised discount rate as of the effective date of the modification.
2. **Adjustment of Right-of-Use Asset**:
   - The right-of-use asset is adjusted to reflect the remeasurement of the lease liability. This adjustment is generally made against the carrying amount of the right-of-use asset without affecting profit or loss.
3. **Modification Accounting**:
   - Depending on the nature of the modification, it can be accounted for as a separate lease (if it increases the scope of the lease by adding the right to use one or more underlying assets and the consideration for the lease increases commensurate with the standalone price) or as a modification of the existing lease.

Examples:

1. **Continuation Scenario**:
   - A lessee has a 5-year lease with an option to extend for another 5 years. If the lessee is reasonably certain to exercise the option due to favourable terms and strategic importance, the lease term is 10 years.
2. **Modification Scenario**:
   - If after 3 years, the lessee negotiates a new 3-year extension with revised terms, this modification would be accounted for by remeasuring the lease liability and adjusting the right-of-use asset accordingly.

Summary:

When considering lease continuation versus modification, lessees must evaluate factors such as economic incentives, strategic importance, contractual terms, historical behaviour, and future plans. For continuation, these factors help determine the lease term. For modifications, changes in lease terms are remeasured and accounted for based on IFRS 16 guidelines, ensuring accurate reflection in financial statements.

Lease Cancellation and Early Termination

Yes, a lease cancellation clause can affect the IFRS 16 recognition of the lease liability. Here's how such clauses are considered under IFRS 16:

Impact of Cancellation Clauses on Lease Term and Liability:

1. **Lease Term Determination**:
    - The lease term is a critical factor in recognising lease liabilities under IFRS 16. It includes the non-cancellable period of the lease, plus 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.
    - If a lease includes a cancellation clause, the lessee must assess whether they are reasonably certain to exercise the cancellation option.
2. **Reasonable Certainty**:
    - The term "reasonably certain" is a high threshold and requires the lessee to consider all relevant facts and circumstances that create an economic incentive to either continue or cancel the lease. This includes:
        - Contractual terms and conditions for the optional periods compared with current market rates.
        - Significant leasehold improvements expected to have a substantial economic benefit for the lessee.
        - Costs relating to the termination of the lease, such as relocation or search costs for a new lease.
        - The importance of the underlying asset to the lessee's operations.
        - The lessee's past practice regarding the period over which they have typically used similar assets.
3. **Initial Recognition**:
    - If the lessee is reasonably certain to exercise the cancellation clause, the lease term would exclude the periods after the cancellation date. This impacts the initial recognition of the lease liability, as it will be based on the shorter lease term.
    - Conversely, if the lessee is not reasonably certain to exercise the cancellation clause, the lease term would include the periods up to the potential cancellation date.

Example Scenario:

Lease Terms:

- A 10-year lease with a non-cancellable period of 5 years.

- A cancellation clause allows the lessee to terminate the lease after 5 years without penalty.

Assessment:

- The lessee must evaluate whether they are reasonably certain to exercise the cancellation option at the 5-year mark.
- If the lessee determines they are reasonably certain to exercise the option due to, for example, high relocation costs or favourable terms at another location, the lease term would be considered 5 years.
- If the lessee is not reasonably certain to exercise the option, perhaps due to significant leasehold improvements made to the current location, the lease term would be 10 years.

Recognition:

- **5-Year Term**: The lease liability is calculated based on the lease payments for the 5-year non-cancellable period.
- **10-Year Term**: The lease liability is calculated based on the lease payments for the entire 10-year period.

Reassessment:

1. **Reassessment of Lease Term**:
   - The lease term should be reassessed if there is a significant event or change in circumstances that is within the control of the lessee and affects the lessee's ability to exercise (or not to exercise) the option to terminate the lease.
2. **Impact on Lease Liability**:
   - Any reassessment of the lease term due to changes in the certainty of exercising the cancellation clause would result in a remeasurement of the lease liability using a revised discount rate as of the effective date of the reassessment.

Summary:

Cancellation clauses do affect the IFRS 16 recognition of lease liabilities. Lessees must assess whether they are reasonably certain to exercise such clauses when determining the lease term. This assessment impacts the initial measurement of the lease liability and the right-of-use asset. Regular reassessments are required if significant changes occur that affect the lessee’s certainty regarding the exercise of the cancellation option.

Lease Example

Let's create an illustrative example under IFRS 16 for a lease with a step-up in payments during the initial 5-year term.

Example Scenario:

Lease Terms:

- Lease commencement date: January 1, 2024
- Lease term: 5 years (non-cancellable period)
- Lease payments:
  - Year 1: R10,000 per year
  - Year 2: R12,000 per year
  - Year 3: R14,000 per year
  - Year 4: R16,000 per year
  - Year 5: R18,000 per year
- No renewal or termination options
- Lessee's incremental borrowing rate: 6% per annum

Step-by-Step Calculation:

1. **Calculate the Lease Liability**:

The lease liability is the present value of the lease payments, discounted at the lessee’s incremental borrowing rate.

Lease Payment Schedule:

- Year 1: R10,000
- Year 2: R12,000
- Year 3: R14,000
- Year 4: R16,000
- Year 5: R18,000

Present Value Calculation:

The formula for present value (PV) of a single future lease payment (P) is: PV=P(1+r)^n where r is the discount rate (incremental borrowing rate), and n is the number of years until the payment.

Let's calculate the present value of each payment:

- Year 1: PV=10,000(1+0.06)1=10,0001.06=9,434.91
- Year 2: PV=12,000(1+0.06)2=12,0001.1236=10,678.89
- Year 3: PV=14,000(1+0.06)3=14,0001.191016=11,754.58
- Year 4: PV=16,000(1+0.06)4=16,0001.262477=12,675.02

- Year 5: PV=18,000(1+0.06)5=18,0001.338226=13,453.91

Total Lease Liability:
PVtotal=9,434.91+10,678.89+11,754.58+12,675.02+13,453.91=57,997.31

So, the initial lease liability to be recognised on January 1, 2024, is R57,997.31.

2. **Calculate the Right-of-Use Asset**:

The right-of-use asset initially equals the lease liability adjusted for any lease prepayments, initial direct costs, and lease incentives received. For simplicity, let's assume there are no adjustments.

Initial Right-of-Use Asset: Right-of-Use Asset = Lease Liability = R57,997.31

3. **Subsequent Measurement**:

Lease Liability: The lease liability is reduced by lease payments and increased by interest expense over the lease term.

Yearly Breakdown:

- **Interest Expense for Year 1**: 57,997.31×0.06=3,479.84
- **Lease Payment for Year 1**: 10,000
- **Lease Liability at End of Year 1**: 57,997.31+3,479.84−10,000=51,477.15

Repeat similar calculations for subsequent years:

- **Interest Expense for Year 2**: 51,477.15×0.06=3,088.63
- **Lease Payment for Year 2**: 12,000
- **Lease Liability at End of Year 2**: 51,477.15+3,088.63−12,000=42,565.78
- **Interest Expense for Year 3**: 42,565.78×0.06=2,553.95
- **Lease Payment for Year 3**: 14,000
- **Lease Liability at End of Year 3**: 42,565.78+2,553.95−14,000=31,119.73
- **Interest Expense for Year 4**: 31,119.73×0.06=1,867.18
- **Lease Payment for Year 4**: 16,000
- **Lease Liability at End of Year 4**: 31,119.73+1,867.18−16,000=16,986.91
- **Interest Expense for Year 5**: 16,986.91×0.06=1,019.21
- **Lease Payment for Year 5**: 18,000
- **Lease Liability at End of Year 5**: 16,986.91+1,019.21−18,000=6.1216,98
  (Essentially zero, considering rounding errors).

Right-of-Use Asset: Depreciate the right-of-use asset on a straight-line basis over the lease term:

- **Annual Depreciation**: 57,997.315/5=11,599.46 per year.

Summary:

- **Initial Lease Liability**: R57,997.31
- **Initial Right-of-Use Asset**: R57,997.31

Subsequent Yearly Entries:

- **Year 1**:
  - Interest Expense: R3,479.84
  - Depreciation Expense: R11,599.46
  - Lease Payment: R10,000
- **Year 2**:
  - Interest Expense: R3,088.63
  - Depreciation Expense: R11,599.46
  - Lease Payment: R12,000
- **Year 3**:
  - Interest Expense: R2,553.95
  - Depreciation Expense: R11,599.46
  - Lease Payment: R14,000
- **Year 4**:
  - Interest Expense: R1,867.18
  - Depreciation Expense: R11,599.46
  - Lease Payment: R16,000
- **Year 5**:
  - Interest Expense: R1,019.21
  - Depreciation Expense: R11,599.46
  - Lease Payment: R18,000

This example demonstrates how to account for a lease with step-up payments under IFRS 16, including the initial recognition and subsequent measurement of the lease liability and right-of-use asset.

ARE YOU STRUGGLING TO KEEP UP WITH THE REQUIREMENTS OF IFRS 16 LEASE ACCOUNTING?

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