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A Digital Learning Platform for Generation Z:
Passport to IFRS®

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# IFRS® Standard 16 Leases

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# IFRS® Standard 16 Leases

## SCOPE AND KEY DEFINITIONS

IFRS Standard 16 Leases sets out the principles for the recognition, measurement, presentation, and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents lease transactions. This information provides a basis for the users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of an entity.
An entity shall consider the terms and conditions of contracts and all relevant facts and circumstances when applying IFRS Standard 16 Leases. An entity shall apply this Standard consistently to contracts with similar characteristics and under similar circumstances.

An entity shall apply this Standard to all leases, including leases of right-of-use assets in a sublease, except for:

(a) Leases involving the exploration or use of minerals, oil, natural gas, and similar non-regenerative resources;

(b) Leases involving biological assets held by a lessee within the scope of IAS Standard 41 Agriculture;

(c) Service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements;

(d) Licences regarding intellectual property granted by a lessor within the scope of IFRS Standard 15 Revenue from Contracts with Customers; and

(e) Rights held by a lessee under licensing agreements within the scope of IAS Standard 38 Intangible Assets regarding such items as motion 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 Paragraph (e).

The key definitions in IFRS Standard 16 Leases are listed in Table 1 as follows.

**Table 1 Key definitions to IFRS 16**

| Term | Definition |
|---|---|
| Lease | A contract or part of a contract that conveys a right-of-use of an asset (the underlying asset) for a period of time in exchange for a consideration. |
| Finance lease | A lease that transfers all the substantial risks and rewards incidental to ownership of an underlying asset. |
| Operating lease | A lease that does not transfer all the substantial risks and rewards incidental to ownership of an underlying asset. |
| Lessee | The entity that obtains the right-of-use of an underlying asset for a period of time in exchange for a consideration. |
| Lessor | The entity that provides the right-of-use of an underlying asset for a period of time in exchange for a consideration. |

## RECOGNITION AND MEASUREMENT

Before discussing how accounting addresses leases, firstly considering the valid business reasons for entering into a lease agreement is important. To imply that the only reason companies lease property is to avoid reporting the lease obligation in their financial statements would be unfair and incorrect. Although the accounting ramifications are an important consideration in structuring a deal as a lease, other financial and tax considerations also play an important role in the leasing decision.

Every situation is different, but the lessee has three primary advantages to lease over purchasing:

**1. No down payment**

Most debt-financed purchases of property require a portion of the purchase price to be paid immediately by the borrower. This provides added protection to the lender in the event of default and repossession. In contrast, lease agreements frequently are structured so that 100% of the value of the property is financed through the lease. This aspect of leasing makes it an attractive alternative to a company that does not have sufficient cash for a down payment or that wishes to use available capital for other operating or investment purposes. Of course, many leases also require a down payment; as an example, look carefully at the fine print the next time you see a car lease advertisement on television.

**2. Avoid the risks of ownership**

Many risks accompany property ownership. These risks include casualty loss, obsolescence, changing economic conditions, and physical deterioration. If the market value of a leased asset decreases dramatically, the lessee may terminate the lease, although usually with some penalty. On the other hand, the owner of the asset is stuck with the asset when its market value declines.

**3. Flexibility**

Business conditions and requirements change over time. If assets are leased, a company can more easily replace assets in response to these changes. This flexibility is especially important in businesses where innovation and technological change make the future usefulness of particular equipment or facilities highly uncertain. A prime example of this condition in recent years has been in high-tech industries that experience rapid changes in areas such as computer technology, robotics, and telecommunications. Flexibility is a primary reason for the popularity of automobile leasing. Car buyers like the flexibility of choosing a brand-new car every two or three years once their leases expire.

The lessor also may find benefits to leasing its property rather than selling it. The advantages of leasing for the lessor include the following:

**1. *Increased sales*.** For the reasons suggested in the preceding paragraphs, customers may be unwilling or unable to purchase property. By offering potential customers the option of leasing its products, a manufacturer or dealer may significantly increase its sales volume.

**2. *Ongoing business relationship with the lessee*.** When property is sold, the purchaser frequently has no more dealings with the seller of the property. In leasing situations, however, the lessor and lessee maintain contact over a period of time, and long-term business relationships can often be established through leasing.

**3. *Residual value retained*.** In many lease arrangements, the title to the leased property never passes to the lessee. The lessor benefits from economic conditions that may result in a significant residual value at the end of the lease term. The lessor may lease the asset to another lessee or sell the property and realise an immediate gain. For example, new car leasing provides auto dealers with a supply of 2- to 3-year-old used cars, which can then be sold or re-leased.

In summary, a leasing arrangement is often a sound business practice for both the lessee and the lessor.

In reference to IFRS 16, a lessee shall recognize a right-of-use asset and lease liability on the date of commencement.

**Initial measurement of the right-of-use asset**

On the commencement date, a lessee shall measure the right-of-use asset at cost.

The cost of the right-of-use asset shall comprise:

(a) The amount of the initial measurement of the lease liability;

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

(c) Any initial direct costs incurred by the lessee; and

(d) An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site upon 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 over a particular period.

**Initial measurement of the lease liability**

On the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are unpaid on that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate is readily determinable. If that rate is not readily determinable, the lessee shall use the lessee's incremental borrowing rate.

On the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right-of-use regarding the underlying asset during the lease term that remain unpaid on the commencement date:

(a) Fixed payments, less any lease incentives receivable;

(b) Variable lease payments that depend on an index or a rate, initially measured using the index or rate valid on the commencement date;

(c) Amounts expected to be payable by the lessee under residual value guarantees;

(d) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(e) Payments of penalties for terminating the lease, if the lease term reflects the right of the lessee to exercise an option to terminate the lease.

**Illustration 1**
Assume that a sales representative for STI Inc. leases a car from Luxury Car Rental at the Istanbul airport, and that Luxury Car Rental charges a total of CU 350. STI Inc., the lessee, records the rental as follows:
Car Rental Expense CU 350

Cash CU 350
(To record payment of lease rental charge)

The lessee may incur other costs during the lease period. For example, in the case above, STI Inc. will generally incur costs for gas.

**The types of contractual provisions typically included in lease agreements**

*Cancellation provisions*: A non-cancellable lease agreement is one that can be cancelled by the lessee only under very unusual circumstances. Only non-cancellable leases can be classified as finance leases.

*Bargain purchase option*: If the lessee has the option to purchase the leased asset in the future at an amount low enough such that exercise of the option is likely, a bargain purchase option exists.

*Lease term*: The lease term includes the non-cancellable lease period plus any periods covered by bargain renewal options that include favourable lease terms (e.g., low lease payments) that will make the lessee's renewal of the lease likely.

*Residual value*: The residual value is the value of the leased asset at the end of the lease term. Sometimes the lease agreement requires that the lessee guarantee the residual value; if the residual value falls below the guaranteed amount, the lessee must pay the lessor the difference.

*Minimum lease payments*: The minimum lease payments include the periodic lease payments plus any bargain purchase option amount or the amount of any guaranteed residual value.

The lessor computes the present value of the minimum lease payments using the implicit interest rate. The lessee computes the present value using the implicit interest rate or the lessee's own incremental borrowing rate, whichever is lower.

**The advantages of leasing over purchasing for the lessee**

The three primary advantages a lessee has in leasing over purchasing are that a lease often involves no down payment, leasing avoids the risks of ownership, and leasing gives the lessee flexibility to change assets when technology or preferences change.

**The economic advantages to a lessor**

Include an increase in sales by providing financing to customers who might not otherwise be able to buy, establishment of an ongoing relationship with customers, and retention of the residual value of the leased asset after the lease term is over.

**PROCEDURES**

A lessor shall classify each of its leases as either an **operating lease** or a **finance lease**. A lease is classified as a finance lease if it transfers all substantial risks and rewards of an underlying asset incidental to ownership. A lease is classified as an operating lease if it does not transfer all the substantial risks and rewards of an underlying asset incidental to ownership.

The following problems and their solutions contain more detailed illustrations of the kinds of provisions found in lease agreements. In addition, the specific accounting rules used to distinguish between operating leases and finance leases will be illustrated through concrete problems.

**Example 1**

**Accounting for an operating lease**

Rea Incorporated needs equipment for its factory. Instead of purchasing the asset, the company chooses to enter into a 5-year operating lease with annual payments of CU 40,000. Assume each lease payment is made on December 31.

**Required:**

a. Prepare the journal entry to record the first annual lease payment.

b. What are the financial reporting advantages of an operating lease over a finance lease?

c. Why might Rea Inc. have chosen to lease the equipment instead of buying it?

**Solution:**

a.

**General Journal**

| **Date** | **Account Names and Explanation** | **Debit** | **Credit** |
|---|---|---|---|
| Dec. 31 | Rent Expense | CU 40,000 | |
| | Cash | | CU 40,000 |

b. Operating leases provide a form of off-balance-sheet financing. This allows financing of an asset that is not reported on the balance sheet as a liability.

c. Rea Inc. might choose to lease the equipment instead of buying it if the company was concerned about incurring the liability involved with a purchase. The lease agreement will give them the right to use the equipment without recording a related asset and liability on the balance sheet.

**Example 2**
**Accounting for a Finance Lease**

Accounting for a finance lease is like accounting for a purchase. The lessee records an asset and a lease liability even though the lessee may never actually own the property.

On January 1, 2019, the grocery chain Migros leases buildings for its stores. Suppose Migros leases a store building for a 20-year period. This lease is similar to purchasing the building on an instalment plan.

Suppose Migros' liability under this finance lease totals CU 4,000,000. The lease liability measures Migros' cost of the building. Make the necessary journal entries at the beginning of the lease!

**Solution:**

Migros makes the following entry at the beginning of the lease.

Jan. 1, 2019

Building . . . . . . . . . . . . . . . . . . . . CU 4,000,000

Lease Liability . . . . . . . . . . . . CU 4,000,000

Acquired building under a finance lease.

During the lease period, Migros will report both the building and the lease liability on its balance sheet.

**Example 3**

**Straight-line depreciation of a lease**

On January 1, Egro Inc. purchased a three-year lease of a shop for a total payment of CU 90,000. Using the straight-line method of depreciation, the amount of depreciation each year will be calculated on a straight-line basis as CU 30,000 (one-third of the cost of the lease). The statement of profit or loss will report this amount as an expense for each year of the 3-year lease. The balance sheet will show on one line the original cost of CU 90,000 and the accumulated depreciation to be subtracted at the end of each year on a second line.

The financial statements over the period of three years will show the following information related to this lease:

The Statement of Profit or Loss (extract)

| Year ended December 31 | Year 2 | Year 3 | Year 4 |
|---|---|---|---|
| Depreciation expense | (CU 30,000) | (CU 30,000) | (CU 30,000) |

The Statement of Financial Position (extract)

| Year ended 31 December | Year 2 | Year 3 | Year 4 |
|---|---|---|---|
| Lease at cost | CU 90,000 | CU 90,000 | CU 90,000 |
| Less Accumulated Depreciation | (CU 30,000) | (CU 60,000) | (CU 90,000) |
| Net Book Value | CU 60,000 | CU 30,000 | CU 0 |

For the lessor, the key accounting issue is whether or not a sale should be recognized on the date the lease is signed. Proper accounting hinges on whether the lease signing transfers effective ownership of the leased asset, whether the lessor has any significant additional responsibilities remaining after the lease is signed, and whether payment collectibility is reasonably assured.

For the lessee, the key accounting issue is whether the leased asset and the lease payment obligation should be recognized on the balance sheet. Again, the proper accounting treatment depends on whether the lease signing transfers effective ownership of the leased asset.

Finance leases are accounted for as if the lease agreement transfers ownership of the leased asset from the lessor to the lessee.

Operating leases are accounted for as rental agreements.

**DISCLOSURES**

The objective of disclosures is for lessees to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss, and statement of cash flows, provides a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of the lessee.

On the other hand, the objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss, and statement of cash flows, provides a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance, and cash flows of the lessor.

Because a key characteristic of an operating lease from the viewpoint of the lessee is that the lease-related asset and liability are off the balance sheet, the financial statement user being able to interpret the associated note disclosure to detect the presence of these off-balance sheet items is important.

The lessee is required to provide enough information on the note disclosure to allow the financial statement users to quantify the magnitude of the off-balance sheet operating leases. The lessor is also required to provide enough in the disclosure note to allow the financial statement user to figure out the extent to which lease-related sales and rentals impact the lessor's financial statements.

**Example 4**

**Leasing or Buying Decision**

Ben Smith is considering either leasing or purchasing a new car that will cost CU 20,000. The 3-year lease requires an initial payment of CU 2,000 and monthly payments of CU 400. Purchasing requires a CU 3,000 down payment, sales tax of 5% (CU 1,000), and 36 monthly payments of CU 412. He estimates the trade-in value of the new car will be CU 10,000 at the end of 3 years. Assuming Smith can earn 4% annual interest on his savings and is subject to a 5% sales tax on purchases, we can make a reasonable recommendation to Smith using the following analysis, ignoring the time value of money for simplicity.

**Lease Cost**

Down payment CU 2,000

Total lease payments (36 months x CU 400/month) CU 14,400

Opportunity cost of initial payment (3 years x 0.04 x CU 2,000) CU 240

Total cost of leasing CU 16,640

**Purchase Cost**

Down payment CU 3,000

Sales tax (0.05 x CU 20,000) CU 1,000

Total loan payments (36 months x CU 412/month) CU 14,832

Opportunity cost of down payment (3 years x 0.04 x CU 3,000) CU 360

Less: Estimated trade-in value of car at end of loan (CU 10,000)

Total cost of purchasing CU 9,192

Because the total leasing cost of CU 16,640 is greater than the total purchasing cost of CU 9,192, Smith should purchase rather than lease the car.

Leasing has a number of commonly cited advantages and disadvantages that managers should consider when making a lease-versus-purchase decision. Some of the advantages are as follows:

- The firm may avoid the cost of obsolescence. This is especially true in the case of operating leases, which generally have relatively short lives.
- A lessee avoids many of the restrictive covenants (such as minimum liquidity, subsequent borrowing, and cash dividend payments) that are normally included as part of a long-term loan but are not normally found in a lease agreement.
- In the case of low-cost assets that are infrequently acquired, leasing—especially operating leases—may provide the firm with needed financing flexibility. The firm does not have to arrange other financing for these assets.
- Sale-leaseback arrangements may permit the firm to increase its liquidity by converting an existing asset into cash. This can benefit a firm that is short of working capital or in a liquidity bind.

Some of the commonly cited disadvantages of leasing are as follow:

- The return to the lessor is quite high in many leases; the firm might be better off borrowing to purchase the asset.
- The terminal value of an asset, if any, is realized by the lessor. If the lessee had purchased the asset, it could have claimed its terminal value. Of course, an expected terminal value when recognized by the lessor results in lower lease payments.
- The lessee is generally prohibited from making improvements on the leased property or asset without the lessor's approval. However, lessors generally encourage leasehold improvements when these are expected to enhance the asset's salvage value.
- If a lessee leases an asset that subsequently becomes obsolete, it still must make lease payments over the remaining term of the lease. This is true even if the asset is unusable.

From this introduction to IFRS 16 Leases, you may get the misleading impression that accounting for leases is straightforward and noncontroversial. In fact, most companies that use assets under lease agreements go to great lengths to ensure that they can account for the bulk of their leases as operating leases as this allows them to keep both the asset and the associated liability off the balance sheet. Keeping the asset off the balance sheet improves the financial ratio measures of efficiency, and keeping the liability off the balance sheet improves the measures of leverage. For companies that lease a large portion of the assets that they use, the accounting standards associated with leasing are the most critical accounting standards they apply.