

A Review of IFRS 16 Leases

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In April 2016, the MASB issued MFRS 16 *Leases* that is identical to IFRS 16 *Leases* issued by the IASB in January 2016. The effective date of this new MFRS is 1 January 2019 with earlier application permitted for entities that also apply MFRS 15 *Revenue from Contracts with Customers* before that effective date. This new lease Standard introduces a new model for lessee accounting and makes some improvements to the standards in the current leases standard, MFRS 117. The new model would affect reporting entities with significant off-balance sheet leasing activities and may bring about fundamental changes to their current practice on operating leases. Hence, it is imperative that preparers and users of financial statements are aware and understand these new developments.

This article examines the reasons for and rationale of the new standard for leases, explains the salient features and principles with illustrative examples, and draws some implications on practice. It aims to assist preparers and users of financial statements better understand the requirements of the new standards and prepare for application when they become effective.

1. Reasons and Rationale of IFRS 16

The current IAS 17 classifies leases into one of two categories: namely finance leases and operating leases. The classification is based largely on the extent to which significant risks and rewards incidental to ownership of a leased asset lie. Users have consistently expressed concerns that applying this “risks and rewards” approach has resulted in many assets and liabilities under lease contracts failing the recognition test, i.e., they are unrecognised (off-balance sheet). For an operating lease, a lessee would just recognise the lease payments as expenses in the income statement. The IASB noted that listed companies using IFRS or US GAAP disclosed almost US\$ 3 trillion of off-balance sheet lease commitments in 2014. In 2005, the US Securities and Exchange Commission (SEC) expressed concerns about the lack of transparency of information on lease obligations, reiterating concerns already expressed by investors and other users of financial statements.

The IASB noted that investors and other users of financial statements have to estimate the effect of operating leases on financial leverage and earnings, as there are deficiencies in the quality of information on lease accounting under the current IAS 17. The current lease accounting does not provide a complete picture of an entity’s leasing activities. Many investors believe that operating leases give rise to assets and liabilities, and hence, should be reflected in the statement of financial position. If similar lease transactions are accounted differently, it would be hard for users to compare different entities and the implications of different leases. It could also lead to structuring opportunities whereby lease contracts could be structured in a particular way that they lead to a particular outcome.

2. The Fundamental Approach

2.1 Lessee Accounting Model

IFRS 16 retains the “*right-of-use*” model proposed in the Exposure Drafts which would require a lessee to recognise assets and liabilities for the rights and obligations created by leases. This model reflects that, at the commencement date of a lease, the lessee obtains a right to use the underlying asset for a period of time, and the lessor makes the underlying asset available for use by the lessee. With IFRS 16, there will no longer be a distinction of finance leases and operating leases for lessee accounting. For current operating leases, the new Standard would have the effect of recognising lease assets and lease liabilities.

The 2013 ED proposed a dual approach to the recognition of expenses in profit or loss arising from leases to reflect the differing economics of the variety of lease transactions. For leases of

equipment and vehicles, the total expenses recognised in the profit or loss would be higher in earlier periods of the lease terms, but for leases of properties, lease costs would be evenly recognised in the profit or loss.

In the final IFRS, the dual approach for the recognition of expenses proposed by the 2013 ED was not adopted. Instead all leases are accounted for in the same manner, i.e. lessee obtained financing for the use of the lease asset. All leases, whether leases of equipment or properties, are akin to borrowings taken to finance the acquisition of the right to use the underlying asset.

2.2 The Lessor Accounting Model

The original proposal in the Exposure Drafts was for applying the same lessees' right-of-use model for lessor accounting. It was rationalised that if a lessee recognises a "part" of the lease asset (i.e. the right to use an asset), a lessor would derecognise that part of the lease asset for which the right-of-use has been granted to the lessee. Lessee accounting and lessor accounting would then be symmetrical.

In the final IFRS, the IASB has dropped the right-of-use approach for lessor accounting and instead, retains the "rights and rewards" approach of the current IAS 17. For lessor accounting, the new IFRS basically carries forward the requirements in IAS 17, and hence, there will be no significant changes to lessor accounting, except for some improved or enhanced disclosures.

Applying different approaches for lessee accounting and lessor accounting may be argued as asymmetrical. The original intention was to apply a single right-of-use model for both lessee accounting and lessor accounting. However, the IASB was informed that the concerns and issues raised were on lessee accounting, not lessor accounting. Preparers and users of financial statements have said that the current requirements on lessor accounting in IAS 17 have worked well and there are no deficiencies in the accounting. Introducing a new right-of-use model for lessor accounting with complex requirements would involve substantial costs that would significantly exceed the marginal benefits to preparers and users of financial statements.

3. Identifying a Lease

The definition of a lease has been changed to a contract, or part of a contract, that conveys to the customer the right to use an asset (the underlying asset) for a period of time in exchange for consideration. The underlying asset is an asset that is the subject of a lease for which the right to use has been provided by a lessor to a lessee. Thus, all contracts that meet the definition of a lease, regardless of their legal form (whether termed as a lease or otherwise) and regardless of the period of time, would be subject to this new requirement.

Leases are different from services because, at the start of a lease, the customer obtains control of a resource (the right to use an asset). In contrast, in a service contract, the supplier retains control of the use of any resources needed to deliver the service. Consequently, the definition of a lease focuses on whether a customer *controls* the use of an asset. An entity shall consider all relevant facts and circumstances in assessing whether a contract is, or contains, a lease.

A lease exists when the customer controls the use of the identified asset throughout the period of use. This is when the customer has the right to: (a) obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use; and (b) direct the use of the identified asset throughout that period.

At the inception of a contract, an entity shall determine whether that contract is, or contains a lease, by assessing: (a) whether the fulfilment of the contract depends on the use of an identified asset; and (b) whether the customer controls the use of the identified asset. These conditions require a series of tests as discussed in the following subsections.

3.1 Is there an identified asset?

In straightforward cases, 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 the asset is made available for use by the customer.

The Standard, however, clarifies that even if an asset is specified, a customer does not have the right to use an identified asset if the supplier (i.e. the entity that provides goods or services under the contract) has the substantive right to substitute the asset throughout the period of use. The supplier has the *substantive right* to substitute an asset only if:

- (a) The supplier has the practical ability to substitute alternative assets throughout the period of use (i.e. 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).

An entity's evaluation of whether a supplier's substitution rights is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception, are not considered likely to occur.

Example 1: Substantive substitution rights (Extracted from the IFRS Illustrative Examples)

A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period. The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer.

Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.

The contract does not contain a lease.

Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:

- (a) Supplier has the practical ability to change the space used by Customer throughout the period of use. There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.
- (b) Supplier would benefit economically from substituting the space. There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

Capacity Portion of an Asset

The Standard further clarifies that a capacity portion of an asset is an identified asset if it is *physically distinct* (for example, a floor of a building or a space within a shopping complex). A

capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre-optic cable or a capacity portion of a manufacturing plant) is not an identified asset, unless it represents substantially all of the capacity of the entire asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from the use of the entire asset.

3.2 Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use?

A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding, or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

An entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset. For example, if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory, and not beyond.

3.3 Does the customer have the right to direct the use of the identified asset throughout the period of use?

A customer has the right to direct the use of an identified asset throughout the period of use only if either:

- (a) the customer has the right to direct how and for what purpose the asset is used i.e. by having the right to make relevant decisions about how and for what purpose the asset is used throughout the period of use; or
- (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

3.3.1 How and for what purpose the asset is used?

A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use.

Example 2: Customer's right to direct the use of the identified asset

A Customer outsources its transport and delivery services in its palm oil processing business to a transport company (the Supplier). The arrangement with the transport company is for a period of five years and it requires that the transport company shall supply two specified trucks to transport the Customer's crude palm oil and palm kernel to the Customer's buyers. The arrangement requires that the transport company shall bear all the costs of maintenance of the trucks and the salaries of truck drivers. The Customer's name will be displayed on the two specified trucks and the arrangement allows the Customer to decide on the frequency and route of delivery. If the two trucks are not operating properly and require repairs and maintenance, the Supplier has the right to substitute the two specified trucks with other trucks that it owns to fulfil its obligation.

In assessing whether this arrangement is, or contains, a lease, the first test is to determine if the two trucks are specifically identified in the arrangement. As the Customer's name will be displayed

on the two trucks and the trucks are specified in the arrangement, the underlying asset is thus specifically identified. The second test is to determine whether the customer controls the use of the identified asset. Although the Supplier can substitute the two specified trucks with other trucks, the Supplier's substitution right is not substantive because its substitution right is limited to circumstances when the two specified trucks are not operating properly. As the Customer can decide on the frequency and route of delivery, it has control of the use of the specified trucks. Thus, this arrangement contains a lease of two specified trucks.

3.4 Separating Lease Components in a Contract

For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract. A lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components. The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximising the use of observable information. These requirements are similar to the transaction price allocation in IFRS 15 for contracts with customers that contain multiple performance obligations.

As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.

3.5 Combination of Lease Contracts

Generally, the requirements of IFRS 16 shall be applied to each individual lease contract. However, as a practical expedient, an entity *may* apply the Standard to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the Standard to the portfolio would not differ materially from applying it to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

For example, an entity enters into an arrangement with a supplier to lease five similar cars. A lease contract is signed for each leased car. The lease payments and lease terms of the contracts are identical. In this case, the entity may account for the five lease contracts as a single portfolio, i.e., a single lease arrangement of five cars, instead of accounting for each separate lease contract. The combination as a portfolio is optional, which means that the entity may choose to account separately for each contract.

However, the Standard specifies that an entity *shall* combine two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if one or more of the following criteria are met:

- (a) the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together;
- (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- (c) the rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component.

If any of these criteria is met, the combination of the lease contracts is a mandatory requirement rather than an option.

For example, if an entity enters into two contracts with the same counterparty to lease two separate buildings and the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together, the two contracts shall be combined as a single contract to lease two buildings.

4. Lease Term

Lease term is the period of time over which the identified asset is available for use by a lessee. An entity shall determine the lease term as the *non-cancellable period* of a lease, together with both:

- (a) periods covered by an *option to extend* the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an *option to terminate* the lease if the lessee is reasonably certain not to exercise that option [IFRS 16.18].

4.1 Reasonably Certain

At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. An entity considers all factors relevant to the assessment and these may include contract-based, asset-based, market-based and entity-based factors. These are inter-related qualitative factors, not quantitative bright-line indicators. Examples of factors to consider include, but are not limited to:

- (a) contractual terms and conditions for the optional periods compared with market rates;
- (b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract;
- (c) costs relating to the termination of the lease;
- (d) the importance of that underlying asset to the lessee's operations; and
- (e) conditionality associated with exercising the option (i.e. when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

Example 3: Determining the lease term

Entity P enters into an arrangement to lease a hotel from its owner for a non-cancellable period of 10 years, paying a yearly fixed lease payment of RM8 million. At the end of year 10, Entity A has an option to extend the lease for another 10 years, with the yearly lease payment being set at the then prevailing market rate at the end of year 10.

Entity P is in the business of hotel management and operations. Its business model is to manage similar leased hotels on a 20-year planning horizon. It expects to incur significant leasehold improvements to the hotel property and these improvements are expected to bring economic benefits for about 20 years.

The amount of lease payment in the optional period, being set at the then prevailing market rate, would not on its own be a significant economic incentive to extend the lease period. However, considering that there is significant economic value of the leasehold improvements at the end of the non-cancellable lease period to Entity P and the importance of the hotel property to its business (i.e. its business model), Entity P would probably conclude that it is reasonably certain to exercise the option to extend the lease. Hence, the lease term is determined at 20 years (i.e. the non-cancellable lease period of 10 years plus the optional period of 10 years).

4.2 Significant Economic Incentive to Exercise Purchase Option

At the commencement date, if the lessee has a significant economic incentive to exercise an option to purchase the underlying asset, the lease term would constitute the periods up to the date

the option is expected to be exercised. For example, in a property lease, if the lessee has an option to purchase the property in the future at an exercise price that is fixed and significantly below the expected fair value of the underlying asset at the end of the exercise term, it would be reasonably certain at the commencement date that the lessee would exercise the purchase option.

Example 4: Lease containing an option to purchase the underlying leased asset

Entity P enters into an arrangement to lease a property from a property developer, Entity Q, for ten years, with an option to purchase the property at the end of Year 5 at an option price of RM655,030. The expected market price of the underlying property at the end of Year 5 is RM972,400. Because the option price is significantly below the expected fair value of the property, Entity P has a significant economic incentive to exercise the purchase option at the end of Year 5. Hence, the lease term is five years.

5. Lessee Accounting

5.1 Recognition Principles

The inception date of a lease is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and condition of the lease. This date may be different from the commencement date of a lease, which is the date on which a lessor makes an underlying asset available for use by a lessee.

At the *commencement date*, a lessee shall recognise a right-of-use asset and a lease liability [IFRS 16.22].

5.2 Initial Measurement of the Right-of Use Asset

The lessee shall initially measure the right-of-use asset at cost [IFRS 16.23]. 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 on 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 during a particular period [IFRS 16.24].

5.3 Initial Measurement of the Lease Liability

The lessee shall initially measure the lease liability at the present value of the lease payments that are not paid at that date [IFRS 16.26].

The lease payments shall be discounted using the *interest rate implicit in the lease*, if that rate can be readily determined. The interest rate implicit in the lease is defined as “the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor”.

For example, assume an asset in a lease has a fair value of RM70,000. The lease term is five years, the lease payments are RM10,000 per year, the unguaranteed residual value accruing to the lessor is RM40,000 and the initial direct costs of the lessor are RM1,000. The interest rate implicit in the lease is calculated as follows:

$$RM70,000 + RM1,000 = \sum_{t=1}^5 \frac{10,000}{(1+r)^t} + \frac{40,000}{(1+r)^5}$$

Where r , the interest rate implicit in the lease, is 6.40% per annum.

As the interest rate implicit in the lease is defined in such a way that it includes the unguaranteed residual value and initial direct costs of the lessor, it is effectively the rate that the lessor charges the lessee in the lease arrangement. If the interest rate implicit in the lease cannot be readily determined (for example, when the lessee is not able to determine the unguaranteed residual value accruing to the lessor), the lessee shall use its *incremental borrowing rate*. The requirements on the discount rates are the same as those prescribed for finance leases in the current IAS 17.

5.4 Determining the Lease Payments

At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- (a) *fixed payments* (including in-substance 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 as at 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 lessee exercising an option to terminate the lease [IFRS 16.27].

Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. The application of this new concept of in-substance fixed payment is likely to be subjective and hence requires judgement.

The Application Guidance of IFRS 16 clarifies that in-substance fixed lease payments exist, for example, if:

- (a) payments are structured as variable lease payments, but there is *no genuine variability* in those payments. Those payments contain variable clauses that do not have real economic substance.
- (b) there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case, an entity shall consider the *realistic set of payments* to be lease payments.
- (c) there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In this case, an entity shall consider the *set of payments that aggregates to the lowest amount* (on a discounted basis) to be lease payments.

Variable lease payments are payments made by a lessee to a lessor for the right to use an underlying asset that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time. In response to the comments from stakeholders, the IASB has changed the proposal in the EDs to exclude all variable lease payments in the measurement of lease assets and lease liabilities unless those payments are in-substance fixed payments or are linked to an index or rate.

Variable lease payments that depend on an index (such as a property price index) or a rate (such as interest rate, i.e. “KLIBOR”) are included in the initial measurement of lease liability based on the

index or rate at the commencement date. For example, if the yearly lease payment in a property lease is based on the property price index, the variable lease payments during the lease term is determined based on the *current* property price index at the commencement date. It does not include probable increase in the property price index in the future years even if that is more likely than not to occur. Consequently, when the property price index or the referenced KLIBOR changes in the future years, the entity needs to perform a remeasurement of the lease liability and right-of-use asset.

Example 5: Initial measurement of a right-of-use asset

On 1 January 20x4, Entity A leases an aircraft from its owner for a non-cancellable lease term of five years (fixed lease payment of RM5 million, payable at the end of each year). Entity A has the option to extend the lease for another five years (variable lease payment being the higher of RM6 million and RM5 million plus an amount based on the increase in the consumer price index ("CPI"); Entity A expects to pay RM6 million as the increase due to an increase in the CPI unlikely will exceed RM1 million). If the option to extend the lease term is not exercised, Entity A is required to pay a penalty of RM4 million. Entity A is in the business of operating aircrafts and it expects to incur significant refurbishment costs that will bring economic benefits for 10 years. Entity A determines that the lease term is 10 years (it expects to exercise the option). Entity A expects to pay a residual value guarantee of RM10 million to the lessor at the end of year 10. The initial direct costs incurred by Entity A amounts to RM2 million. The interest rate implicit in the lease is 6% per annum.

Based on the above facts, the lease term is 10 years because at the commencement date, it is reasonably certain that Entity A will exercise the option to extend the lease for the following reasons: (i) Entity A expects to incur significant refurbishment costs that are expected to generate economic benefits over 10 years (the extended period is included) and (ii) Entity A has to incur penalty costs if it does not exercise the option.

At commencement date, the following elements are included in the initial measurement of the cost of the right-of-use asset:

- (i) Fixed lease payments of RM 5 million each year during the first 5 years;
- (ii) In-substance fixed payments of RM6 million each year during the subsequent 5 years;
- (iii) Expected residual value guarantee of RM 10 million at the end of year 10; and
- (iv) Initial direct costs of RM 2 million.

The present value of payments (i) to (iii) discounted at 6% per annum is RM45.53 million. At the commencement date, Entity A recognises the following:

	RM'm	RM'm
Dr Right-of-use asset (45.53 + 2)	47.53	
Cr Lease liability		45.53
Cr Cash – initial direct costs		2.00

5.5 Subsequent Measurement of Right-of-Use Asset

After the commencement date, a lessee shall measure the right-of-use asset applying a cost model, unless it applies either of the measurement models described below [IFRS 16.29]. To apply a cost model, the right-of-use asset shall be measured at cost:

- (a) less any accumulated depreciation and any accumulated impairment losses; and
- (b) adjusted for any remeasurement of the lease liability [IFRS 16.30].

Depreciation of the right-of-use asset shall be over the useful life of the underlying asset if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the

cost reflects that the lessee will exercise a purchase option. Otherwise, the lessee depreciates the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. A lessee shall apply IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

Other Measurement Models

If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in IAS 40 [IFRS 16.34].

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16 *Property, Plant and Equipment*, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment [IFRS 16.35].

5.6 Subsequent Measurement of the Lease Liability

After the commencement date, a lessee shall measure the lease liability by:

- (a) increasing the carrying amount to reflect interest on the lease liability;
- (b) reducing the carrying amount to reflect the lease payments made; and
- (c) remeasuring the carrying amount to reflect any reassessment or lease modifications, or to reflect revised in-substance fixed lease payments [IFRS 16.36].

The measurement of a lease liability is similar to the amortised cost effective interest method used in IFRS 9 for debt instruments, such as a term loan with scheduled repayments. The interest on the lease liability in each period during the lease term shall be the amount that *produces a constant periodic* rate of interest on the remaining balance of the lease liability (being the implicit rate of return of the lease).

5.7 Recognition of Expenses in the Profit or Loss

A lessee shall recognise costs relating to leases in profit or loss (unless the costs are included in the carrying amount of another asset in accordance with other applicable Standards). Costs relating to leases comprise (a) the unwinding of the discount on the lease liability (interest expense) accounted according to the effective interest rate method in IFRS 9; and (b) depreciation of the right-of-use asset.

Interest expense on the lease liability shall be recognised as finance cost in profit or loss, unless it is capitalised in a qualifying asset in accordance with IAS 23 *Borrowing Costs*.

Variable lease payments (linked to sales or uses of the lease asset) not included in the initial measurement of the lease liability shall be expensed to the profit or loss when they are incurred.

For an individual former off-balance sheet lease, IFRS 16 results in a different total expense recognition pattern compared to IAS 17. This is because interest expense is typically higher in the earlier years of a lease than in the later years. When combined with typically straight-line depreciation of lease assets, this results in a total lease-related expense (interest plus depreciation) that is higher than a straight-line lease expense during the first half of the lease term. The opposite is true in the second half of the lease term. Over the lease term, the total amount of expense recognised is the same.

Example 6: Recognition of expenses related to leases

On 1 January 20x4, a lessee enters into a contract to lease an asset from a lessor for a lease term of 5 years, with yearly fixed lease payment of RM1 million, payable at the end of each year. In addition, the lessee needs to pay 5% per annum on any sales of goods produced by the asset in

excess of RM10 million (variable lease payment). In year 1, the variable lease payment made for the excess sales amounted to RM200,000. The rate the lessor charges the lessee cannot be determined readily. The lessee's incremental borrowing cost is 8% per annum.

At the commencement date, the lease asset has a remaining economic life of eight years and has a current market value of RM8 million. The present value of fixed lease payments of RM1 million per year over the five years discounted at 8% per annum amounted to RM3,993,000. The lessee recognises the right-of-use asset and the lease liability at RM3,993,000 at the commencement date.

Under the current IAS 17, the lease payments over the five-year term are recognised as an expense on the straight-line basis at RM1 million per year. Under IFRS 16, the total expenses recognised for the lease comprise the interest expense on the lease liability and the amortisation of the right-of-use asset, as follows:

Lease liability					Lease Asset	Profit or Loss
Year	Opening liability	Interest at 8%	Lease payment	Closing liability	Depreciation	Total expense
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	3,993	319	(1,000)	3,312	799	1,118
2	3,312	265	(1,000)	2,577	799	1,064
3	2,577	206	(1,000)	1,783	799	1,005
4	1,783	143	(1,000)	926	798	941
5	926	74	(1,000)	(0)	798	872
		1,007	(5,000)		3,993	5,000

The variable lease payment of RM200,000 is not included in the initial measurement of lease liability and is recognised as an expense in the year it is incurred.

5.8 Reassessment of the Lease Liability

The measurement of a lease liability is based on estimates of cash flows of variable lease payments linked to index or rate, lease term, options, penalties, residual value guarantees, etc. The actual cash flows may differ from the initial estimates. After the commencement date, lease payments may change due to a change in the lease term, the relevant factors that result in the lessee having incentive, or no longer reasonably certain, to exercise a purchase option or termination option, the amounts expected to be payable under residual value guarantees, or an index or rate used to determine the lease payments during the reporting period.

A lessee shall remeasure the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss [IFRS 16.39].

5.9 Lease Modifications

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).

A lease modification is accounted separately from a reassessment of the lease liability because the former arises from changes in terms and conditions that were not in the original contract whereas the latter involves a remeasurement of the estimates used in the initial measurement.

A lessee shall account for a lease modification as a separate lease if both:

- (a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- (b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

For a lease modification that is not accounted for as a separate lease, at the effective date of the lease modification, a lessee shall:

- (a) allocate the consideration in the modified contract;
- (b) determine the lease term of the modified lease; and
- (c) remeasure the lease liability by discounting the revised lease payments using a *revised discount rate*. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

In such cases, the lessee shall account for the remeasurement of the lease liability by:

- (a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall *recognise in profit or loss* any gain or loss relating to the partial or full termination of the lease.
- (b) making a corresponding *adjustment to the right-of-use asset* for all other lease modifications.

5.10 Presentation for Lessees

IFRS 16 requires a lessee shall either present in the statement of financial position, or disclose in the notes:

- (a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
 - (i) include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
 - (ii) disclose which line items in the statement of financial position include those right-of-use assets.
- (b) lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

In the statement of profit or loss and other comprehensive income, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which IAS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss and other comprehensive income.

In the statement of cash flows, a lessee shall classify:

- (a) cash payments for the principal portion of the lease liability within financing activities;
- (b) cash payments for the interest portion of the lease liability applying the requirements in IAS 7 *Statement of Cash Flows* for interest paid; and

- (c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

6. Lessor Accounting

6.1 Classification of Leases

As IFRS 16 retains the “risks and rewards” approach of IAS 17, a lessor shall classify each of its leases as either an *operating lease* or a *finance lease* [IFRS 16.61]. A lease is classified 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 [IFRS 16.62].

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. IFRS 16 carries forward from IAS 17 the examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease.

6.2 Finance Leases

6.2.1 Recognition

At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the *net investment in the lease* [IFRS 16.67]. Net investment in the lease is defined as gross investment in the lease discounted at the interest rate implicit in the lease. Gross investment in the lease is defined as the sum of: (a) lease payments receivable by a lessor under a finance lease; and (a) any unguaranteed residual value accruing to the lessor. These are similar to the requirements in the current IAS 17.

6.2.2 Initial Measurement of the Net Investment in the Lease

For the initial measurement of the net investment in a lease, a lessor would need to discount the gross investment in the lease (comprising the sum of the lease payments and unguaranteed residual value) at the interest rate implicit in the lease.

6.2.2.1 Interest Rate Implicit in the Lease

The lessor shall use the *interest rate implicit in the lease* to measure the net investment in the lease. The use of the equivalent lessee’s incremental borrowing cost is not permitted because a lessor would typically know the effective interest rate that it charges the lessee. In the case of a sublease, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease.

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 this reduces 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 because the initial direct costs would be included in the calculation of the effective interest rate.

6.2.2.2 Lease Payments included in the Net Investment in the Lease

The elements in the lease payments are similar to those used for lessee accounting except for the inclusion of residual value guarantees by a related party of the lessee or a third party unrelated to the lessor. Lease payments do not include unguaranteed residual value. However, like in the current IAS 17, the gross investment in the lease shall include any unguaranteed residual value, which is

defined as “that portion of the residual value of the underlying asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor”.

6.2.3 Subsequent Measurement

A lessor recognises finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor’s net investment in the lease. The aim is to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the *gross investment in the lease* to reduce both the principal and the *unearned finance income*. The method of allocation is similar to debt instrument measured at the amortised cost effective interest method in IFRS 9 *Financial Instruments*.

6.2.4 Manufacturer or Dealer Lessors

Manufacturers or dealers often provide their customers with the choice of either buying or leasing an asset. IFRS 16 requires that at the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:

- (a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;
- (b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the *unguaranteed residual value*; and
- (c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which IFRS 15 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15.

A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts.

A manufacturer or dealer lessor shall recognise as an expense costs incurred in connection with obtaining a finance lease at the commencement date because they are mainly related to earning the manufacturer or dealer’s selling profit. Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged.

6.3 Operating Leases

6.3.1 Recognition and Measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense. The initial direct costs incurred in obtaining an operating lease shall be added to the carrying amount of the underlying asset and those costs shall be recognised as an expense over the lease term on the same basis as the lease income.

The depreciation policy for depreciable underlying assets subject to operating leases shall be consistent with the lessor's normal depreciation policy for similar assets. A lessor calculates depreciation in accordance with IAS 16 and IAS 38. Also, a lessor shall apply IAS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

6.3.2 Presentation

A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

7. Sale and Leaseback Transactions

In the current IAS 17, the accounting for sale and leaseback transactions is dependent mainly on whether the leaseback is a finance lease or an operating lease. In the new Standard, the accounting for such transactions depends on whether the transfer of the asset is a sale or not a sale, rather than on the nature of the leaseback.

IFRS 16 requires that if an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease depending on whether the transfer of the asset is a sale or not a sale. If the buyer-lessor has control of the asset, the transfer of the asset is a sale transaction. Conversely, if the seller-lessee retains control of the asset, the transfer of the asset is not a sale transaction.

7.1 Assessing whether the transfer of the asset is a sale

An entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 *Revenue from Contracts with Customers* to determine whether the transfer of an asset is accounted for as a sale of that asset [IFRS 16.99]. The critical determinant is who has control of the underlying asset. The existence of the leaseback (i.e. the transferor's right to use the asset for a period of time) does not, in isolation, prevent the transferee from obtaining control of the asset. However, if the leaseback provides the seller-lessee with the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, then the buyer-lessor does not obtain control of the asset and the transfer is not a sale.

For example, the seller-lessee may be considered to have the ability to direct the use of and obtain substantially all of the remaining benefits from the asset, if the lease term is for the major part of the remaining economic life of the asset or the present value of the lease payments accounts for substantially all of the fair value of the asset.

7.2 Transfer of the asset is a sale

If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset:

- (a) the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
- (b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in IFRS 16.

Example 7: Sale and leaseback transaction when a transfer is a sale
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At 1 January 20x8, Entity K (seller-lessee) owns a ship with a carrying amount of RM30 million. The fair value of the ship on this date is RM40 million. On this date, it sells the ship to a finance entity (buyer-lessor) at fair value for cash consideration of RM40 million and immediately leases back the ship for a non-cancellable lease period of five years, with an option to extend the lease term for another five years at the end of year 5. The lease payment in the non-cancellable lease period is fixed at RM6 million per year, payable in arrears at the end of each year. The lease payment in the optional extension period will be set at the then prevailing market rate. The remaining economic life of the ship is 20 years.

Entity K determines that the sale satisfies the requirements of IFRS 15 to be accounted for as a sale of the ship. The interest rate implicit in the lease is 8% per annum. There is no significant economic incentive to extend the lease period and Entity K determines the lease term at five years. The finance entity classifies the lease as an operating lease.

The present value of the lease payments discounted at 8% is RM23,956,000. The fair value of the ship is RM40,000,000. The allocation of the carrying amount of the ship is as follows:

Components	Fair value RM'000	Proportion %	Carrying amount RM'000
Right-of-use retained	23,956	59.89%	17,967
Rights transferred	16,044	40.11%	12,033
Total	40,000	100.00%	30,000

At the commencement date, Entity K measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the ship that relates to the right of use retained by Entity K of RM17,967,000, which is calculated as follows: RM30 million (carrying amount of the ship) ÷ RM40 million (fair value of the ship) × RM 23,956,000 (discounted lease payments for the right-of-use asset).

Entity K recognises only the amount of the gain that relates to the rights transferred to the finance entity of RM4,011,000, which is calculated as follows: RM10 million (RM40million – RM30 million) ÷ RM40 million (fair value of the ship) × RM 16,044,000 (proportion that relates to the rights transferred to the finance entity).

At the commencement date, Entity K accounts for the transaction as follows:

	RM'000	RM'000
Dr Cash	40,000	
Dr Right-of-use asset	17,967	
Cr Lease liability		23,956
Cr PPE – ship		30,000
Cr Gain of disposal in profit or loss		4,011

At the commencement date, the buyer-lessor books recognises the purchase of the ship at RM40 million and accounts for it as a property, plant and equipment. Subsequently, the leaseback shall be treated as an operating lease and the lessor recognises rental income on a straight-line basis.

If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

- any below-market terms shall be accounted for as a prepayment of lease payments; and
- any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

The entity shall measure any potential adjustment on the basis of the more readily determinable of:

- (a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and
- (b) the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

Example 8: Fair value of consideration received does not equal the fair value of the asset transferred

Assume the facts are the same as Example 7 except that, the consideration received for the sale is RM35 million, which is lower than the fair value of the asset of RM40 million (the other terms remain the same). Entity K shall account for the below-market terms as a prepayment of lease payments:

	RM'000	RM'000
Dr Cash	35,000	
Dr Prepayment (adjustment for below-market terms)	5,000	
Dr Right-of-use asset	17,967	
Cr Lease liability		23,956
Cr PPE – Ship		30,000
Cr Gain on disposal of ship in profit or loss		4,011

However, if the consideration received for the sale is RM46 million, which is higher than the fair value of the asset of RM40 million (other terms remain the same), Entity K shall adjust the above-market terms as additional financing provided by the buyer-lessor to the seller-lessee:

	RM'000	RM'000
Dr Cash	46,000	
Dr Right-of-use asset	17,967	
Cr Lease liability (additional RM6 million relates to the additional financing)		29,956
Cr PPE – Ship		30,000
Cr Gain on disposal of ship in profit or loss		4,011

7.3 Transfer of the asset is not a sale

If the transfer of an asset by the seller-lessee does not satisfy the requirements of IFRS 15 to be accounted for as a sale of the asset:

- (a) the seller-lessee shall continue to recognise the transferred asset and shall recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying IFRS 9.
- (b) the buyer-lessor shall not recognise the transferred asset and shall recognise a financial asset equal to the transfer proceeds. It shall account for the financial asset applying IFRS 9.

Example 9: Sale and leaseback transaction when transfer is not a sale

Assume the facts are the same as Example 7, but the transfer of the ship does not meet the requirements of IFRS 15 to be accounted for as a sale of the asset. This transaction merely represents a financing arrangement by the lessee of which the seller-lessee recognises the following:

	RM'000	RM'000
Dr Cash	40,000	
Cr Financial liability (borrowings)		40,000
- to recognise borrowings obtained.		
And the buyer-lessee shall recognise the following:		
Dr Financial asset (receivable)	40,000	
Cr Cash		40,000
- to recognise lending given to borrower.		

8. Exemptions for Short-Term Leases and Low-Value Assets - Lessees Only

Some respondents had commented that the recognition and measurement requirements can be cumbersome and costly to apply for short-term leases and low-value assets but with little benefit because the effect on profit or loss is about the same as the current treatment for operating leases. Consequently, for lessee accounting, IFRS 16 provides exemptions for lessees of short-term leases and low-value assets from applying the requirements of IFRS 16 [IFRS 16.5]. A lessee may recognise the lease payments in profit or loss on a straight-line basis (or another systematic basis) over the lease term. An entity that elects to apply this exemption shall disclose the expense recognised as it provides useful information to users of financial statements about the lease payments that are excluded from lease liabilities as a consequence of the exemptions.

Short-term leases are leases that, at the commencement date, have a lease term of 12 months or less. The 12-months criterion shall include not just the non-cancellable lease period, but also any period covered by an option to extend or an option not to terminate a lease if the option to exercise the extension option or not to terminate a lease is reasonably certain. This is consistent with the determination of lease term in the Standard. Thus, if a lease arrangement has a non-cancellable lease period of one year with an option to extend for another year, the exemption does not apply if the lessee is reasonably certain to exercise the extension option and it determines the lease term to be two years. In the IASB's view, using only the non-cancellable lease period as a basis could lead to abuses because a longer contractual term could be structured in a series of one-year renewal options to obtain the benefit of short-term lease accounting. Also, any lease that contains a purchase option is not a short-term lease.

The assessment of whether an asset is low-value shall be performed on an absolute basis. A lessee shall assess the value of an asset based on the value of an asset when it is new, regardless of the age of the asset being leased or whether those leases are material to the lessee (i.e. the materiality concept does not apply in this assessment). For example, leases of motor vehicles would not qualify as leases of low-value assets because a new motor vehicle would typically not be of low value. In addition, the assessment is also not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value. There is no threshold prescribed for what amount is considered to be of low value. In the Basis for Conclusions, the IASB did consider an amount of US\$5,000 or less [paragraph BC.100] but that was not included in the final IFRS 16. In the absence of an absolute threshold or "bright-lines", an entity applies judgements in its assessment of what is considered as low-value assets and discloses those judgements. Examples of low-value assets may include tablets, personal computers, and small items of office furniture and telephones.

9. Sublease Arrangements

A sublease is within the scope of IFRS 16 and it is defined as a transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and lessee remains in effect. The lessee in the original head lease becomes

an intermediate lessor in the sublease. The head lease and the sublease are therefore two separate contracts.

The accounting requirements shall apply to each party. The original lessor in the head lease accounts for the head lease using the “risks and rewards” approach. The lessee in the sublease accounts for it using the requirements prescribed for lessees. However, the intermediate lessor has to account for two separate arrangements: (a) as a lessee in the original head lease, and (b) as a lessor in the sublease. In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

- (a) if the head lease is a short-term lease that the entity, as a lessee, has availed the short-term lease exemption, the sublease shall be classified as an operating lease.
- (b) otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant or equipment that is the subject of the lease).

Example 10: Sublease classified as an operating lease

WTT Bhd owns a shopping complex, which has a fair value of RM500 million. The economic life of the shopping complex is 50 years. On 1 January 20x6, it enters into an arrangement to lease the entire shopping complex to Beon Bhd, a manager-cum-operator of shopping complexes. The lease term is for a non-cancellable period of five years with an option to extend for another five years at the end of the non-cancellable lease period. Lease payment is fixed at RM40 million for the first five years. Lease payment in the optional extension period will be set at the then prevailing market rate for rental of properties, which is expected be RM50 million per year. Beon Bhd expects to undertake substantial leasehold improvements to the shopping complex and it expects to exercise its option to extend the lease period. The lease term is determined at ten years. The interest rate implicit in the lease is not readily determinable. At the commencement date of the head lease, Beon Bhd’s incremental borrowing cost is 8% per annum.

Beon Bhd will use part of the shopping complex for its own operations and the remaining part will be subleased to tenants. The sublease arrangements will be for a period of two years with an option for tenants to extend for another two years. Beon Bhd expects to receive rental income of RM25 million per year from the subleases.

In this case, WTT Bhd classifies the head lease as an operating lease and recognises the shopping complex as its PPE. The lease payments receivable are recognised as income on a straight-line basis over the lease term.

Beon Bhd, the intermediate lessor, shall account for the head lease arrangement as a lessee. The present value of the lease payments (RM40 million for the first five years and RM50 million for the subsequent five years) discounted at 8% per annum amounted to RM295,577. At the commencement date, Beon Bhd recognises the following:

	RM’000	RM’000
Dr Right-of-use asset	295,577	
Cr Lease liability		295,577

As a lessor in the sublease, Beon Bhd classifies the sublease arrangement as an operating lease and recognises rental income on a straight-line basis over the lease term.

Each tenant in the sublease shall account for the arrangement as a lease of space in the shopping complex. At the commencement date, each tenant shall recognise a right-of-use asset and a corresponding lease liability in accordance with IFRS 16.

10. Transitions

IFRS 16 provides for numerous transitional requirements when an entity first applies the new Standard, including practical expedients. The impact of the new IFRS 16 would be most significant for lessees with current operating leases. IFRS 16 requires that a lessee shall apply the Standard to its leases either:

- (a) retrospectively to each prior reporting period presented applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
- (b) retrospectively with the cumulative effect of initially applying IFRS 16 recognised at the date of initial application (“modified retrospective approach”).

A lessee shall apply the election consistently to all of its leases in which it is a lessee.

If a lessee elects to apply the modified retrospective approach in accordance with (b) above, the lessee shall not restate comparative information. Instead, the lessee shall recognise the cumulative effect of initially applying IFRS 16 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

11. Implications and Conclusions

The new leases standard, IFRS 16, would address the weaknesses and deficiencies in IAS 17. The right-of-use model for lessee accounting would resolve the long-debated concern surrounding off-balance sheet financing. A lessee is required to recognise assets and liabilities for all leases with terms of more than 12 months, unless the underlying asset is of low value. This would affect the current practice of many entities with significant operating lease arrangements. For example, airline entities and shipping entities that currently treat rental of airplanes and ships as operating leases would have to recognise right-of-use assets and corresponding lease liabilities in the statement of financial position. Similarly, a utility entity that purchases power or energy in a concession arrangement might need to recognise a right-of-use asset on the power plant or the network infrastructure and a corresponding lease liability.

The adoption of IFRS 16 is expected to be significant for companies with material off balance sheet leases. Key performance and reporting ratios (such as financial leverage, gearing ratio, etc), credit ratings, compliance of borrowings covenants and capital management, amongst others, may be affected. Hence, such companies would need to quickly assess the extent of the Standard’s impacts so that the wider business implications, if any, can be addressed promptly. For example, terms of lease arrangements and borrowing covenants may need to be re-negotiated and capital management policy may need to be reviewed.

The scope of IFRS 16 is wide as it covers contracts that convey the entity with a right to use an asset. A reporting entity would need to reassess all its contracts with counterparties to determine whether the contracts contain any embedded lease component (similar to the assessment of embedded derivatives in financial and non-financial contracts in IAS 39). These may include outsourcing, sale or purchase contracts that contain a right to use an asset and manufacturing, construction or service contracts that contain lease components.

Rental of equipment, property tenancy agreement and lease of land that convey a right to use an asset for a consideration would fall within the scope of IFRS 16. In Malaysia, tax treatment for leases (whether finance or operating leases) are generally based on rentals paid. Recognising lease assets and lease liabilities in the statement of financial position under the new lease accounting models might result in additional deferred tax assets and deferred tax liabilities. The tax consequences of the new requirements would need to be carefully considered for all lease transactions.

For lessee accounting of an individual former off-balance sheet lease, IFRS 16 would result in a different total expense recognition pattern compared to IAS 17. This is because interest expense is typically higher in the earlier years of a lease than in the later years. When combined with typically straight-line depreciation of lease assets, this results in a total lease-related expense (interest plus depreciation) that is higher than a straight-line lease expense during the first half of the lease term. The opposite is true in the second half of the lease term. Over the lease term, the total amount of expense recognised is the same. However, for leases that are classified as finance leases, the adoption of the new Standard is not expected to have a significant impact on current practice.

IFRS 16 would provide a more complete picture of lessees' leasing arrangements. Capturing all lease assets and liabilities in the statement of financial position would result in greater transparency in financial reporting and enable users of financial statements to compare and analyse the financial statements of reporting entities better. For lessees, there will be increased costs of compliance (for example, costs to gather information and record operating leases that were previously off-balance sheet, costs to re-negotiate lease contracts and costs to change the accounting systems to capture the needed financial information for financial reporting purpose). However, the benefits to users of financial statements, in terms of improved financial reporting and disclosures, are expected to significantly exceed costs.

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