



Brewing Over

IFRS vs IFRS for SMEs – Part 3

Leases (IFRS 16) vs Leases (Section 20)

In comparing IFRS and IFRS for SMEs, this series of articles highlights some of the similarities and differences between the two accounting frameworks.

This third article in this series of similarities and differences between IFRS and IFRS for SMEs outlines the difference between IFRS 16 Leases and IFRS for SMEs Section 20 Leases for Lessee accounting and Lessor accounting.

Lessee Accounting IFRS for SMEs – Section 20

Definition

IFRS for SMEs defines a lease as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Type of lease

IFRS for SMEs makes a clear distinction between finance leases and operating leases. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction instead of the form of the contract.

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership.

A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

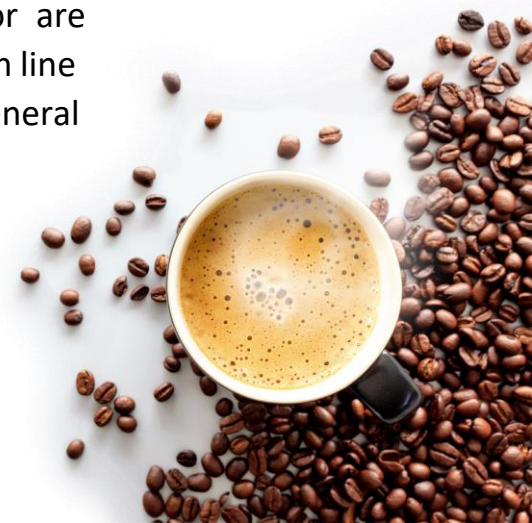
Lease term

IFRS for SME does not define a lease term BUT is the period over which the asset is leased for. Unlike IFRS, IFRS for SMEs does not provide further guidance on assessing the options to renew or terminate where it is reasonably certain the lessee will not terminate the lease.

Recognition

Operating lease

- “lease payments under operating leases shall be recognised as an expense over the lease term on a straight-line basis unless another systematic basis is more representative of the time pattern of the user’s benefit or the payments to the lessor are structured to increase in line with expected general inflation.”



Finance lease

- “a lessee shall recognise its rights of use and obligations under finance leases as assets and liabilities in its statement of financial position.” - See below for further guidance on the measurement required.

Finance lease indicators:

The following indicators must be considered in assessing if a lease is a finance lease:

Primary indicators:

- the lease transfers ownership of the asset to the lessee by the end of the lease term;
- the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable;
- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Secondary indicators:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee (for

example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Initial measurement: Finance lease

At the commencement of the lease term (the date on which the lessee has the right to use the asset), a lessee shall recognise an asset and a liability in its statement of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, determined at the inception of the lease. Any initial direct costs of the lessee (incremental costs that are directly attributable to negotiating and arranging a lease) are added to the amount recognised as an asset.

The minimum lease payments are the payments over the lease term that the lessee is required to make, excluding (certain items).

Unlike IFRS, IFRS for SMEs does not include further inclusions for the measurement of the liability such as variable lease payments that depend on an index or rate as well as the exercise price of a purchase option if the lessee is reasonably certain to exercise that option.

The lease payments are discounted using the interest rate that is implicit in the lease. Implicit rate is the rate that, at commencement of the lease, discounts the minimum lease payments + the



unguaranteed residual value of the asset to equal the FV of the asset and initial direct costs of the lessor
If the implicit rate cannot be determined, the incremental borrowing rate should be used.

Operating Lease

Straight lining of operating leases

There is no requirement to straight-line operating leases if increases are in line with expected general inflation (based on published indexes or statistics).

Subsequent measurement

Finance lease liability:

- A lessee shall apportion minimum lease payments between the finance charge and the reduction of the outstanding liability using the effective interest method.
- The lessee shall allocate the finance charge to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.
- A lessee shall charge contingent rents as expenses in the periods in which they are incurred.

Asset:

- A lessee shall depreciate an asset leased under a finance lease in accordance with the relevant section of this Standard for that type of asset, for example, Section 17 Property, Plant and Equipment or Section 19 Business Combinations and Goodwill.
- If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term,

the asset shall be fully depreciated over the shorter of the lease term and its useful life.

- A lessee shall also assess at each reporting date whether an asset leased under a finance lease is impaired.

Lessee Accounting – IFRS 16

Definition

IFRS 16 states a contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The standard looks at control as:

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

The assessment is made at inception and only reassessed if the terms of the contract are changed.

Type of lease

In terms of lessee accounting, IFRS 16 does not distinguish between finance leases and operating leases. This means a lessee is required to account for most leases on-balance sheet. Optional exemptions available to lessees are for leases of low value assets and short-term leases (i.e. leases of 12 months or less).

Lease term

IFRS 16 defines the lease term as: *the non-cancellable period + extensions where the lessee is reasonably certain to exercise*



that option + any period covered by an option to terminate where it is reasonably certain the lessee will not terminate the lease.

The entity must consider all relevant factors and circumstances that create economic incentive for the lessee to exercise the option.

Some examples of these are:

- If significant leasehold improvements were done resulting in significant benefit in the option period
- Cost of relocating
- Importance of the asset to the lessee's operations
- Conditionality linked to the exercise of the options and the likelihood that those conditions will exist.

Initial measurement: Liability

At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

The lease payments included in the measurement of the lease liability include the following:

- (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 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.

Initial measurement: Asset

Right of use asset comprises:

- the amount of the initial measurement of the lease liability;
- any lease payments made at or before the commencement date, less any lease incentives received;
- any initial direct costs incurred by the lessee; and
- an estimate of costs to be incurred by the lessee in dismantling/restoring/removing the asset if the liability for such is raised in terms of IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

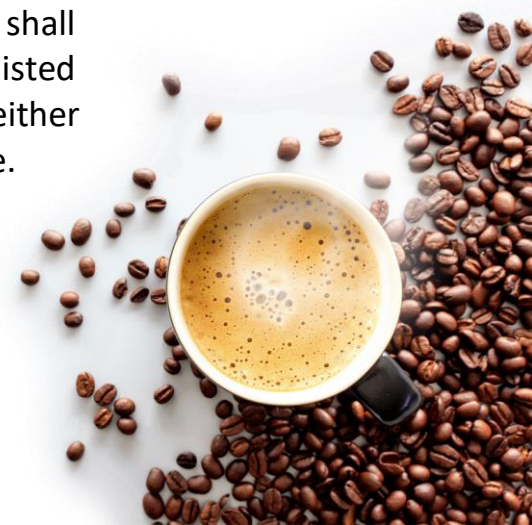
Subsequent measurement

The liability is subsequently measured by:

- increasing the carrying amount to reflect interest on the lease liability;
- reducing the carrying amount to reflect the lease payments made; and
- remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

Lessor Accounting – IFRS 16 & IFRS for SMEs Section 20

IFRS and IFRS for SMEs accounts for Lessor accounting in the same manner. The lessor shall consider the same indicators listed above in classifying the lease as either a finance lease or operating lease.



Finance lease:

The lessor derecognises the asset and recognises a receivable equal to the net investment in the lease. (There is however one difference in IFRS 16, as variable lease payments that depend on an index or a rate are included in the measurement of the lease receivable.)

Operating lease:

Lease payments under an operating lease shall be recognised as an expense on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

IFRS 16 became effective for years starting on or after 1 January 2019. Currently, IFRS for SMEs has not been updated to reflect nuances introduced by IFRS 16, therefore resulting in the differences highlighted above. In the coming months the IASB will discuss the specific section of IFRS for SMEs standard that could be amended to reflect new requirements in IFRS standards that are not currently incorporated in the standard, including the potential alignment of IFRS 16 and IFRS for SMEs Section 20.

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