The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Topic wise Selected Opinions

IFRS 16 - Leases

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1. Implications of IFRS 16 on Aviation Industry

Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the enquirer highlighted the significant adverse impact of change in foreign currency exchange rates related to lease liabilities under IFRS 16 Leases on the financial statements of the Company (operating in aviation industry) and requested the Board to consider following measures to address the same:

A. Issuance of Technical Release by the ICAP to define right-of-use asset as a monetary item so that impacts of foreign currency translations of right-of-use asset and lease liability offset each other;

B. Issuance of Technical Release by the ICAP to allow recognition of foreign exchange gain/(loss) on translation of lease liabilities over the lease term;

C. Deferment of adoption of IFRS 16 for aviation industry; or

D. Issuance of any other Technical Release to provide relief to the aviation industry.

Opinion:

The Board noted that IFRS 16 requires that the right-of-use asset should be measured at cost model or revaluation model.

IFRS 16 in its Basis of Conclusions (paragraphs BC196-BC199) explains that:

- Any foreign currency exchange differences relating to lease liabilities denominated in a foreign currency should be recognised in profit or loss; and
- Subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item i.e. right-of-use asset.

In other words, lease liability would be revalued through profit and loss at the current exchange rate (similar to a foreign currency loan) while the right-of-use asset would remain at the historical exchange rate (similar to an item of property, plant and equipment).

The Board observed that paragraph 23 of IAS 21 Effect of Changes in Foreign Exchange Rates, explains that at the end of reporting period the:

a) Foreign currency monetary items shall be translated using the closing rate;

b) Non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of transaction.

Paragraph 16 of IAS 21 outlines that right-of-use asset is a non-monetary asset as this right does not contain any right to receive a fixed or determinable number of units of currency.

The Board noted that the Financial Accounting Standards Board (FASB) of USA also issued the new leasing standard i.e. Accounting Standards Codification (ASC) 842. In context of the nature of right-of-use asset and the possible impact of exchange rate changes on the right-of-use asset, paragraph 842-20-55-10 of ASC 842 explains that:

- The right-of-use asset is a non-monetary asset;
- Lease liability is a monetary liability; and

- The lease liability is re-measured using the current exchange rate, while the right-of-use asset is measured using the exchange rate as of the commencement date.

The Board also noted that International Air Transport Association (IATA) formed an Industry Accounting Working Group (IAWG) for developing application guidance on IFRS 16.

In its publication (titled IATA Industry Accounting Working Group Guidance IFRS 16, Leases) IATA also explained that right-of-use asset is a non-monetary asset and foreign exchange rate changes would only impact the lease liability.

This publication also highlighted and discussed the adverse effects of exchange rate movement and resultant management of foreign currency mismatch. It noted that there are a number of viable approaches to eliminating or minimizing the foreign exchange volatility created in the financial statements (by IFRS 16).

The Board noted that in general, it is understood that businesses are likely to be exposed to foreign exchange risk/s arising from volatility in the currency markets.

The Board considered that changes in foreign exchange rate (US dollar to Pakistan Rupee) are market driven, affecting all entities in Pakistan. The IFRS Standards contain accounting guidance on the financial risk management, and accordingly expect entities to properly identify, anticipate and manage volatility in equity and the income statement through financial risk management objectives and strategies. In this regard, companies that are reporting under IFRS can use different techniques, including hedging to safeguard against unfavorable foreign currency risks. Accordingly, under IAS 21, the presentation of a foreign currency liability in functional currency provides relevant information to users about measurement and level of economic resources to settle the obligation. Further, the exchange losses arising on the translation of foreign currency lease liabilities are an indicative of the performance of the company, and are accordingly reported in the statement of profit or loss.

The Board noted that changes in a reporting entity's economic resources and claims result from that entity's financial performance. Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. In this regard, the statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period.

In view of above, it is important to reflect the adverse impact of translation of foreign currency lease liabilities in the statement of profit or loss as this has resulted from events and conditions during the year, representing possible outflow of economic resources in Pakistan Rupees, and impacting company's returns adversely.

The Board observed that the ICAP issues Accounting Technical Releases (TRs) on matters that have relevance and implications on financial accounting and reporting at wider-scale, and such matters are not explained in the financial reporting framework. Fundamentally, a Technical Release while explaining an accounting requirement cannot be in conflict with the requirements of IFRS Standards.

The Board also noted that based on the requirements and explanations contained in IFRS Standards, including IFRS 16 and IAS 21, adequate basis and guidance is available to company to determine the required accounting. Further, there is no evidence that a widespread financial reporting problem exists. The Board noted that IASB, in the exposure draft of IFRS 16 as well as in the final issued standard, has discussed the matter of accounting of exchange losses related to lease liabilities.

The IASB standard-setting is based on the areas where wide-spread implications are noted across various jurisdictions. In context of the enquired matter, IASB has already considered and concluded that the accounting of right-of-use assets should be principally similar to the items of property, plant and equipment.

The Board noted that no other entity, regulator or other stakeholder in Pakistan has raised this matter with the Board; therefore, the matter lacks the widespread and material effect (if any) on the entities reporting under IFRS Standards in Pakistan. Approaching IASB, accordingly, as suggested by the enquirer would not provide additional input or change in the requirements of the standard.

Based on the above analysis, the Board concluded that:

(a) Under IFRS Standards, the right-of-use asset is a non-monetary asset.

(b) In accordance with IFRS 16 as well as IAS 21, foreign currency exchange differences relating to lease liabilities (denominated in a foreign currency) should not be included in the carrying amount of the related right-of-use asset.

(c) IFRS 16 provides sufficient guidance on accounting of foreign currency exchange impacts. IFRS 16 in its Basis of Conclusions provides detailed discussion and rationale for not allowing re-measurement of right-of-use asset due to change in foreign exchange rates. In consideration of requirements and discussion available in relevant IFRS Standards, Institute is not required to issue a Technical Release / Accounting directive.

(d) In consideration of all the relevant factors, including guidance and requirements contained in IFRS Standards, approaching IASB and IFRIC for consideration of the Company's specific scenario would not be appropriate

(e) To ensure compliance with the accounting and reporting standards as applicable in Pakistan, company in context of the submitted matter should apply IFRS 16 and IAS 21 for measurement of right-of-use assets and lease liabilities.

(Issued in November 2020)

2. Determination and Reassessment of Discount Rate under IFRS 16 Leases

Brief facts of the enquiry:

The Accounting Standards Board (the Board) received following enquiries relating to the application of IFRS 16 Leases:

- Whether discount rate shall be reviewed / reassessed at any specific time, other than at the time of lease modification?
- Whether existing leases are subject to re-measurement in case of change in interest rates by the State Bank of Pakistan (SBP) under the monetary policy?
- Whether a company shall re-assess discount rate at a specific frequency, when as a practical expedient a single discount rate is used for a portfolio of leases?

Opinion:

The Board based on the enquired fact pattern discussed the following matters:

A. Requirement for reassessment / review of discount rate under IFRS 16

B. Impact of changes in SBP policy interest rate on the discount rate under IFRS 16

C. Frequency of reassessment of discount rate for leases measured using portfolio approach under IFRS 16

A. Requirement for reassessment / review of discount rate under IFRS 16

The Board noted that IFRS 16 outlines specific scenarios (paragraphs 40 - 43 and 45 of IFRS 16) under which a lessee shall re-measure the lease liability using a revised discount rate.

These scenarios, in addition to lease modification, include:

- a change in the lease term;
- a change due to reassessment of an option to purchase the underlying asset;
- a change in amount payable under residual value guarantee; and
- a change in floating interest rates.

B. Impact of changes in SBP Policy Interest Rate on the discount rate under IFRS 16

The Board observed that a mere change in the policy interest rate by the SBP would not require reassessment of the discount rate or re-measurement of existing lease liability. However, the Board noted that if the change in policy interest rate by the SBP results in a change in the floating rate used to determine lease payments, then the lessee would be required to use revised discount rate and accordingly re-measure the lease liability.

C. Frequency of reassessment of discount rate for leases measured using portfolio approach

The Board noted that IFRS 16 as a practical expedient permits that its requirements can be applied at a portfolio level (i.e. leases with similar characteristics). Accordingly, an entity can establish and apply a single discount rate to all leases in a portfolio, provided that using single discount rate would not result in a materially different answer than using a discount rate determined for each individual lease.

The Board also noted that under the portfolio approach any reassessment or review of discount rate shall be required under the scenarios outlined in paragraph 1, above.

Moreover, in such a case a lessee would also be required to assess whether the specific circumstances triggering reassessment of discount rate and re-measurement of lease liability are relevant for the entire lease portfolio as a whole or for any particular lease within that portfolio. Where the specific circumstances are valid only for a particular lease within the portfolio then such lease shall be singled out and excluded from the portfolio and a revised discount rate shall be determined for re-measurement of that particular lease only.

(Issued in August 2020)

3. Accounting of tenancy agreement in light of IFRS 16 Leases

Enquiry:

We are a professional body for regulation and oversight of individual members practicing a particular profession. We are seeking your technical advice on following accounting matter:

Guidance on IFRS 16

The professional body as a lessee has entered into tenancy agreements for its offices and libraries in various cities of the country. Till the year ended June 30, 2019, the tenancy agreements were accounted for as operating leases with the rent expense being recognized as an expense and any prepaid rent being recognized as a current asset. With the adoption of IFRS 16, the distinction between finance and operating lease with regards to accounting by a lessee, has been eliminated.

In order to evaluate the implications of IFRS 16, management has performed an assessment of all the rental agreements to determine the termination rights of both the parties and the non-cancellable period of the lease.

The enquirer has shared its assessment of terms of lease agreements and has mentioned therein that:

(a) All of its leased properties, except two leased properties in Hyderabad and Lahore, provide the right of both lessor and lessee to terminate the lease by giving less than 12 months' notice and without any penalty payment to other party or purchase option.

(b) The lease agreements for leased properties in Hyderabad and Lahore provide lessees with a right to terminate the lease by giving 3 months' prior notice without any penalty. However, the lessor (property owner) will have the same termination option only after expiry 5 years from commencement of lease.

Management is of the view that where agreement provides the cancellation rights to both the parties and the non-cancellable period is less than 12 months, then the lease agreement will not fall under the scope of IFRS 16 as it will be considered as a "Short term Lease". In cases where either the lessee or the lessor do not have the termination rights and the non-cancellable period is more than 12 months, the agreement would fall under the scope of IFRS 16.

Opinion:

Accounting of tenancy agreements under IFRS 16

The Board noted that IFRS 16 defines lease as *"a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration."*
The identification of a lease includes assessment of the 'period of the time' (i.e. Term of the lease contract).

Paragraph 9 of IFRS 16, reproduced hereunder, states that:

> *"At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset <u>for a period of time</u> in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease."* (Emphasis is ours)

The Board noted that in context of the enquirer's question, the fundamental point is to assess lease terms of the professional body's tenancy agreement, in accordance with IFRS 16. This assessment would provide guidance on whether the leases are short term under IFRS 16.

IFRS 16, through paragraph 5(a) allows recognition exemption (i.e. right of use asset and corresponding lease liability) to short-term leases.

Paragraph 5 is reproduced here under:

> *"A lessee may elect not to apply the requirements in paragraphs 22–49 to:*
> *(a)* <u>*short-term leases;*</u> *and*
> *(b) leases for which the underlying asset is of low value."* (Emphasis is ours)

Further paragraph 8 outlines that:

> *"The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis."*

Paragraph 6 of IFRS 16 adds that if a lessee elects not to apply the requirements of IFRS 16 to short-term leases, the lessee shall recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis.

The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

The IASB while providing underlying reason for allowing exemption to short-term leases in paragraph BC87 and BC89 noted that:

> *"The IASB concluded that the benefits of requiring a lessee to apply all of the requirements in IFRS 16 to short-term leases do not outweigh the associated costs...."*
> *"The IASB concluded that, even with simplified measurement requirements, the benefits of requiring a lessee to recognise right-of-use assets and lease liabilities for short-term leases would not outweigh the associated costs. Consequently, paragraph 5(a) of IFRS 16 permits a lessee to elect not to apply the recognition requirements to short-term leases. Instead, a lessee can recognise the lease payments associated with short-term leases as an expense over the lease term, typically on a straight-line basis. The IASB decided that this choice should be made by class of underlying asset."*

Short-term leases are defined in IFRS 16 as *"a lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease."*

In the Basis of Conclusion of IFRS 16 (paragraphs BC9I-BC97), IASB explained the background to the definition of short-term lease definition, and paragraph BC93 is reproduced hereunder:

> *"Instead, the IASB decided to expand the short-term lease exemption by making the determination of duration of short-term leases consistent with the determination of lease term, thus considering the likelihood of extension options being exercised or termination options not being exercised (see paragraphs BC152–BC159). Accordingly,* <u>*IFRS 16 defines a short-term lease as a lease that, at the commencement date, has a lease term of 12 months or less."*</u> (Emphasis is ours)

IFRS 16 in paragraph 18 defines 'lease term' as the non-cancellable period for which a lessee has the right to use an underlying asset, 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.

Paragraph B34 explains that in determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

> *"In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party <u>with no more than an insignificant penalty."</u>*
> (Emphasis is ours)

As explained in BC156, in the IASB's view, the lease term should reflect an entity's reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information.

Paragraph BC129 outlines, IASB's thought process on economic substance of lease contract.

> *"The IASB considered whether applying enforceability to leases in this way might encourage entities to add a clause to a lease that does not have economic substance, for example, stating that the lease could be cancelled at any point, knowing that, in practice, it would not be cancelled. However<u>, the IASB is of the view that such clauses are unlikely to be added because there often is an economic disincentive for either the lessor or lessee to agree to their inclusion.</u> For example, if a lessor has priced a contract assuming that the lessee will not cancel the contract, including such a clause would put the lessor at risk of being exposed to higher residual asset risk than had been anticipated when pricing the contract, which would be an economic disincentive for the lessor. Conversely, if the lessor has priced the contract assuming that the lessee will or may cancel the contract, the lessee would be likely to have to pay higher rentals to compensate the lessor for taking on more residual asset risk. Those higher rentals would be an economic disincentive for the lessee, if it does not intend to cancel the contract."* (Emphasis is ours)

Further, paragraph B35 outlines the requirement to consider the termination rights of lessee in calculating the lease-term. This paragraph adds that if only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

Paragraph B35 is reproduced hereunder:

> *"If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-*

> *cancellable period of the lease includes the period covered by the option to terminate the lease."*

Based on the above (paragraph B34 of IFRS 16), the Board considered that the lease term assessment also requires consideration of the "*with no more than an insignificant penalty'.* However, the Board noted that there is no further discussion in IFRS 16 on what constitutes an insignificant penalty and hence, it is a matter of judgement considering all relevant facts and circumstances of each case.

The Board also considered that IFRS Interpretations Committee (IFRIC) in its draft agenda decision issued in November 2019 highlighted that an entity needs to make a holistic assessment of lease term that considers all relevant facts and circumstances.

Applying this context, IFRS 16 requires consideration of contracts economics when determining the enforceable period and ultimately term of a lease. In other words, a broader reading of the word penalty is consistent with this context, whereas a narrow reading would be inconsistent with this context and would risk undermining the economic perspective sought by the International Accounting Standards Board (IASB).

Accordingly, the Board understands that the use of term 'penalty' in paragraph B34 indicates that it means something different from only contractual termination payments, and in this case refers to any economic penalty (that is more than insignificant) that might arise from termination.

Such factors may include:

- Contract-based factors (e.g., the terms and conditions of termination in the contract);
- Asset-based factors (e.g., impact of significant leasehold improvements, impact of lessor's renovations);
- Market-based factors (e.g., costs associated with terminating versus separately buying a similar asset or entering into a new lease for a similar asset);
- Entity-based factors (e.g., the lessee's intent and past experience with lessor).

Paragraph 19 of IFRS 16 requires that in assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

This is further described in paragraphs B37-B40 of IFRS 16, that at 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. The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

Examples of factors to consider include, but are not limited to:

(a) contractual terms and conditions for the optional periods compared with market rates, such as:

  i. the amount of payments for the lease in any optional period;

  ii. the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and

iii. the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

(b) <u>significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease,</u> or to purchase the underlying asset, becomes exercisable;

(c) costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;

(d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset, the location of the underlying asset and the availability of suitable alternatives; 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.

The Board finds it relevant to highlight here that an option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease. The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

In accordance with IFRS 16, the leases whose lease term is determined to be more than 12 months, accordingly do not qualify for short term lease exemption outlined in paragraph 5 of IFRS 16, the recognition and measurement under new lessee accounting model would be as under.

In accordance with paragraphs 23-24 of IFRS 16, the lessee shall recognise a right-of-use asset and a lease liability at the commencement date. The lessee shall measure the right-of-use asset at cost. The cost of the right-of-use asset shall comprise of:

(a) the amount of initial measurement of the lease liability, as described in paragraph 26 of IFRS 16;

(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.

The lease liability in (a) above shall be measured 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 can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

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.

In the submitted fact pattern, the Board noted the enquirer's submission about its assessment of terms of lease agreements of lessee's leased properties that:

(a) All of its leased properties, except two leased properties in Hyderabad and Lahore, provide the right of both lessor and lessee to terminate the lease by giving less than 12 months' notice and without any penalty payment to other party or purchase option.

(b) The lease agreements of Hyderabad and Lahore properties, provide Lessee's a right to terminate the lease by giving 3 months' prior notice without any penalty. However, the lessor (property owner) will have the same termination option only after expiry 5 years from commencement of lease.

The Board understands that for determination of the enforceable/non-cancellable lease term of these properties, it needs to be assessed at the lease commencement date that whether it is reasonably certain that the professional body will not exercise the termination option before the lessor's right to terminate becomes exercisable.

The Board further understands that application of IFRS 16 on the fact pattern submitted by the enquirer would be under following two (I and II) broad categories:

I. The tenancy agreement having a tenor of more than 12 months would be short-term lease if the lease arrangement contains:

- Termination rights - Both Lessee and lessor have right to terminate the tenancy agreement at any time after the lease commencement date, without permission of the other party.
- Notice period – A notice of termination can be served any time after the lease commencement date, and the notice period does not exceed 12 months. It is 3 months in the professional body's tenancy agreements.
- Termination and economic penalties - There are no significant termination penalties under the tenancy agreement. Further, there are no significant economic penalties of termination.

Under this category of tenancy agreements of the professional body, the Board noted that though the lease agreement is signed for a tenor of more than 12 months, however, the lessee and lessor's rights to terminate the lease at any time (e.g. by serving a 3 months' notice and without consent of the other party) makes such contracts enforceable for 3 months only, provided there are no significant penalties.

Applying above guidance of IFRS 16 on the submitted fact patterns (related to tenancy agreements and categorized under I, above), the Board concluded that:

(a) After the lease commencement date, lessee can terminate the lease by serving a 3 months' notice. Therefore, lessee does not have an obligation to make lease payments past the notice period.

On the other hand, lessor also has the right to terminate the lease by serving 3 months' prior notice, after the lease commencement. Thereby limiting professional body's ability to extend the lease past the notice period.

(b) Besides these termination rights and length of notice period, as per paragraph B34 of IFRS 16, lessee's assessment of the contractual penalties and the economic penalties of lease termination are also critical to the determination of the lease term.

(c) If the professional body concludes that the lease agreement is enforceable beyond the notice period (i.e. 3 months), then it would be required to assess the time period it is reasonably certain not to exercise the option to terminate the lease.

II. A tenancy agreement having tenor of more than 12 months could be long-term lease if the lease arrangement provides:

- Termination rights - Both lessee and lessor have the rights to terminate the arrangement. However, under the submitted fact pattern, the lessor can exercise this right after 5 years of the lease agreement date. On the other hand, lessee has the right to terminate the arrangement at any time after the agreement signing.

- Notice period - Both lessee and lessor can exercise the termination right by serving at least 3 months' prior notice.

- Termination and economic penalties - There are no significant termination penalties under the lease agreement. Further, there are no significant economic penalties of termination.

Under this category of tenancy agreements, in accordance with paragraph B35 of IFRS 16, the lease term would include the periods covered by an option to terminate the lease, if lessee is reasonably certain not to exercise that (termination) option.

Applying above guidance of IFRS 16 on the fact patterns shared by the enquirer (related to tenancy agreements and categorized under II, above), the Board concluded that:

(a) Both lessee and lessor can terminate the tenancy agreement at any time without consent of the other, only by serving a prior notice. However, lessor has the right to terminate the tenancy agreement after 5 years of the lease agreement date. On the other hand, at any time lessee can terminate by serving 3 months' prior notice. Therefore, contractually it does not have an obligation to make lease payments past that period.

(b) In accordance with paragraph B35 of IFRS 16, lessee would be required to assess when it would exercise the termination option. In the determination of the exercise of termination option, management should make an assessment of the economic penalty under the termination of the lease arrangement.

(c) In case, lessee assesses that it will not exercise its termination option before lessor's right to terminate the lease becomes exercisable (i.e. 5 years of the lease agreement date), then the lease term would be as follows:

   i. The period over which lessor has no right to terminate the lease; and

   ii. Notice period to be given by lessor to lessee for termination of lease.

(February 20,2020)

4. Application of IFRS 16 Leases in circumstances where entire lease payments are paid in advance

Enquiry:

For the purposes of its power project, the Company (the "Lessee") has obtained a land on lease from Government (the "Lessor") under a lease agreement (the Agreement) for a period of 25 years. Term of the power project is also 25 years. As per the Agreement, the entity has paid all the lease rentals for 25 years in advance.

As all lease payments have been made in advance, your professional advice is required on following questions related to a lease arrangement:

1) How will we determine the lease liability?

2) How will we determine the finance cost?

3) What would be the value of the asset at initial recognition?

Opinion:

The Board would like to highlight that IFRS 16 defines lease as “a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.”

IFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

IFRS 16, through paragraph 5 allows recognition exemption (i.e. right of use of asset and corresponding lease liability) to short-term leases and low value leases.

Paragraph 5 is reproduced here under:

> *“A lessee may elect not to apply the requirements in paragraphs 22–49 to:*
>
> *(a) short-term leases; and*
>
> *(b) leases for which the underlying asset is of low value.”*

For availing the recognition exemption for low value assets, paragraph B4 of IFRS 16 explains that the assessment of whether an underlying asset is of low value is performed on an absolute basis, i.e. regardless of whether those leases are material to the lessee. The assessment is 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.

However, IFRS 16 does not allow any recognition exemption for leases where entire lease payments have been made in advance and there is no lease liability for future lease payments.

Determination of lease liability

The Board noted that paragraph 26 of IFRS 16 outlines that at the commencement date, a lessee measures the lease liability as the present value of lease payments that have not been paid at that date.

Paragraph 26 of IFRS 16 states (underline is ours):

> *"At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments* <u>*that are not paid at that date.*</u> *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 Board understands that as per the above paragraph, only the remaining payments due should be used to measure the lease liability at lease commencement. In the submitted fact pattern, the enquirer has shared that the lease payments for entire lease term of the project site land have been paid in advance. Therefore, in terms of paragraph 26 of IFRS 16, the Board understands that the lease liability in the enquired scenario would be nil.

Determination of finance cost

The Board noted that paragraph 49 of IFRS 16 requires that in the statement of profit or loss and other comprehensive income, a lessee shall present finance costs on the lease liability separately from the depreciation charge for the right-of-use asset. In the submitted fact pattern, since no lease liability is recognised in respect of lease of project land, therefore, Board understands there will be no recognition of finance costs in respect of lease liability.

Determination of right-of-use asset

Paragraph 23 of IFRS 16 states that *"at the commencement date, a lessee shall measure the right-of-use asset* <u>*at cost."*</u>

The constituents of cost as mentioned in paragraph 23 above, are outlined in paragraph 24 as follows:

> *"A fair value measurement requires an entity to determine all the following:*
>
> *(a) the amount of the initial measurement of the lease liability, as described in paragraph 26;*
>
> *(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."*

As discussed above, the Board considered that in the submitted fact pattern lease liability would be nil. Since the lease payments for the entire lease term have been paid in advance, the right of use asset in the submitted fact pattern should be measured at:

- Amount of lease payments made at or before the commencement date, i.e. lease payments paid in advance under paragraph 24(b) of IFRS 16;
- Any initial direct costs incurred by the company under paragraph 24(c) of IFRS 16;
- An estimate of costs to incurred by the company (if any) in restoring the project land to the condition required by the terms and conditions of the lease, under paragraph 24(d) of IFRS 16.

(February 07, 2020)