CPA Uganda

INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
OF UGANDA

IMPLEMENTATION GUIDANCE

IFRS 16: LEASES

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CPA Uganda

TABLE OF CONTENTS

About ICPAU

The Institute of Certified Public Accountants of Uganda (ICPAU) was established in 1992 by an Act of Parliament now the Accountants Act, 2013. The functions of the Institute, as prescribed by the Act, are:

- To regulate and maintain the standard of accountancy in Uganda.
- To prescribe and regulate the conduct of accountants and practicing accountants in Uganda.

Vision

To be a world-class professional accountancy institute.

Mission

To develop, promote and regulate the accountancy profession in Uganda and beyond.

Core Values

- Professional Excellence.
- Accountability
- Integrity.
- Innovation

International Affiliations

- The Institute is a member of the International Federation of Accountants (IFAC),
- The Pan African Federation of Accountants (PAFA)
- The Association of Education Assessment in Africa (AEAA).

Purpose

This Guidance has been designed to assist accountants in business and industry comply with the requirements of IFRS 16. The Guidance also intends to give practicing accountants an appreciation of the requirements of IFRS 16 and how their clients apply the standard. The Guidance gives an analysis of the requirements around identification of a lease, lease term lease payments, modifications of a lease among others. The required approaches to recognition and measurement of leases by either a lessor or lessee are equally demonstrated not forgetting a discussion around the impact of the standard as a whole.

Whereas every industry may use leasing as a means to obtain access to assets, the type and volume of assets that they lease, and the terms and structures of these lease agreements differ significantly. As a result, different implications may arise for different industries when adopting the new leases standard. Therefore, every effort has been taken not to design the Guidance with reference to a particular sector, but to give a general appreciation and pointer to the expected direction when applying the requirements of the standard. We have incorporated a number of illustrations to enable a better appreciation of the concepts within the standard.

Disclaimer

This Guidance is persuasive rather than prescriptive. The Guidance is not intended to be comprehensive or to deal with all situations that might be encountered, i.e. it is supplementary to and not a substitute for the International Financial Reporting Standards (IFRS) and any other directives that may be developed over time by ICPAU, which should be regarded as the primary source of guidance for accountants. Accountants are encouraged to apply professional judgment in complying with the requirements of IFRS 16.

ICPAU will not be liable for any reliance you place on the information in this material. You are advised to seek independent but professional guidance whenever you are faced with complex matters of the standard.

1.0 INTRODUCTION

1.1 Background

Until recently, under the IAS 17 Leases, whereas finance leases were recognized on balance sheets, operating leases were not. As such, most leases, were off-balance-sheet but disclosed as commitments in the notes to the financial statements. Financial statement users were continually seeking transparency and comparability, and in its efforts to obtain feedback from financial statement users, the IASB concluded that the existing lease guidance did not meet the needs of users because, despite disclosure in the notes to the financial statements, it did not require lessees to present assets and liabilities arising from operating lease activities. A 2005 SEC survey estimated the off-balance sheet obligation associated with operating leases for public companies at $1.25 trillion. In 2016, the FASB and IASB issued new standards to bring these obligations on the balance sheet.

1.2 About IFRS 16

The publication of IFRS 16 Leases realised the IASB's long-standing goal of bringing all significant leases on-balance sheet for lessees. IFRS 16 fundamentally changes the accounting treatment of leases by lessees. The Standard has eliminated the previous dual accounting model for lessees, which was a long- standing distinction between on-balance sheet finance leases and off-balance sheet operating leases. Instead, there is introduction of now a single, on-balance sheet accounting model that is similar to the current finance lease accounting model, with some limited exemptions for short-term leases and leases of low-value assets. Lessor accounting has however, remained similar to the previous practice under IAS 17 – i.e. lessors will continue to classify leases as finance and operating leases. IFRS 16 is effective for annual periods beginning on or after 1 January 2019, with earlier application permitted provided IFRS 15 *Revenue from Contracts with Customers* is also applied.

IFRS 16 superseded IAS 17 Leases together with the related interpretations IFRIC 4 Determining whether an Arrangement contains a Lease, SIC-15 Operating Leases – Incentives and SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

2.0 SALIENT PRINCIPLES ILLUSTRATED

2.1 Objective

The objective of IFRS 16 is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents their lease transactions in their financial statements. This information provides a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. [IFRS 16:1]

When applying IFRS 16, an entity is required to:

- Consider the terms and conditions of contracts [1]
- all relevant facts and circumstances; and
- Apply the Standard consistently to contracts with similar characteristics and in similar circumstances

Practical expedient – application to a portfolio of leases

Although IFRS 16 specifies the accounting for an individual lease, as a practical expedient the Standard can be applied to a portfolio of leases with similar characteristics provided that it is reasonably expected that the effects on the financial statements of applying a portfolio approach will not differ materially from applying IFRS 16 to the individual leases within that portfolio. When accounting for a portfolio, estimates and assumptions that reflect the size and composition of the portfolio should be used. [IFRS 16:B1]

Within the scope of this practical expedient are circumstances when an entity enters into a single contract to lease a number of identical assets. Take, for example, a contract to lease 20 photocopiers (assumed for the purposes of this example to be high-volume commercial photocopiers that do not qualify as low-value assets).

If the photocopiers can be operated on a stand-alone basis, the right to use each photocopier is required to be accounted for as a separate lease component. The practical expedient helps to reduce that complexity by permitting the entity to account for the lease as one portfolio, rather than recognising and accounting for 20 leases separately.

[1] *A contract is defined as "an agreement between two or more parties that creates enforceable rights and obligations". [IFRS 16:Appendix A] However, note that the application of IFRS 16 is not restricted to contracts, or portions of contracts, that are specifically described or labeled as leases*

2.2.1 Combining contracts

Two or more contracts that are interdependent should be combined and accounted for as a single contract. This requirement applies when: [IFRS 16:B2]

- the contracts are entered into at or near the same time; and
- the contracts are with the same counterparty (or related parties of the counterparty); and
- one or more of the following criteria are met:
  - the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together; or
  - the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
  - 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 as described in IFRS 16:B32.

The requirements of IFRS 16:B2 are intended to capture circumstances in which an entity enters into a number of contracts in contemplation of one another such that the transactions, in substance, form a single arrangement that achieves an overall commercial objective that cannot be understood without considering the contracts together.

For example, assume that a lessee enters into a one-year lease of an asset with particular characteristics. The lessee also enters into a one-year lease for an asset with those same characteristics starting in one year's time and a similar forward contract starting in two years' time and in three years' time. The terms and conditions of all four contracts are negotiated in contemplation of each other such that the overall economic effect cannot be understood without reference to the series of transactions as a whole. In effect, the lessee has entered into a four-year lease. In such situations, accounting for the contracts independently of each other might not result in a faithful representation of the combined transaction. [IFRS 16:BC130]

2.2 Scope

IFRS 16 should be applied to all leases except the following: [IFRS 16:3]

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources; IFRS 6 Exploration for and Evaluation of Mineral Resources specifies the accounting for rights to explore for and evaluate mineral resources.

(b) leases of biological assets within the scope of IAS 41 Agriculture held by a lessee; Biological assets that are bearer plants are within the scope of IAS 16 Property, Plant and Equipment rather than IAS 41 and, consequently, are within the scope of IFRS 16. For example, leases of bearer plants such as orchards and vineyards held by a lessee are within the scope of IFRS 16. [IFRS 16:BC68(b)]
(c) service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements;
(d) licences of intellectual property granted by a lessor within the scope of IFRS 15 Revenue from Contracts with Customers; and
(e) rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.A lessee is permitted, but not required, to apply IFRS 16 to leases of intangible assets other than those described in IFRS 16:3(e). [IFRS 16:4]

Leases of 'other' intangible assets in the context of IFRS 16:4 might include, for example, exclusive licences for brands or trademarks held by a lessee. Such leases were previously considered to fall within the scope of IAS 17. The IASB decided to permit, but not require, entities to account for these leases in accordance with IFRS 16. Although there is no conceptual basis for excluding them from the scope of IFRS 16, the Board considered that a more comprehensive review of the accounting for intangible assets is required before requiring leases of intangible assets to be accounted for under the new Standard. [IFRS 16:BC71]

2.3 Other Considerations

2.3.1 Long-term leases of land

The IASB considered, but decided against, a scope exclusion for long-term leases of land (see IFRS 16:BC78). Therefore, such leases should be accounted for in accordance with IFRS 16.

2.3.2 Leases of investment property

Unlike IAS 17, IFRS 16 contains no scope exclusions in relation to investment property. Therefore, all aspects of leases of investment property are accounted for under IFRS 16. Consequential amendments arising from IFRS 16 have amended the definition of investment property in IAS 40 Investment Property to include both owned investment property and investment property held by a lessee as a right-of-use asset. Under IFRS 16:34, if a lessee applies IAS 40's fair value model to its owned investment property, it is also required to apply that fair value model to right-of-use assets that meet the definition of investment property.

2.3.3 Subleases

Leases of right-of-use assets in a sublease are within the scope of IFRS 16, subject to the exclusions set out at [IFRS 16:3]. Subleases are required to be accounted for in the same way as other leases and, accordingly, are within the scope of IFRS 16. [IFRS 16:BC73]

2.3.4 Leases of inventories

IFRS 16 does not specifically exclude leases of inventories from its scope. However, the IASB believes that few such transactions would meet the definition of a lease under IFRS 16 because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business, or for consumption in the process of production for sale in the ordinary course of business. [IFRS 16:BC74]

2.3.5 Derivatives embedded in a lease

The IASB decided to require an entity to separate from a lease any derivatives embedded in the lease (as defined in IFRS 9 Financial Instruments), and account for the derivatives applying IFRS 9. Nonetheless, IFRS 16 includes specific requirements for features of a lease such as options and residual value guarantees that may meet the definition of a derivative. The IASB noted that the lease accounting model in IFRS 16 was not developed with derivatives in mind and, consequently, IFRS 16 would not provide an appropriate basis on which to account for derivatives. Accordingly, if derivatives embedded in leases were not accounted for separately, unrelated derivative contracts could be bundled with leases to avoid measuring the derivatives at fair value. [IFRS16:BC81]

2.3.6 Short-term leases

IFRS 16 applies to all leases except those specifically excluded under IFRS 16:3. However, the Standard includes recognition exemptions available to lessees for short-term leases.

A short-term lease is defined as one that has a lease term at the commencement date of 12 months or less, provided that the lease does not contain a purchase option. Lessees can elect to leave short-term leases off-balance sheet. Instead they can simply recognise an expense, typically on a straight-line basis, over the lease term. Lessees must apply – or not apply – the exemption for short-term leases consistently for each class of underlying leased asset. When an entity elects to leave short-term leases off-balance sheet, they will be accounted for in a manner consistent with the IAS 17 accounting for operating leases although IFRS 16 requires certain disclosures for such leases.

Alert - Determining the lease term

Entities will need to take care when determining whether or not a lease qualifies as a short-term lease. It should be remembered that the lease term stated in the contract will not necessarily be the lease term used when deciding whether or not a lease is of less than 12 months' duration. Reference should be made to the question above on options to extend or terminate early as these may affect the lease term.

2.3.7 Leases of low-value items

Based on the recognition exemption in paragraph 5 of IFRS 16 Leases, a lessee can elect not to recognize a right-of-use asset and a lease liability for leases for which the underlying asset is of low value. The value of an underlying asset is based on the value of the asset when it is new, regardless of the age of the asset being leased. This election can be made on a lease-by-lease basis. If a lessee applies the recognition exemption, the lease payments are recognized as an expense on either a straight-line basis over the lease term or another systematic basis. Whereas the standard does not assign a monetary threshold for low-value assets, the basis for conclusions does, however, suggest that the IASB had in mind leases of underlying assets with a value, when new, of US Dollars 5,000 or less.

Examples of low-value assets may therefore include personal computers, small items of office furniture and telephones. It should be noted that the low-value exemption applies only to leased assets that are not highly dependent on or highly interrelated with other assets. It will not be possible to minimise the amount of lease liabilities by breaking what is in substance a lease of an individual asset down into a series of separate leases, in which each relates to a component that has a value, when new, of US$5,000 or less. This is because the low-value assets exemption cannot be applied when the leased asset is highly dependent on or highly interrelated with other assets.

Alert - low-value items

An entity may lease a number of similar low value items. For example, an entity may lease 100 metal detectors each of which is worth less than US Dollars 5,000. Provided the metal detectors are not highly dependent on or highly interrelated with each other or with other assets and the lessee could benefit from each one on its own, it will be possible for the entity to elect to leave any or all of them off-balance sheet even if the lease liability in aggregate is material.

3.0 IDENTIFYING A LEASE

3.1 Definition of a lease

A lease is defined 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:Appendix A]

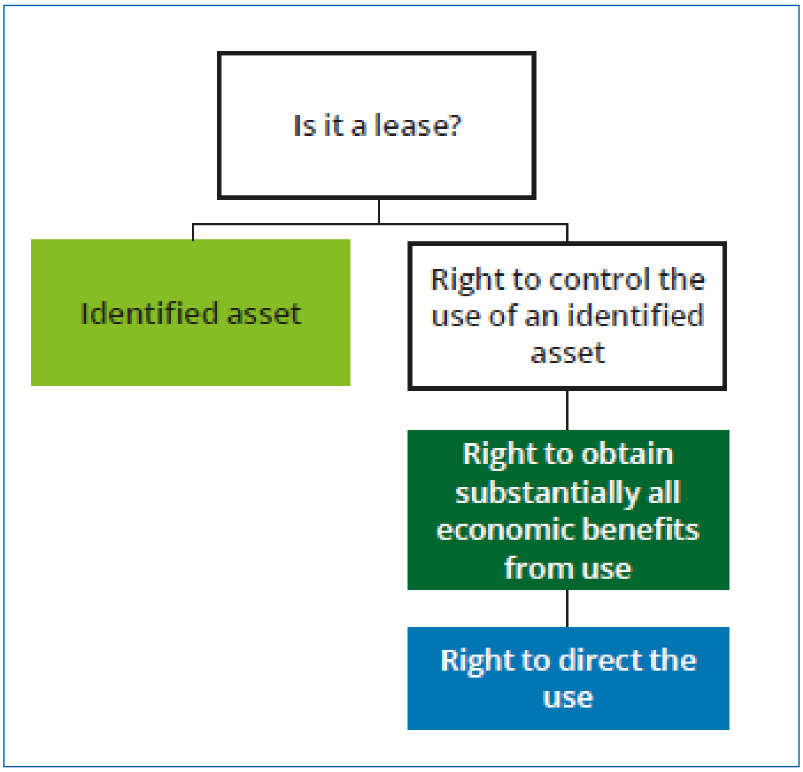
Although the detailed requirements regarding the identification of a lease are amended by IFRS 16, the key principles of IFRIC 4 and SIC-27 are carried forward, i.e. that:

- some arrangements that do not take the legal form of a lease nevertheless meet the definition of a lease under the Standard; and
- not all transactions that involve the legal form of a lease will fall within the definition of a lease under the Standard.
- To assess whether a contract is or contains a lease, an entity must assess whether, throughout the period of use, the customer has both:
- the right to obtain substantially all of the economic benefits from use of the identified asset; and
- the right to direct the use of the identified asset. [IFRS 16 B9]

At inception of a contract, an entity is required to 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 for a period of time in exchange for consideration. [IFRS 16:9]

The key aspects of this definition are that:

- the asset that is the subject of a lease must be specifically identified; and
- a lease must convey the right to control the use of that identified asset for a period of time.



The increased focus on control of both the identified asset and the related economic benefits means that some arrangements that qualified as leases under IAS 17 may fall outside the scope of IFRS 16. For example, some contracts that had previously been treated as leases may be considered to be service contracts under the new standard, therefore careful consideration of the contractual terms and conditions is necessary on transition to ensure that all leases are correctly identified. Thereafter reassessments of whether a contract is or contains a lease will be required where the terms and conditions of the contract have changed.

Alert

Although the IASB believes that, in most cases, the assessment as to whether a contract is or contains a lease should be straightforward, it acknowledges that significant judgement will be required to make this assessment in some cases. [IFRS 16:BC109]. Entities may thus wish to refer to the illustrative examples (Examples 1 to 10 – Appendix 1) that accompany IFRS 16, which demonstrate how an entity would determine whether a contract is, or contains, a lease in a number of different scenarios.

3.2 Other Considerations

3.2.1 Lease vs 'in-substance' sale or purchase

When assessing the nature of a contract, an entity should consider whether the contract transfers control of the underlying asset itself (as opposed to conveying the right to control the use of the underlying asset for a period of time). If so, the transaction is a sale or purchase within the scope of other Standards (e.g. IFRS 15 Revenue from Contracts with Customers or IAS 16 Property, Plant and Equipment). [IFRS 16:BC140]

3.2.3 Leases vs service contracts

IFRS 16 aims to distinguish a lease from a service contract on the basis of whether a customer is able to control the use of the asset being leased. If the customer controls the use of an identified asset for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way to that in which it makes decisions about owned assets that it uses. In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service. [IFRS 16:BC105]

Alert

Under IAS 17, operating leases were straight-line expensed through operating profit, like a service contract, and therefore, some entities did not always scrutinise whether an arrangement was a service contract or operating lease. A renewed focus on contracts has led to some entities identifying contracts as leases under IFRS 16, which were not previously closely considered. As all leases (with limited exemptions) are on balance sheet under IFRS 16, entities will need to review carefully whether an arrangement is or contains a lease. Going forward, entities should consider these types of contracts before entering into new, similar arrangements which would be in scope of IFRS 16. This is largely likely to impact IT and manufacturing contracts.
scenarios.

3.2.4 Controls over a portion of the term of a contract

If the customer has the right to control the use of an identified asset for only a portion of the term of a contract, the contract contains a lease for that portion of the lease term. [IFRS 16:B10]

3.2.5 Assessment for each potential separate lease component

The assessment as to whether a contract contains a lease should be made for each potential separate lease component [IFRS 16:B12]

Previously a number of arrangements would embed an operating lease into the contract or operating lease contracts would include non-lease (e.g. service) components. A number of entities would not consider separating the operating lease component in the contracts because the accounting for an operating lease and for a service/supply arrangement generally had a similar impact on the financial statements.

With IFRS 16, lessee accounting for the two elements of the contract have now changed because leases have to be recognised on the balance sheet. The Standard now requires an entity to account for each lease component within a contract as a lease separately from non-lease components of the contract

(IFRS 16.12-17). A lease component is part of a contract that contains a lease (ie it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Anything which doesn't meet the definition of a lease is a non-lease component.

A right to use an underlying asset is a separate lease component in a contract if both of the following criteria are met:

Criteria	Commentary	Examples
(a) The lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee	Readily available resources are goods or services that are sold or leased separately or resources that the lessee has already obtained. These may be available from the same lessor or another supplier.	A company which leases a van and trailer can easily use either item on its own or lease another van/trailer either from the same supplier or a different one.
(b) The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract	This relates to whether or not a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract.	Where assets are highly dependent, forexample an organisation leases an Automated Teller machine (ATM) which will only work with a specific till system from the same supplier.

3.2.5 Allocating consideration between lease and non-lease components

For a lessee, the price of components should be based on the price a lessor, or similar supplier, would charge to purchase that component separately. The standard acknowledges that such information may not always be available and, in these cases, allows the lessee to estimate the stand-alone price of each lease component and the aggregate stand-alone selling price of the non-lease components (but using as much observable information as possible to make this estimate). [IFRS 16.13-14]

Illustration

An entity enters into a three-year contract to use a machine provided by a supplier. The supplier will also maintain the machine throughout the life of the contract. Annual payments under the contract are Ugx. 1,000,000, including maintenance. If the entity had paid for the maintenance costs itself rather than including them as part of the package, annual payments would have been reduced to Ugx. 800,000. The entity establishes that a stand-alone maintenance contract would cost Ugx 400,000 per annum. In this scenario, 800,000/1,200,000 X 1,000,000 = Ugx. 666,667 would be allocated to the lease component, with 800,000/1,200,000 X 1,000,000 = Ugx. 333,333 allocated to the service contract.

3.2.6 Practical expedient

The standard includes a practical expedient for lessees only. This allows organisations to elect to not separate lease and non-lease components and instead account for both as if it were one lease component. An example of where this might be the case is if a company leases a car for Ugx 5,000 per year but also pays Ugx 200 a year as part of the contract for maintenance. The maintenance element is not a lease component, but because it is a component of a larger contract which contains a lease component the company may elect to apply the practical expedient and therefore treat the whole contract as one lease.

The expedient may be applied only where it is applied to the entire class of similar assets. In the above example the company could not elect to do this for some cars but not others. This practical expedient is also not applicable to embedded derivatives that meet the criteria in paragraph 4.3.3 of IFRS 9.
A lessor should allocate consideration between individual lease and non-lease components of a contract in line with IFRS 15's guidance on allocating the transaction price to performance obligations, ie based on stand-alone selling prices or estimation thereof. The practical expedient mentioned above is not available to lessors.

3.2.7 Whether a contract contains a lease when the customer is a joint arrangement

When a contract to receive goods or services is entered into by, or on behalf of, a joint arrangement (as defined in IFRS 11 Joint Arrangements), the joint arrangement is considered to be the customer in the contract. Accordingly, when assessing whether such a contract contains a lease, an entity should assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use. [IFRS 16:B11]

3.2.8 Identified asset

The asset that is the subject of a lease must be specifically identified. This will be the case if either of the following applies: [IFRS 16:B13]

- the asset is explicitly specified in the contract (e.g. a specific serial number); or
- the asset is implicitly specified at the time that it is made available for use by the customer (e.g. when there is only one asset that is capable of being used to meet the contract terms).

Even if an asset is specified in the contract, the lessee does not control its use if the lessor has a substantive right to substitute the asset with an alternative asset during the lease term. A lessor's substitution right is substantive if the lessor has both the practical ability to substitute an asset and it would benefit economically from doing so. A supplier's right or obligation to substitute the asset for repairs or maintenance does not, in isolation, equate to a substantive right of substitution. [IFRS 16 B14-B19] The standard further requires that the supplier's substitution rights should be assessed at the inception of the contract to determine if they are substantive or not. At that time all facts and circumstances should be considered – but not future events that are unlikely to occur.

Alert

If a supplier would benefit from substitution only in circumstances that are not likely to occur, such as those listed in IFRS 16:B16, those substitution rights are not substantive, regardless of whether the circumstances are specified in the contract. [IFRS 16:BC114]

Illustration

Substantive substitution rights

An entity enters into a contract with a parking lot manager to use space at the parking lot to assemble its 200 fleet of cars for a seven-year period. The contract states the exact amount of space that will be provided and that that space must be located at any one of the several openings within the parking lot. However, the parking lot manager can change the location of the space allocated to the entity at any time. The costs of relocation would be minimal as the space is tied within the same location.

In these circumstances it appears that the parking lot manager's substitution rights are substantive as it has the practical ability to substitute an asset and would benefit economically from doing so. The parking lot manager benefits from substitution because it allows the manger to make the most effective use of space to meet changing circumstances.

Non-substantive substitution rights

An entity enters into a contract with a property owner to use one of several similar retail units in a shopping centre for a seven-year period. The contract specifies that the entity will occupy a specific unit. However, it also allows the property owner to relocate the entity to a similar unit provided the property owner covers the costs of the relocation. The property owner would only benefit economically from doing so if a new tenant were to pay rent at a rate significantly above the market rate. It is possible this could happen but it is not considered likely.

In these circumstances the property owner's substitution rights are not considered to be substantive as, even though it may be economically beneficial for it to substitute the asset specified in the contract for a similar asset in some circumstances, at inception of the contract those circumstances are considered unlikely to arise.

3.2.9 Whether portions of an asset can be an identified asset?

A 'capacity portion' of an asset – such as a floor in a building or distinct fibres within a cable – can be an identified asset if it is physically distinct. A capacity portion that is not physically distinct is not an identified asset unless it represents substantially all of the capacity of the entire asset. [IFRS 16 B20]

Illustration:

Substantially all of the capacity of an asset

An entity may enter into a contract for only a part or proportion of an asset, but obtain substantially all of the capacity of the entire asset due to practical considerations. For example, if an entity leases a percentage of a cargo storage container but the contract includes restrictions that prohibits the entity's cargo from being mixed with another customer's, the entity would in substance be using the entire capacity of the container, as no other users could practically utilise any capacity of the cargo storage container.

3.3 The right to control the use of an identified asset

To assess whether a contract conveys the right to control the use of an identified asset for a period of time (as required under IFRS 16:9), an entity is required to assess whether, throughout the period of use, the customer has both of the following:

- the right to obtain substantially all of the economic benefits from use of the identified asset ((a 'benefits' element); and
- the right to direct the use of the identified asset ('power' element)

The 'period of use' is "[t]he total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)". [IFRS 16:Appendix A]

3.3.1 What is meant by obtaining substantially all of the economic benefits?

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use for example, by having exclusive use of the asset throughout that period. [IFRS 16 B21-B23]

Alert

Therefore, in circumstances when an asset might be considered to be implicitly identified (e.g. the supplier has only one machine capable of delivering the customer's requirements), if the supplier can regularly use the machine for other purposes during the course of the contract (e.g. to supply other customers), the customer does not have the right to obtain substantially all of the economic benefits from the use of that asset and there is no lease.

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 and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

The economic benefits to be considered are those that are available within the defined scope of the customer's right to use the asset. [IFRS 16:B22]

Illustration:

Economic benefits

An entity enters into a 30-year contract with an energy company to purchase all of the power produced by a new biogas plant. The entity will also receive the renewable energy tax credits that accrue from using the biogas plant. In this scenario, the entity obtains substantially all of the economic benefits from use of the asset as it obtains both the primary output (ie, the electricity produced by the biogas plant) and the by-products of using the asset (ie, the tax credits arising).

Alert

The assessment as to whether a contract contains a lease should not consider economic benefits relating to ownership of an asset (e.g. tax benefits as a result of owning an asset). This is because a lease does not convey ownership of the underlying asset. [IFRS 16:BC118]

Where a contract requires a Customer to pay a portion of the cash flows derived from use of the asset as consideration

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration should be considered to be part of the economic benefits that the customer obtains from use of the asset. [IFRS 16:B23]

For example, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the total cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space. [IFRS 16:B23]

3.4 Right to direct the use

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

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
- the relevant decisions about how and for what purpose the asset is used are predetermined and:
  - 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 lessor having the right to change those operating decisions; or
  - the customer designed the asset in a way that predetermines how and for what purpose it will be used throughout the period of use.

If neither of the conditions in IFRS 16:B24 is met, the supplier directs how and for what purpose the asset is used and, consequently, the contract does not contain a lease.

In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used. Decision-making rights are relevant when they affect the economic benefits to be derived from use. Which rights are relevant will depend on the nature of the asset and the terms and conditions of the contract.

Examples of decision-making rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used include rights to change;what is produced,(e.g. to decide whether to use a shipping container to transport goods or for storage, or to decide upon the mix of products sold from retail space) where it is produced,(e.g. to decide upon the destination of a truck or a ship, or to decide where an item of equipment is used);when it is produced, ((e.g. to decide when an item of machinery or a power plant will be used); and whether it is produced and the quantity of that output (e.g. to decide whether to produce energy from a power plant and how much energy to produce from that power plant)

Rights that are limited to operating or maintaining the asset are examples of rights that do not grant the right to change how and for what purpose the asset is used. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined eg, by the design of the asset or by contractual restrictions on the use of the asset.

Illustration: directing the use of identified asset

An entity enters into a contract with a trailer owner to transport some cargo from point A to point B. The trailer owner will pick up the specified goods on an agreed date. It will then operate and maintain the trailer and ensure safe passage of the cargo to its destination. The entity does not have the right to direct how and for what purpose the trailer is used as this is predetermined in the contract. In these circumstances the entity would be able to direct the use of the trailer only if it had the right to operate it throughout the period of use or if the entity designed the trailer in a way that predetermined how and for what purpose it would be used. This does not appear to be the case in this scenario. Therefore, the contract does not contain a lease.

3.4.1 Protective rights

A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may: [IFRS 16:B30]

- specify the maximum amount of use of an asset or limit where or when the customer can use the asset; or

- require a customer to follow particular operating practices; or
- require a customer to inform the supplier of changes in how an asset will be used.

Rights of this nature typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset. [IFRS 16:B30]

3.5 Lease term

3.5.1 Introduction

A lease term is defined as "the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

- periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option". [IFRS 16:18]

3.5.2 Consideration of enforceability

As part of its assessment of the lease term and the length of the non-cancellable period of a lease, an entity should consider the definition of a contract ("[a]n agreement between two or more parties that creates enforceable rights and obligations") and determine the period for which the contract is enforceable. [IFRS 16:B34]

For the purposes of IFRS 16, a contract is considered to exist only when it creates rights and obligations that are enforceable. Any non-cancellable period or notice period in a lease meets the definition of a contract and, therefore, should be included as part of the lease term. Any options to extend or terminate the lease that are included in the lease term must also be enforceable.

In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse a request from the lessee to extend the lease. If optional periods are not enforceable (e.g. if the lessee cannot enforce the extension of the lease without the agreement of the lessor), the lessee does not have the right to use the asset beyond the non-cancellable period. By definition, there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. [IFRS 16:BC127]

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. [IFRS 16:B34]

Alert – Determination of lease term

A lessee enters into a non-cancellable seven-year contract to lease a building. The lease comes with an option to extend for another seven years at the same rent. Market rentals in the area are expected to increase by 15% over the next fourteen years. Moreover, the location of the building is considered critical to the lessee's business and there are few suitable alternatives available in the area. The lessee therefore concludes that for accounting purposes the lease term is fourteen years.

3.5.3 Beginning of lease term

The lease term begins on the 'commencement date' of the lease. [IFRS 16:B36] This is defined as the date on which the lessor makes an underlying asset available for use by a lessee. [IFRS 16:Appendix A] It is the date on which the lessee initially recognises and measures right-of-use assets and lease liabilities. It is also the date on which the lessor recognises assets held under a finance lease in its statement of financial position.

IFRS 16 makes an important distinction between the 'inception date' and the 'commencement date' of a lease. The inception date of the lease is defined as the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. [IFRS 16:Appendix A] This is the date on which an entity evaluates a contract to determine whether it is, or contains, a lease. For lessors, it is also the date at which the classification of a lease is determined.

Therefore, although important assessments are made at the inception date, the assets, liabilities, income and expenses resulting from a lease are not recognised in the financial statements or measured until the commencement date (see IFRS 16:BC142 to BC144 for further discussion).

A lessee does not obtain and control its right to use the underlying asset until the commencement date. Before that date, the lessor has not yet performed under the contract. Although a lessee may have a right and an obligation to exchange lease payments for a right-of-use asset from the date of inception, the lessee is unlikely to have an obligation to make lease payments before the asset is made available for its use. [IFRS 16:BC142]. If such circumstances do arise (i.e. if the entity is required to make payments for the right to use the underlying asset before the commencement date), IFRS 16:B44 explicitly requires that they be included in lease payments.

Illustration

Lease payments on assets not in use

TAS Ltd is planning a major expansion of its oil production capacity beginning in 20X2. In order to ensure sufficient shipping capacity is available when production increases, TAS Ltd enters into a lease contract on 1 January 20X1 for oil tankers to ship the oil. The oil tankers will be made available to TAS Ltd from 1 July 20X1. TAS Ltd does not expect to use the oil tankers for its own shipping purposes until 20X2, but it may consider other options (e.g. to rent out the tankers to other producers) in the second half of 20X1. The sole reason for entering into the lease contract in 20X1 is to ensure that the oil tankers will be available to TAS Ltd in 20X2.

The inception date of the lease is 1 January 20X1 (or any earlier date on which the parties committed to the principal provisions of the lease). This is the date on which TAS Ltd evaluates the contract to determine whether it is, or contains, a lease. Assume that, having regard to the requirements set out in 3.0 (identified assets, no substantive substitution rights and, from 1 July 20X1, the right to control the use of the oil tankers), TAS Ltd determines that the contract is a lease. [In fact, each of the oil tankers may be considered a separate lease component. However, it is assumed that TAS Ltd applies the practical expedient in IFRS 16:B1 (see section 3.2.6) and accounts for the portfolio of leases together.]

The lessor makes the oil tankers available for use by TAS Ltd on 1 July 20X1. TAS Ltd has the right to control the use of the oil tankers from that date. Although TAS Ltd does not intend to use the oil tankers until 20X2, it has the right to determine how and for what purpose the tankers are used from 1 July 20X1. If TAS Ltd chooses to store the tankers rather than use them for a period of time, this is a demonstration of its control over those tankers. Therefore, 1 July

20X1 is the commencement date of the lease and the assets, liabilities, income and expenses resulting from the lease are recognised and measured from that date.

The depreciation of the right-of-use asset should commence from 1 July 20X1 (i.e. the commencement date) even if the oil tankers are not used until 20X2.

3.5.4 Rent-free periods

The lease term includes any rent-free periods provided to the lessee by the lessor. [IFRS 16:B36]

3.5.5 Lessor termination options

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. [IFRS 16:B35]

Alert

A lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. [IFRS 16:BC128]

This principle applies for the determination of the lease term for the lessor as well as for the lessee – there is no assessment regarding whether the lessor is reasonably certain not to terminate, as is the case with lessee termination options.

3.5.6 Lessee Extension and Termination Options

In contrast to lessor termination options, if the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease are required to consider those optional periods in their assessment of the lease term. [IFRS 16:BC128]

In accordance with IFRS 16:18, the lease term will be considered to extend beyond the non-cancellable period if the lessee has an extension option that it is considered to be reasonable certain to exercise, or a termination option that it is considered to be reasonably certain not to exercise.

At the commencement date, the entity should assess whether the lessee is reasonably certain: [IFRS 16:B37]

3.5.7 Assessing and applying reasonable certainty

Reasonable certainty is a "measurement" that the lessee should apply under IFRS 16:B37 to whether they are likely to

- to exercise an option to extend the lease; or
- to exercise an option to purchase the underlying asset; or
- not to exercise an option to terminate the lease.

In making these assessments, 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 must be valued and that value taken into account - [IFRS 16:19 & B37].

Therefore, determining whether there is an 'economic incentive' to exercise an option to extend a lease or to forfeit an option to terminate early will be a matter of judgement. Examples of factors to consider when making these assessments include, but are not limited to the ones listed under para [IFRS 16:B37]

A contractual option to extend or terminate a lease may be combined with one or more other obligations (e.g. 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, there can be assumed a "reasonable certainty" that the termination option will not be exercised and the extension option will be – IFRS 16:B38.

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, locating it, installing it and retraining staff are likely to be proportionately higher the shorter the non-cancellable period - IFRS 16:B39.

Similarly, an assessment can be made on "reasonable certainty" of adoption of an option by taking account of the behaviour of the 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 should consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets. [IFRS 16:B40]

Alert – Choice to extend vs. to terminate

Entities should take care when assessing the impact of extension or termination options on the lease term. For example, a lease may be structured as:

- • A lease with an initial term of Six years, plus an option for the lessee to extend for a further six years; or
- • A lease with an initial term of twelve years, with an option to terminate the lease after six years.

Despite the differing lease structures, both leases have a non-cancellable period of six years. For each case, the entity would then need to consider whether it is reasonably certain that it will extend or that it will not terminate the lease to determine whether an additional period should be added to the non-cancellable period.

3.5.8 Reassessment of extension and termination options

A lessee should reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that: [IFRS 16:20]

- is within the control of the lessee; and
- affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

Alert

The IASB is of the view that users of financial statements receive more relevant information if lessees reassess extension, termination and purchase options on a regular basis. However, requiring reassessment at each reporting date would be costly for an entity with many leases that include options. In order to address that concern, while still providing useful information to users of financial statements, the Board decided that an appropriate balance would be achieved by requiring reassessment only if both of the criteria in IFRS 16:20 are met. Consequently reassessment is required only upon the occurrence of a significant event or a significant change in circumstances that is within the control of the lessee and that affects whether the lessee is reasonably certain to exercise, or not to exercise, an option to extend a lease, to terminate a lease or to purchase an underlying asset.

Limiting the reassessment requirement to events within the control of the lessee means that a lessee is not required to reassess options in response to purely market-based events or changes in circumstances. To assist lessees, IFRS 16:B41 (see below) includes some examples of possible triggering events to help entities apply judgement in identifying significant events or significant changes in circumstances that trigger reassessment. [IFRS 16:BC184 – BC186]

3.5.9 Revision of Lease Term

An entity should revise the lease term if there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if one of the following occurs:

- the lessee exercises an option not previously included in the entity's determination of the lease term;
- the lessee does not exercise an option previously included in the entity's determination of the lease term;
- an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term; or
- an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term. [IFRS 16:21]

Alert

The lease term may also be revised following a reassessment as to whether an extension option is reasonably certain to be exercised, or a termination option is reasonably certain not to be exercised. Although such a reassessment does not affect the non-cancellable period, it affects the total lease term comprised of the non-cancellable period and reasonably certain extension periods.

4.0 LEASE PAYMENTS

4.1 Lease payments – definition

A number of the measurement requirements in IFRS 16 are determined by reference to the 'lease payments'. Lease payments are defined as payments made by a lessee to a lessor relating to the right to use of an underlying asset during the lease term, comprising the following:

- fixed payments (including in-substance fixed payments –, less any lease incentives;
- variable lease payments that depend on an index or a rate;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option;
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease; and
- residual value guarantees. [IFRS 16:Appendix A]

Alert

In accordance with IFRS 16:18, the lease term will be considered to extend beyond the non-cancellable period if the lessee has an extension option that it is considered to be reasonably certain to exercise, or a termination option that it is considered to be reasonably certain not to exercise. Therefore, lease payments include optional payments payable after the non-cancellable period if it is considered reasonably certain that the lease will extend beyond that period.

In contrast lease payments exclude (1) variable lease payments linked to future performance or use of the underlying asset, and (2) optional payments payable after the non-cancellable period if it is not considered reasonably certain that the lessee will extend the lease beyond that period.

4.2 Exclusion of payments allocated to non-lease components

Entities are generally required to separate lease and non-lease components of a contract. For a lessee, lease payments do not include payments allocated to non-lease components of a contract, unless the lessee has elected to combine lease and non-lease components under the practical expedient permitted under IFRS 16:15. [IFRS 16:Appendix A]

For a lessor, lease payments do not include payments allocated to non-lease components. [IFRS 16:Appendix A]

For a lessor, there is no practical expedient permitting lease and non-lease components to be combined.

4.3 Fixed payments

Fixed payments are defined as "[p]ayments made by a lessee to a lessor for the right to use an underlying asset during the lease term, excluding variable lease payments". [IFRS 16:Appendix A]

'In-substance' fixed lease payments, which are specifically required to be included in lease payments, are payments that may, in form, contain variability but that, in substance, are unavoidable.
In-substance fixed lease payments are provided for in detail under IFRS 16:B42, but would essentially exist for example if:

- payments are structured as variable lease payments, but there is no genuine variability in those payments.
- there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic; and
- 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.

4.3.1 Lease incentives

Lease incentives are defined as "[p]ayments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee". [IFRS 16:Appendix A]

Alert

Such incentives may take the form, for example, of an up-front cash payment to the lessee or a reimbursement or assumption by the lessor of costs of the lessee (e.g. relocation costs and costs associated with a pre-existing lease commitment of the lessee).
Such payments are offset against lease payments made by the lessee to the lessor. When any incentives are paid to the lessee, even if they are not part of the formal lease agreement, they should be offset against lease payments.

4.4 Variable lease payments

4.4.1 Variable lease payments – definition

Variable lease payments are defined as "[t]he portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time". [IFRS 16:Appendix A]

Variability arises if lease payments are linked to the factors as mentioned under [IFRS 16:BC163]

4.4.2 Variable lease payments that depend on an index or a rate

Lease liability initially measured using the index or rate as at the commencement date

This approach applies to, for example, payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate (e.g. LIBOR) or payments that are adjusted to reflect changes in market rental rates [IFRS 16:28]

When measuring a lessee's lease liability or a lessor's net investment in a lease, such payments should initially be measured using the index or rate as at the commencement date.

Alert

Variable lease payments that depend on an index or a rate are included in lease payments. They meet the definition of liabilities for the lessee because they are unavoidable and do not depend on any future activity of the lessee. Any uncertainty, therefore, relates to the measurement of the liability that arises from those payments and not to the existence of that liability. [IFRS 16:BC165]

At initial recognition, such payments are measured using the index or rate at the commencement date (without estimating changes in the index or rate over the remainder of the lease term). The IASB considered that using forecasting techniques or forward rates to estimate changes in the index or rate would be costly, and might introduce measurement uncertainty and reduce comparability between entities. [IFRS 16:BC166]

4.4.3 Variable lease payments that depend on an index – example

On lease commencement, variable lease payments that depend on an index are measured using the index as at the commencement date of the lease.

When the change in future lease payments is a result of a change in an index (or rate), the lessee remeasures the liability using an unchanged discount rate.

Usually in practice, it is common for lease agreements to include periodic rent review clauses that depend on a published index. These clauses adjust contracted lease payments to reflect changes in inflation measures and other factors. Common indices used include the following.

- Consumer price index (CPI).
- Producer price indices (PPIs).
- Retail price indices (RPIs).
- House price indices.
- Average earnings indices.

The guidance described above applies only when the lease payments depend on the future – i.e. uncertain – level of an index. It does not apply to fixed uplifts designed to reflect expected changes in an index. We can consider a comparison of the two different rent adjustment clauses below:

Adjustment Clause Under Agreement A	Adjustment Clause Under Agreement B
The rent for Year 1 is Ugx. 5000. At the end of each year, the rent is adjusted to reflect the change in RPI over the preceding months. Average annual inflation over the previous three years has been 6%.	The rent for the first year is Ugx. 5000. Rents increase by 6% in each subsequent year. This increase is designed to compensate the lessor for expected changes in RPI, because average annual inflation over the previous three years has been 6%.
Mode of Payment	**Mode of Payment**
The rents depend on an index – i.e. on the future amount of RPI. On lease commencement, the lessee includes in the lease liability the annual lease payments of Ugx. 5000. At the end of Year 1, the lessee remeasures the lease liability to include future lease payments based on the then level of RPI.	The rents are fixed; they do not depend on the future value of RPI. On lease commencement, the lessee includes in the lease liability the annual lease payments that increase by the fixed factor of 6% – that is, Ugx. 5000, 5300, 5618, 5955 etc. There are no future changes in lease payments that require the lessee to remeasure the lease liability.

4.4.4 Payments that depend on a rate

Consistent with payments that depend on an index, variable lease payments that depend on a rate are initially measured using the rate as at the commencement date of the lease.

The lease liability is subsequently remeasured if the variable lease payments change as a result of a change in the relevant rate (e.g. LIBOR).

The lessee remeasures the liability using an unchanged discount rate when the change in future lease payments results from a change in a rate, with the exception of floating interest rates. [IFRS 16:42(b), 43]

In the case of a floating interest rate, the lessee revises the discount rate for the change in the interest rate.

4.4.5 Lessor considerations

There are no differences in the identification of lease payments for lessees and lessors regarding lease payments that depend on an index or a rate, though the accounting consequences may be different due to the different accounting models for lessees and lessors. One key distinction is that for a lessor the presence of variable lease payments may affect lease classification.

4.4.6 Rent reviews to market rates or upward-only

When a lease contract includes the potential for rent reviews (whether to market rates or upward only), the lease payments included in the measurement of the lessee's lease liability and the lessor's net investment in the lease at the commencement date will be the payments agreed at inception, without consideration of future rent reviews.

Whether a lease specifies a rent of Ugx 100 annually plus market increases, or Ugx 100 annually resetting up or down to market every five years, the lease payments recognised at the commencement date are Ugx 100 annually. Any increase or decrease as a result of subsequent rent reviews will be recognised when the adjustment to the lease payments takes effect.

The basis of any rent review under a lease should be evaluated carefully to determine whether the rent review resets the lease payments to market at the date of the review or whether, in substance, the amount of change in the lease payments at the date of the review was fixed at inception. In the latter case, the changes in rent would represent 'in-substance' fixed payments and would therefore be included in lease payments from the commencement date.

Alert - In-substance fixed payments

When calculating the value of the right of use asset and the lease liability, all fixed lease payments should be included regardless of how they are structured in the contract. This includes what the standard refers to as 'in-substance' fixed payments ie, payments that could, according to the contract, be variable but are in reality unavoidable. A common example of an in-substance fixed payment is when a payment has to be made only if an event occurs that has no genuine possibility of not occurring.

4.4.7 Variable lease payments linked to future performance or use of an underlying asset

Variable lease payments linked to future performance or use of an underlying asset are excluded from the measurement of lease liabilities (see IFRS 16:BC168 and BC169 for a discussion of the IASB's considerations in this regard). Such payments are required to be recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.

Illustration - Variable lease payments linked to sales

A lessee enters into a Ten-year lease of a parking rot. In addition to fixed annual payments, the lessee is also required to make variable payments each year based on 3% of the sales that it generates from the leased property. Such variable lease payments are linked to future sales, the variable payments do not meet the definition of lease payments and are consequently not included when measuring the lease liability

4.4.8 Options to purchase the underlying asset

Purchase options are required to be included in the measurement of a lessee's lease liability and a lessor's lease receivable in the same way as options to extend the term of a lease (i.e. the exercise price of a purchase option is included in the measurement of a lease liability/receivable if the lessee is reasonably certain to exercise that option). The IASB views a purchase option as effectively the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. [IFRS 16:BC173]

4.4.9 Residual value guarantees

A residual value guarantee is defined as "[a] guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount". [IFRS 16:Appendix A]

For a lessee, lease payments include amounts expected to be payable by the lessee under residual value guarantees. [IFRS 16:Appendix A]

A lessee should estimate the amount that it expects to pay to the lessor under a residual value guarantee and include that amount in the measurement of its lease liability. This treatment reflects the fact that payments resulting from a residual value guarantee cannot be avoided by the lessee – the lessee has an unconditional obligation to pay the lessor if the value of the underlying asset moves in a particular way. Accordingly, any uncertainty relating to the payment of a residual value guarantee does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary in response to movements in the value of the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee. [IFRS 16:BC170 & BC171]

5.0 LESSEE ACCOUNTING

5.1 Introduction

Under IFRS 16, lessees recognise an asset reflecting their right to use the leased asset for the lease term (referred to as the 'right of use' asset) and a lease liability reflecting their obligation to make lease payments. Both the asset and the liability are recognised on-balance sheet at the commencement of the lease ie, the date on which the lessor makes the underlying asset available for use by the lessee.[IFRS 16,22]. The standard applies to all leases with a few exceptions for short term leases and leases of low value assets introduces a single lessee accounting model for both finance and operating leases.

Alert

(i) The standard defines a short-term lease, the lease term should be determined under the general requirements of IFRS 16. Consequently, lessees will need to assess the effect of extension and termination options. The prohibition on a lease containing a purchase option being classified as a short-term lease applies for any lease containing a purchase option, irrespective of the probability that the option will be exercised.

Note also that there is no restriction on qualification as a short-term lease based on the value of the underlying asset or the amount of the consideration paid. This exemption is available for high-value items that are leased for the short term.

(iii) IFRS 16 does not provide an explicit definition for what is meant by 'low-value' assets. However, the Basis of Conclusions states that "[a]t the time of reaching decisions about the exemption in 2015, the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US$5,000 or less". [IFRS 16:BC100] Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones. [IFRS 16:B8]

5.2 Accounting for lease liability

The lease liability is initially calculated as the present value of the lease payments, discounted at the rate implicit in the lease or, if this cannot be readily determined, the lessee's incremental borrowing rate. 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:

- fixed payments (including in-substance fixed payments) less any lease incentives receivable;
- variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- payments of penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease. IFRS 16.26-27

In subsequent years the lease liability is increased by the unwinding of the discount and reduced by lease payments made to the lessor. IFRS 16.36

Illustration: Accounting for the lease liability

A lessee enters into a ten-year lease of a warehouse building. Lease payments are Ugx 200,000 per annum payable in advance. The lessee incurs direct costs of Ugx 20,000 and lease incentive of Ugx 8,000. The lease contains neither a residual value guarantee nor a purchase option. The interest rate implicit in the lease is determined to be 6%.

At the commencement date, the lessee makes the lease payment for the first year and incurs the initial direct costs. These payments are therefore excluded when calculating the lease liability, which is initially calculated as the present value of the remaining nine lease payments discounted at the interest rate of 6%.

The lease liability is subsequently accounted for as follows:
Future payments for the lease are listed in the table below. For each payment, the discount factor is calculated in order to determine the total present value of the lease liability. Initial measurement of a lease liability amounts to Ugx 1,360,338 and is calculated as follows:

SN	FUTURE PAYMENT	DATE OF PAYMENT	DISCOUNT FACTOR	DISCOUNTED AMOUNT
1	200,000	1/1/2002	0.9434	188,679
2	200,000	1/1/2003	0.8900	177,999
3	200,000	1/1/2004	0.8396	167,924
4	200,000	1/1/2005	0.7921	158,419
5	200,000	1/1/2006	0.7473	149,452
6	200,000	1/1/2007	0.7050	140,992
7	200,000	1/1/2008	0.6651	133,011
8	200,000	1/1/2009	0.6274	125,482
9	200,000	1/1/2010	0.5919	118,380
	Lease liability at initial recognition			**1,360,338**

The right-of-use asset at initial recognition amounts to:

SN	Item	Amt in Ugx
1	Initial measurement of the lease liability	1,360,338
2	Plus: Lease payments made at or before commencement date	200,000
3	Plus: Initial direct costs incurred by the lessee	20,000
4	Less: Lease incentives received	(8,000)
5	Plus: Estimated restoration costs	Nil
	Total Right of Use Asset	**1,572,338**

Alert – Right of Use

The right of use asset generally will subsequently be accounted for using the cost model of IAS 16 Property, Plant and Equipment. As such, it will be amortised over the life of the lease – often on a straight-line basis – and tested for impairment in accordance with IAS 36 Impairment of Assets when appropriate. However, if the lessee applies IAS 16's revaluation model to a class of property, plant and equipment then it may elect to apply the revaluation model to all right of use assets that belong to the same class of asset. This choice is not available on a lease-by-lease basis. [IFRS 16.29-33, 35]

Leased investment property must be measured at fair value if the lessee applies the fair value model under IAS 40 Investment Property to its other investment properties. [IFRS 16.34]

The schedules for accounting in subsequent years for the lease liability and right-of-use asset are presented below. Note that lease liability increases every year due to unwinding of discount (charged as finance costs in P/L) and decreases with each payment made:

YEAR	OPENING (1 JAN)	PAYMENT (1 JAN)	DISCOUNT	CLOSING (31 DEC)
2001	1,360,338	-	81,620	1,441,959
2002	1,441,959	(200,000)	74,518	1,316,476
2003	1,316,476	(200,000)	66,989	1,183,465
2004	1,183,465	(200,000)	59,008	1,042,473
2005	1,042,473	(200,000)	50,548	893,021
2006	893,021	(200,000)	41,581	734,602
2007	734,602	(200,000)	32,076	566,679
2008	566,679	(200,000)	22,001	388,679
2009	388,679	(200,000)	11,321	200,000
2010	200,000	(200,000)	(0)	(0)

The carrying amount of the right-of-use asset decreases with depreciation charged each year:

YEAR	NBV OPENING (1 JAN)	DEPRECIATION	NBV CLOSING (31 DEC)
2001	1,572,338	(157,234)	1,415,105
2002	1,415,105	(157,234)	1,257,871
2003	1,257,871	(157,234)	1,100,637
2004	1,100,637	(157,234)	943,403
2005	943,403	(157,234)	786,169
2006	786,169	(157,234)	628,935
2007	628,935	(157,234)	471,702
2008	471,702	(157,234)	314,468
2009	314,468	(157,234)	157,234
2010	157,234	(157,234)	(0)

As we can see, total lease payments amount to Ugx 2,012,000 (this includes initial direct costs, lease incentives and upfront lease payment for year 20X1). Total expense recognised during the lease term amounts to Ugx 2,012,000 as well and is split between depreciation expense (Ugx 1,572,338) and discounting expense (Ugx 439,662).

The lessee's accounting policy is therefore to apply the cost model of IAS 16. It therefore depreciates the Right of Use asset (Ugx. 1,572,338) on a straight-line basis over the life of the lease, with depreciation of Ugx 157,234 being charged each year.

Alert – Incremental Borrowing rate

It may not be possible to readily determine the rate of interest implicit in the lease so it will often be necessary to calculate the present value of the lease payments using the lessee's incremental borrowing rate. This is defined as the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right of use asset in a similar economic environment. However, the lease term may be longer than the period for which an entity typically borrows so determining an appropriate interest rate may also be challenging in some instances.

Entities may wish to consider the following in determining the incremental borrowing rate:

- External borrowing rates;
- Risk adjusted risk-free rates, like government bond rates;
- In groups, reviewing the parent/group borrowing rate in cases where a lessor would take into account the security of the group as a whole. Entities should be aware that in general it will not be appropriate to calculate a group rate to apply across the board;
- Property yield rates; and/or
- Specialist advice or engagement with lender stakeholders.

The nature of the lease and the terms and conditions of the lease may have an impact on the discount rate. Entities should use a rate specific to each lease.

Alert - Initial direct costs

A lessee's initial direct costs are the incremental costs of obtaining a lease that would otherwise not have been incurred. The standard does not provide a list of items that qualify as initial direct costs but such costs will typically include things such as commissions, legal fees, costs of negotiating the lease and costs of arranging collateral. They do not include general overheads such as employee costs, even if the employees are working on obtaining the lease, as such costs are not incremental.

Alert - costs of dismantling, removing or restoration

The cost of a right of use asset includes an estimate of any costs of dismantling, removing or restoring the underlying asset or restoring the site on which it is located when appropriate and once the obligation for those costs has been incurred. The obligations for such costs are recognised and measured applying IAS 37 Provisions, Contingent Liabilities and Contingent Assets, with the corresponding entry being recognised as a provision.

Alert – IFRS 16 and IAS 40

Changes have been made to IAS 40 following the publication of IFRS 16. All investment properties held by lessees as right of use assets are now within scope of the standard. Previously, lessees typically applied IAS 40 only to investment properties held under finance leases.

5.3 Presentation within the financial statements IFRS 16.47-50

5.3.1 Statement of financial position

Right-of-use assets and lease liabilities are presented separately in the statement of financial position or are disclosed in the notes. If the right-of-use assets are not presented separately, they should be included in the same line as is suitable for the underlying assets (IFRS 16.47-48). The standard does not say whether the right of use asset is a tangible or intangible asset, but where it is just disclosed separately in the notes it would be included in the line item on the face of the balance sheet that it would fall under were it owned.

5.3.2 Profit or loss

Depreciation charge for the right-of-use asset is presented the same way as depreciation/ amortisation of assets accounted for under IAS 16/IAS 38. IFRS 16 does not require separate presentation of depreciation of right-of-use assets.
Interest expense on the lease liability should be included in finance costs (IFRS 16.49).

5.3.3 Statement of cash flows

Leases impact the statement of cash flows in the following way (IFRS 16.50):

- repayments of the principal portion of the lease liability are presented within financing activities
- payments relating to accrued interest are classified according to the policy choice for interest payments that is either cashflows from operating or financing activities depending on the entity's election.
- short-term lease payments and payments for leases of low-value assets are presented within operating activities when the lessee adopted a relevant recognition exemption
- variable lease payments not included in the measurement of the lease liability are presented within operating activities

5.4 Hypothetical Presentation Illustration

Whereas the earlier illustration under 5.2 was not intended to be comprehensive enough to enable an elaborate illustration of expected leases related transactions, we choose to present herein below a hypothetical demonstration [2] on how leases would be presented in a typical real scenario. We have endeavored to include all items that may relate to lease but the demonstration may not be exhaustive. As such the presentation may vary from entity to entity depending on the nature of leases, the lease term and the general operations of the entity.

[2] This illustration does not include a full set of financial statements; only the statement of financial position, statement of profit or loss and statement of cash flow and the notes relevant to IFRS 16. For illustrative purposes, the illustrative provides only an example of statement of profit or loss guide, without presenting: the allocation of profit or loss and total comprehensive income to non-controlling interests and owners of the entity; and basic and diluted earnings per share.

5.4.1 Statement of Financial Performance for the Period ended 31 Dec 2XX1

REFERENCE	NARRATION	NOTES	AMOUNT UGX
	Revenue		XXXX
	Other Investment income		XXX
	Expenses		(XXXX)
	EBITDA		XXXX
IFRS 16.49)	Finance Cost - Interest [3]	A	(XXX)
IFRS 16.49)	Depreciation & Amortization (ROU)	B	(XXX)
	Profit Before Tax		XXXX
	Income Tax Expenses		(XXX)
	Profit After Tax		XXX

5.4.2 Statement of Financial Position as at 31 December 2XX1

REFERENCE	NARRATION	NOTES	AMOUNT UGX
	Asset		
	Non-Current Assets		
	Property Plant and Equipment	C	XXXX
IFRS 16.47(a)	Right of Use Assets	D	XXX
	Current Assets		
	Inventory		XXX
	Trade and other receivables		XXX
IFRS 16.47(a)	Right of Use Assets	D	XXXX
	Total Assets		XXXX
	Equity and Liabilities		
	Capital and Reserves		XXXX
	Liabilities		
	Non-Current Liabilities		
IFRS 16.47(b)	Lease Liabilities	E	XXXX
	Borrowings		XXX
	Total non-Current Liabilities		XXX
IFRS 16.47(b)	Lease Liabilities	E	XXX
	Borrowings		XXX
	Other financial liabilities		XX
	Total Equity and Liabilities		XXXX

[3] A lessee presents 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 is presented separately in the statement of profit or loss and other comprehensive income.

5.4.3 Statement of Cashflows as at 31 December 2XX1

REFERENCE	NARRATION	NOTES	AMOUNT UGX
	Cashflows from operating activities		
	Depreciation of ROU Asset		XXX
IFRS 16.50(c)	Payments to suppliers & employees [4]		XXX
IAS 7.31–32	Interest Paid [5]		XXX
	Net cash generated by operating activities		XXXX
	Cash Flows from investing activities		
	Lease payments received from finance leases		
	Cash flows from financing activities		
IFRS 16.50(a)–(b) IAS 7.17(e), 31	Payment of lease liabilities		
		(XXX)	
	Net decrease in cash and cash equivalents		
	Cash and cash equivalents at 1 January		XXX
	Cash and cash equivalents at 31 December		XXX

Explanatory Notes to the Financial Statements

Note A - Finance costs

	Interest on loans from related parties	XXX
IFRS 16.53(b)	Interest expense on lease liabilities	XXX
	Other interest expense	XX
	Total Finance Costs	XXXX

[4] Lease payments for short-term leases, lease payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability are classified as cash flows from operating activities
[5] The Entity has classified the principal portion of lease payments within financing activities and the interest portion within operating activities

Note B - Depreciation and amortisation expense

	Depreciation of property, plant and equipment	XXX
IAS 38.118(d)	Amortisation of intangible assets	XXX
IFRS 16.53(a)	Depreciation of right-of-use-assets	XX
IAS 1.104	Total depreciation and amortisation expense	XXXX

Note C – Property Plant and Equipment

	Freehold land	XXX
	Buildings	XXX
	Plant and equipment	XX
IFRS 16.95	Assets subject to operating lease agreements (by class of assets	XXXX

Note D – Right of Use Assets

Assuming that the entity leases several assets including; buildings, plants, IT equipment.

	Cost	Right of Use- Buildings	Right of Use- Plants	Right of Use- IT Equipment	Total Ugx
IFRS 16.53(j)	As at January 20X1	XXX	XXX	XXXX	XXX
IFRS 16.53(h)	Increases		XXX	XXX	XXX
	Asset Retirement obligation	(XXX)			(XXX)
	Decreases	(xx)	(xx)	(xx)	(xx)
	As at December 20X1				
	Accumulated depreciation				
	As at January 20X1				
IFRS 16.53(a)	Depreciation expense for the year ended	XXX	XXX	XXX	XXX

	Charge on Asset Retirement	XX			XX
	Decreases	(XX)	(XX)	(XX)	(XX)
	As at December 20X1	XXX	XXX	XXX	XXXX
	Net Book Value as at December 31 20X1	XXXX	XXXXX	XXXX	XXXX

- The decrease in gross book value of Right of Use assets: Buildings result from mainly reassessment of estimation of lease term.
- The cost relating to variable lease payments that do not depend on an index or rate amounted to Ugx. XXXX.(IFRS 16.53(e).
- There were no leases for which the entity applied the practical expedient described under paragraph 5a of IFRS 16
- There were no leases with residual value guarantees or leases not yet commenced to which the entity committed.

Note E – Lease liabilities

		Amount (UGX)
	Current	
IFRS 16.53(j)	Non-current	XXXX

IFRS 16.58 - Maturity Analysis

IFRS 16.58	Not later than 1 year	XXX
IFRS 7.39(a)	Later than 1 year and not later than 5 years	XXX
IFRS 7.B11	Later than 5 years	XXX

IFRS 7.39(c) - The Entity does not face a significant liquidity risk with regard to its lease liabilities. Lease liabilities are monitored within the Entity's treasury function.

Amounts recognized in the profit or loss

		Amounts Ugx.
IFRS 16.53(a)	Depreciation expense on right-of-use assets	(XXXX)
IFRS 16.53(b)	Interest expense on lease liabilities	(XXXX)
IFRS 16.53(c)	Expense relating to short-term leases	(XXXX)
IFRS 16.53(d)	Expense relating to leases of low value assets	(XXXX)
IFRS 16.53(e)	Expense relating to variable lease payments not included in the measurement of the lease liability	(XXXX)
IFRS 16.53(f)	Income from subleasing right-of-use assets	(XXXX)

Alert - Intercompany leases

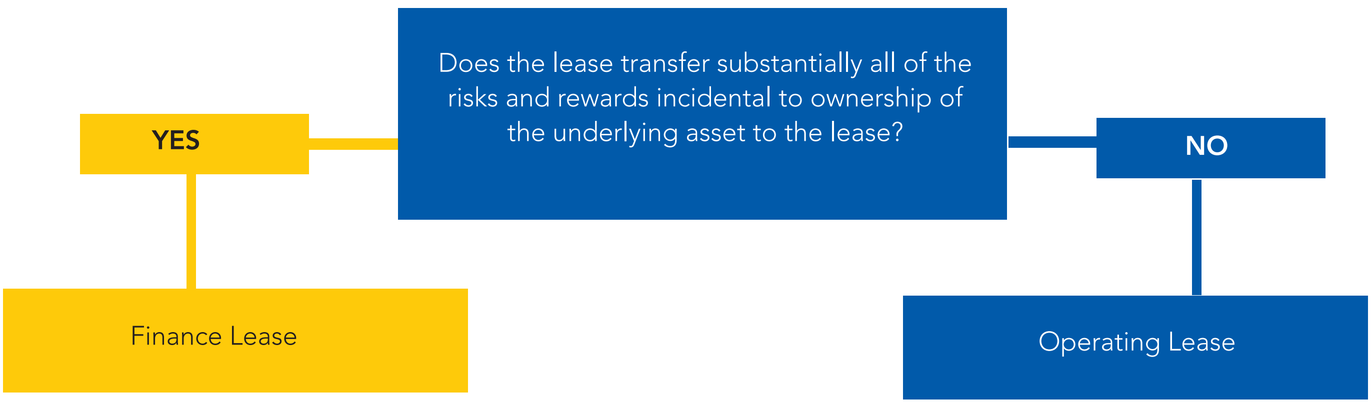
It is common in groups for assets to be leased from one group company to another group company. While at a group level these intra-group leases should be eliminated, at a statutory level they will have implications which may be material to individual entity accounts.

6.0 LESSOR ACCOUNTING

6.1 Introduction

The adoption of IFRS 16 by lessors, however, will not be complex as IFRS 16 retains the *IAS 17 Leases* accounting treatment for lessors. Lessors therefore continue to classify leases as operating leases or finance leases. If substantially all the risks and rewards incidental to ownership are transferred to the lessee, the lease will be accounted for as a finance lease. If they are not, it will be accounted for as an operating lease.

LESSOR ACCOUNTING



6.2 Accounting for finance leases

Under IFRS 16, lessors account for finance leases by initially derecognising the asset and recognising a receivable for the net investment in the lease and finance income recognised over the lease term based on a pattern reflecting a constant periodic rate of return on that net investment. [6]

> **Alert**
>
> If the lessor grants any incentives to the lessee, such as an initial rent-free period, then, at the inception of the lease, the calculation of the minimum lease payments and determination of the interest rate implicit in the lease will factor in nil payments by the lessee during such a rent-free period.

Initial direct costs [7] (other than those incurred by a manufacturer or dealer lessor) are included in the net investment in the lease.

> **Alert – Initial direct costs**
>
> This definition is consistent with the definition of incremental costs of obtaining a contract in IFRS 15 *Revenue from Contracts with Customers.* Consequently, the costs incurred by a lessor to obtain a lease are accounted for consistently with costs incurred to obtain other contracts with customers. [IFRS 16:BC237]

For lessors (other than a manufacturer or dealer lessor), initial direct costs should be included in the initial measurement of the investment in the lease, and reduce the amount of income recognised over the lease term. The definition of the interest rate implicit in the lease results in such costs being included automatically in the finance lease receivable; there is no need to add them separately. [IFRS 16:69]

These costs should include only costs that are incremental, and that are directly attributable to negotiating and arranging a lease (e.g. commissions, legal fees and incremental internal costs). General overheads, such as costs of sales and marketing,

---

[6] The net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease. The gross investment in the lease is the sum of (1) lease payments receivable by the lessor under a finance lease, and (2) any unguaranteed residual value accruing to the lessor. [IFRS 16:Appendix A]

[7] Initial direct costs are the "[i]ncremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease". [IFRS 16:Appendix A]

are excluded. If a lessor employs permanent staff to negotiate and arrange new leases, it is not appropriate for the salary costs of those staff to be included within the initial measurement of finance lease receivables.

The lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:

- Fixed payments, less any lease incentives payable
- Variable lease payments that depend on an index or a rate, initially measured using the index/rate at the commencement date
- Any residual value guarantees provided to the lessor by the lessee, a related party of the lessee, or other parties unrelated to the lessor that are financially capable of discharging the obligations under the guarantee
- The exercise price of a purchase option if the lessee is reasonably certain to exercise that option, and
- Payments of penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.

The lessor must use the interest rate implicit in the lease to measure the net investment in the lease.

Subsequent to initial recognition, a lessor must recognise 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 (i.e. it must use the amortised cost method).

The new impairment requirements for financial assets included in IFRS 9 *Financial Instruments* must be applied to the lease receivable.

6.3 Accounting for operating leases

Lessors continue to recognise underlying assets for operating leases on-balance sheet, with lease payments recognised as income on a straight-line basis or another systematic basis if it is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

The lessor must also:

- Recognise costs incurred in earning the lease income as an expense
- Depreciate the asset in a manner that is consistent with the lessor's normal depreciation policy for similar assets

- Assess the leased asset for impairment under IAS 36 Impairment of Assets, and
- Add initial direct costs incurred in obtaining the lease to the carrying amount of the leased asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

7.0 OTHER CONSIDERATIONS

7.1 Sale and leaseback transactions – general

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Because IFRS 16 requires lessees to recognise most leases on the balance sheet (i.e., all leases except for leases of low-value assets and short-term leases depending on the lessee's accounting policy election), sale and leaseback transactions no longer provide lessees with a source of off-balance sheet financing.

In considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback (e.g. a sale and leaseback transaction may be structured in the form of a lease and leaseback). [IFRS 16:BC261]

The accounting is therefore determined by whether or not the initial transfer of the underlying asset qualifies as a sale under IFRS 15. This assessment will determine how the transaction is accounted for in the books of both the lessee/seller and lessor/buyer. The possible outcomes are summarised below.

Where the transfer amounts to sale;

(a) the seller-lessee shall:

- Derecognise the underlying asset and apply the lessee accounting model to the leaseback.
- measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount (i.e the cost) of the asset that relates to the right of use retained by the seller-lessee.

- recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.

(b) The buyer-lessor on the other hand recognise the underlying asset and apply the lessor accounting model to the leaseback.

Where the transfer does not amount to a sale:

(a) the seller-lessee shall:

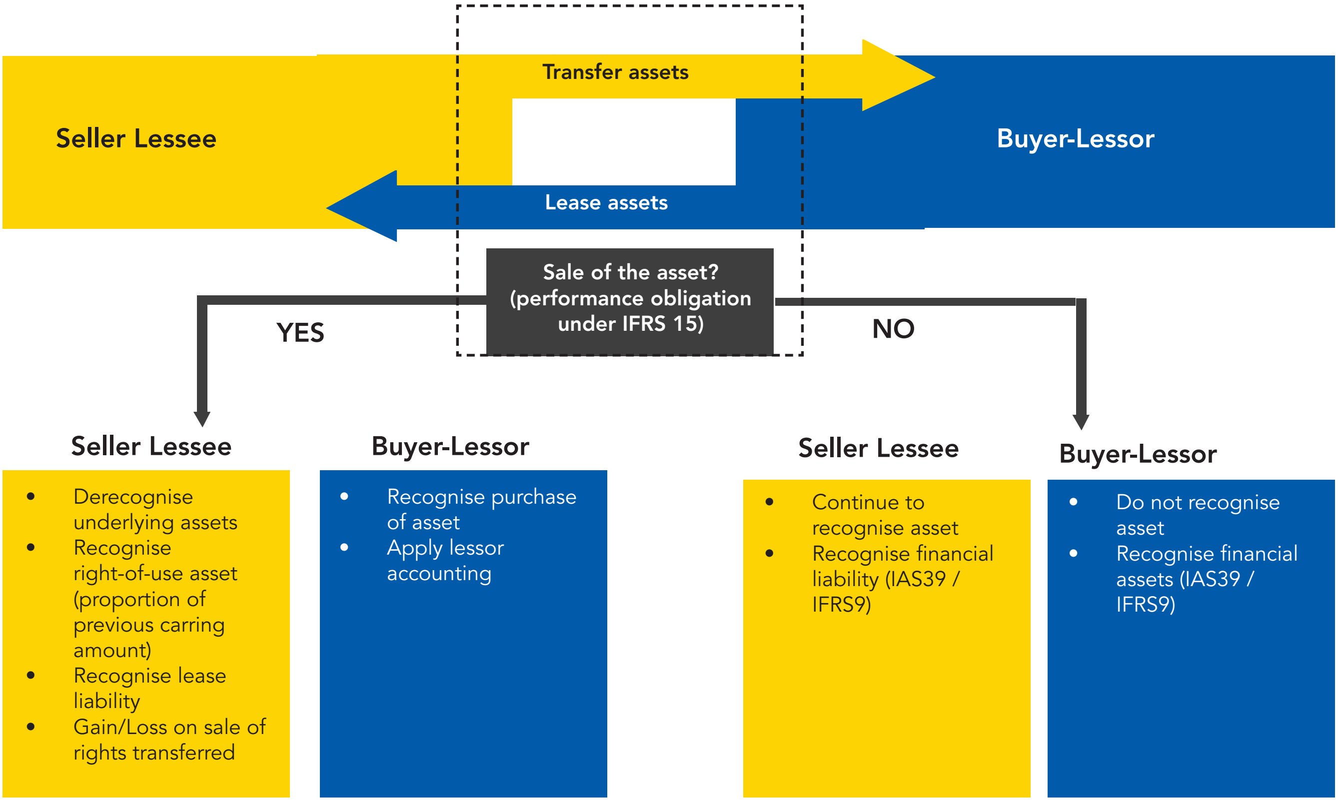
- Continue to recognise the underlying asset.
- Recognise a financial liability under IFRS 9 for any amount received from the lessor/buyer.

While the buyer – lessor will:

- Not recognise the underlying asset.
- Recognise a financial asset under IFRS 9 for any amount paid to the lessee/seller.

An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control[8] of that asset

[8] Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.



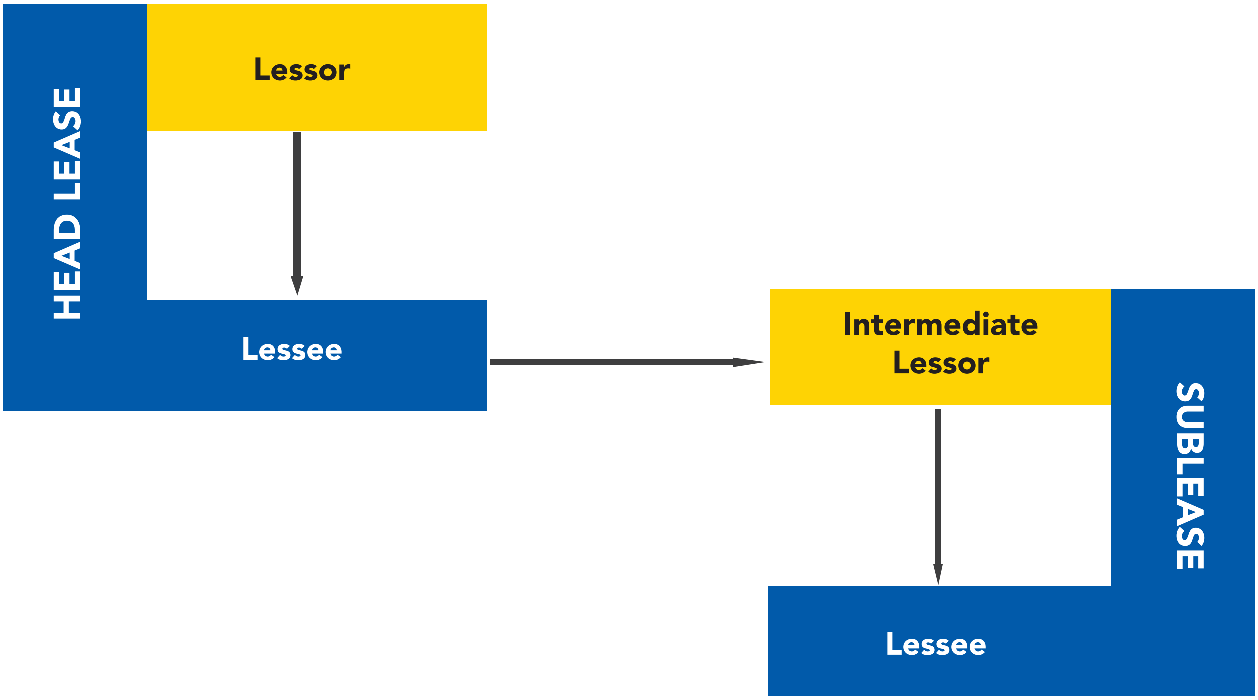
Unlike with IAS 17, under IFRS 16, lessees/sellers will always recognise a sale and leaseback transaction on-balance sheet unless the lease is short-term or the underlying asset is of low value. The profit from the 'sale' is likely to be reduced when compared to IAS 17.

Alert –

Existence of a leaseback, in isolation, does not preclude a sale. This is because a lease is different from the sale or purchase of an underlying asset, as a lease does not transfer control of the underlying asset. Instead, it transfers the right to control the use of the underlying asset for the period of the lease. However, if the seller-lessee has a substantive repurchase option for the underlying asset (i.e., a right to repurchase the asset), no sale has occurred because the buyer-lessor has not obtained control of the asset.

7.2 Sub Lease

A sub-lease 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.



IFRS 16 requires an intermediate lessor to account for a head lease and a sublease as two separate contracts, applying both the lessee and lessor accounting requirements. This approach is considered to be appropriate because, in general each contract is negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to the head lease. Accordingly, for an intermediate lessor, the obligations that arise from the head lease are generally not extinguished by the terms and conditions of the sublease. [IFRS 16:BC232]

Therefore, where the head lease is not a short-term lease expensed on a straight line basis over the lease term, the lessor must use the general principles for classification of a lease as an operating or a finance lease by reference to the right-of-use asset.

Alert –

Intermediate lessors in a sub-lease transaction could face significant changes as a result of the requirements in IFRS 16, particularly if the head lease was an operating lease under IAS 17. As a result of the requirements, such head-leases will have to be recognised on the balance sheet.

Intermediate lessors will need to assess sub-lease classification as an operating or finance lease based on the right of use asset arising from the head lease, not the underlying item of property, plant and equipment that it leases from the head lessor. For further guidance, refer to Appendix B paragraph 58 of the standard and paragraph IE8 (examples 20 and 21) accompanying the standard.

Illustration – Sublease as an operating lease

An intermediate lessor enters into a ten-year lease for 15,000 square metres of office space (the head lease) with the head lessor. At the commencement of the head lease, the intermediate lessor subleases the 15,000 square metres of office space for seven years to a sub-lessee.

Analysis

From the above it is evident that:

- The sublease is for seven years
- Right-of-use asset arising from the head lease has a useful life of ten years
- Intermediate lessor concludes that the sublease is an operating lease because none of the indicators for a finance lease in IFRS 16, paragraphs 61-66, are present.

Accounting for the lease

When the intermediate lessor enters into the sublease:

- It retains the lease liability and the right-of-use asset relating to the head lease in its statement of financial position.

During the term of the sublease, the intermediate lessor:

- Recognises a depreciation charge for the right-of-use asset and interest on the lease liability
- Recognises lease income from the sublease.

Illustration – Sublease as an operating lease

An intermediate lessor enters into a ten-year lease for 15,000 square metres of office space (the head lease) with the head lessor. At the beginning of year 7 of the lease, the intermediate lessor subleases the 15,000 square metres of office space for the remaining four years of the head lease to a sub-lessee

Analysis

- The sublease is for four years
- Right-of-use asset arising from the head lease has a remaining useful life of four years
- Intermediate lessor concludes that the sublease is a finance lease after considering the indicators for a finance lease in IFRS 16, paragraphs 61-66.

From the intermediate lessor's perspective, at the time the sub-lease is entered into, the right-of-use asset has a remaining economic life of four years, and it is being sub-leased for the entirety of that period. As the sub-lease is for all of the remaining useful economic life of the right-of-use asset, the sub-lease is classified as a finance lease, even though four years is unlikely to be the full remaining useful economic life of the underlying property.

Accounting treatment

The intermediate lessor shall:

- Derecognise the right-of-use asset relating to the head lease that it transfers to the sub-lessee, and recognises the net investment in the sublease
- Recognise any difference between the right-of-use asset and the net investment in the sublease in profit or loss, and
- Retain the lease liability relating to the head lease in its statement of financial position, which represents the lease payments owed to the head lessor.

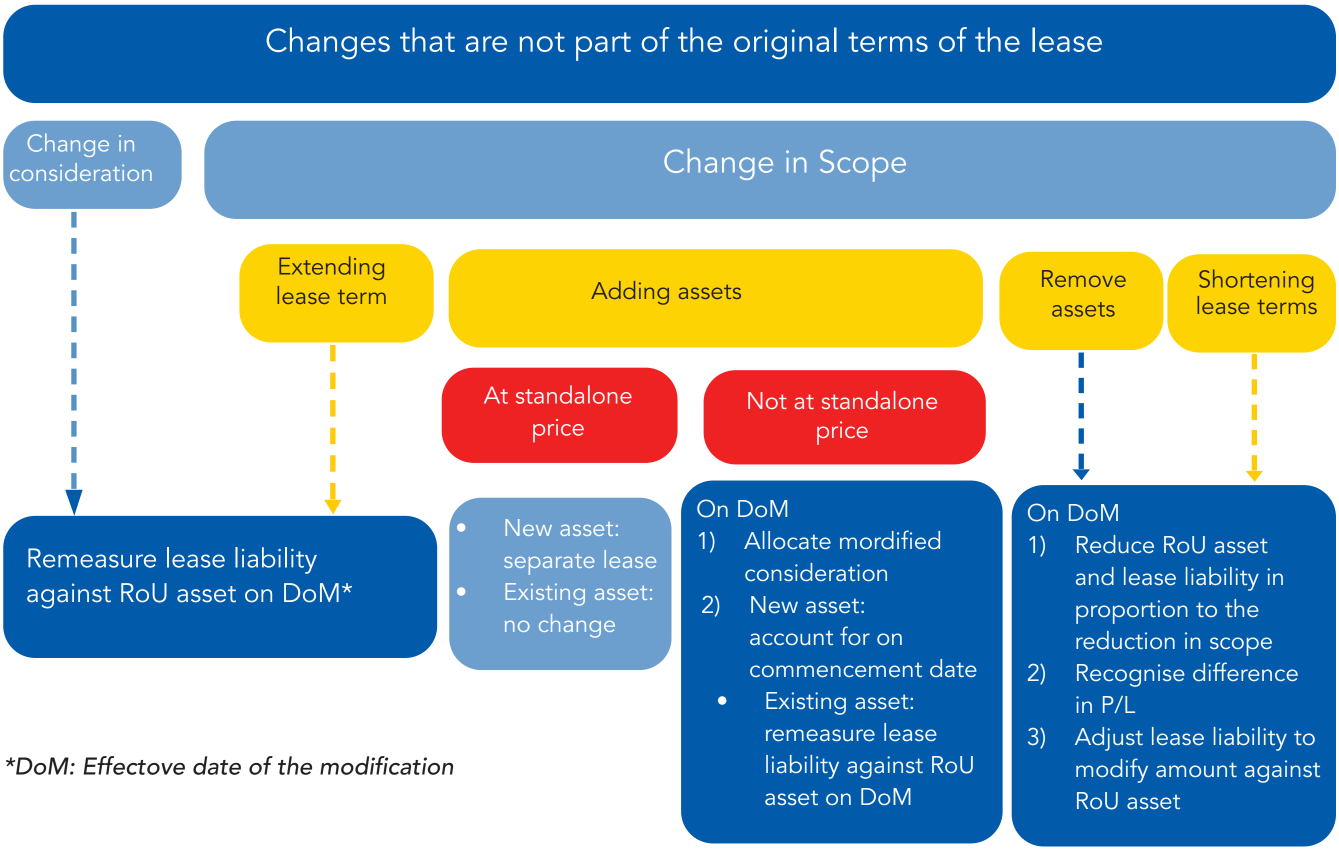
During the term of the sublease, the intermediate lessor recognises:

- Finance income on the sublease, and
- Interest expense on the head lease.

8.0 Lease Modifications

8.1 Introduction

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 (IFRS 16.Appendix A). Examples of lease modifications are adding or terminating the right to use one or more underlying assets or extending or shortening the contractual lease term. When a lease modification occurs, it is accounted for either as a separate lease or adjustment to an existing lease. IFRS 16's lease modification guidance can be summarised into the illustration below.



**DoM: Effectove date of the modification*

8.2 Lease modification as a Separate lease

A lessee (customer) accounts for a lease modification as a separate lease if both the criteria are met;That is;

(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. (IFRS 16.44):

When a lease modification is treated as a separate lease, the original right-for-use asset remains unaffected. See Example 15 accompanying IFRS 16.

8.3 Lease modification not accounted for as a separate lease

When a lease modification is not accounted for as a separate lease, a lessee (customer):

a. allocates the consideration in the modified contract as when separating components of a contract,
b. determines the lease term of the modified lease,
c. remeasures the lease liability by discounting the revised lease payments using a revised discount rate. (IFRS 16.45):

It should be noted that the above accounting is made at the effective date of the lease modification, which is the date when both parties agree to a lease modification.

8.4 Decrease in the scope of a lease

When a lease modification decreases the scope of a lease (IFRS 16.46(a):

- the right-of-use asset and lease liability are decreased to reflect partial of full termination of the lease
- any gain or loss resulting from the above-mentioned derecognition is immediately recognised in P/L.

Illustration: Lease modification – decrease in scope

Assuming that entity A enters into a 10-year lease for a 4,000 sq meters of office space. The annual lease payments are Ugx. 800,000 payable at the end of each year. The commencement date for the lease is 20X1-01-01 and the discount rate is 5%.

The table below shows future payments for the lease. For each payment, the discount factor is calculated in order to determine the total present value of the lease liability but since there were no payments at the commencement of the lease, lease liability and the right-of-use asset are equal at initial recognition and amount to Ugx. 6,177,388 as shown below

			5%	discount rate
1/1/2001	commencement date			
	payment	date of payment	discount factor	discounted amount
1	800,000	12/31/2001	0.9524	761,905
2	800,000	12/31/2002	0.9070	725,624
3	800,000	12/31/2003	0.8638	691,070
4	800,000	12/31/2004	0.8227	658,162
5	800,000	12/31/2005	0.7835	626,821
6	800,000	12/31/2006	0.7462	596,972
7	800,000	12/31/2007	0.7107	568,545
8	800,000	12/31/2008	0.6768	541,471
9	800,000	12/31/2009	0.6446	515,687
10	800,000	12/31/2010	0.6139	491,131
	initial measurement			**6,177,388**

You will note that lease liability increases every year due to unwinding of discount (charged as finance costs in P/L) and decreases with each payment made:

Lease liability – Schedule before Modification

year	Opening (1 Jan)	Discount	Payment (31 Dec)	Closing (31 Dec)
2001	6,177,388	308,869	(800,000)	5,686,257
2002	5,686,257	284,313	(800,000)	5,170,570
2003	5,170,570	258,529	(800,000)	4,629,099
2004	4,629,099	231,455	(800,000)	4,060,554
2005	4,060,554	203,028	(800,000)	3,463,581
2006	3,463,581	173,179	(800,000)	2,836,760
2007	2,836,760	141,838	(800,000)	2,178,598
2008	2,178,598	108,930	(800,000)	1,487,528
2009	1,487,528	74,376	(800,000)	761,905
2010	761,905	38,095	(800,000)	(0)

The carrying amount of the right-of-use asset decreases with depreciation charged each year:

Asset – Schedule before modification

year	NBV opening (1 Jan)	Depreciation	NBV closing (31 Dec)
2001	6,177,388	(617,739)	5,559,649
2002	5,559,649	(617,739)	4,941,910
2003	4,941,910	(617,739)	4,324,172
2004	4,324,172	(617,739)	3,706,433
2005	3,706,433	(617,739)	3,088,694
2006	3,088,694	(617,739)	2,470,955
2007	2,470,955	(617,739)	1,853,216
2008	1,853,216	(617,739)	1,235,478
2009	1,235,478	(617,739)	617,739
2010	617,739	(617,739)	(0)

With the above information in mind we shall now assume that a lease modification is made on 1 January 20X7. The scope of the lease decreases by 50% so that Entity A leases only 2,000 sq m out of original 4,000 sq m. The annual payment decreases as well from Ugx 800,000 to Ugx 400,000. The discount rate is revised to 4% at the modification date. Entity A calculates a gain in P/L as follows:

2,470,955	Right-of-use asset before modification
50%	Modified scope (2000 sq m out of original 4,000 sq m)
1,235,478	Decrease of right-of-use asset
1,235,478	Right-of-use after scope decrease
2,836,760	Liability before modification
50%	Modified scope (2000 sq m out of original 4,000 sq m)
1,418,380	Decrease of liability
1,418,380	Liability after scope decrease

Entity A recognises Ugx 182,903 (Ugx 1,418,380 – Ugx 1,235,478) as a gain on the termination of the lease under old terms (immediate recognition in P/L).

Entity A calculates lease liability corresponding to annual payments of Ugx 400,000 and revised discount rate of 4% as follows:

	YEAR	PAYMENT	DATE OF PAYMENT	DISCOUNT FACTOR	DISCOUNTED AMOUNT
1	2007	400,000	12/31/2007	0.9662	386,473
2	2008	400,000	12/31/2008	0.9335	373,404
3	2009	400,000	12/31/2009	0.9019	360,777
4	2010	400,000	12/31/2010	0.8714	348,577
					1,469,232

Liability -Schedule after lease modification

YEAR	OPENING (1 JAN)	DISCOUNT	PAYMENT (31 DEC)	CLOSING (31 DEC)
2007	1,469,232	51,423	(400,000)	1,120,655
2008	1,120,655	39,223	(400,000)	759,878
2009	759,878	26,596	(400,000)	386,473
2010	386,473	13,527	(400,000)	-

Accounting entries at the lease modification date (1 January 20X7) made by Entity A are as follows

DR	CR	
	1,235,478	Right-of-use asset
1,418,380		Lease liability
	182,903	Gain on the termination of the lease under old terms -> immediate recognition in P/L
	50,851	Lease liability
50,851		Right-of-use asset

Illustration: Lease modification - a change in consideration

An Entity enters into a 10-year lease for office space. The annual lease payments are Ugx. 2,000,000 payable at the end of each year. The commencement date for this lease is 20X1-01-01 and the discount rate is 8%.

The calculations for initial recognition of a lease liability and right-of-use asset will yield Ugx. 13,420,163 as seen below

1/1/2001	commencement date			
	PAYMENT	**DATE OF PAYMENT**	**DISCOUNT FACTOR**	**DISCOUNTED AMOUNT**
1	2,000,000	12/31/2001	0.9259	1,851,852
2	2,000,000	12/31/2002	0.8573	1,714,678
3	2,000,000	12/31/2003	0.7938	1,587,664
4	2,000,000	12/31/2004	0.7350	1,470,060
5	2,000,000	12/31/2005	0.6806	1,361,166
6	2,000,000	12/31/2006	0.6302	1,260,339
7	2,000,000	12/31/2007	0.5835	1,166,981
8	2,000,000	12/31/2008	0.5403	1,080,538
9	2,000,000	12/31/2009	0.5002	1,000,498
10	2,000,000	12/31/2010	0.4632	926,387
	initial measurement		**13,420,163**	

Schedule of liability before lease modification

YEAR	OPENING (1 JAN)	DISCOUNT	PAYMENT (31 DEC)	CLOSING (31 DEC)
2001	13,420,163	1,073,613	(2,000,000)	12,493,776
2002	12,493,776	999,502	(2,000,000)	11,493,278
2003	11,493,278	919,462	(2,000,000)	10,412,740
2004	10,412,740	833,019	(2,000,000)	9,245,759
2005	9,245,759	739,661	(2,000,000)	7,985,420
2006	7,985,420	638,834	(2,000,000)	6,624,254
2007	6,624,254	529,940	(2,000,000)	5,154,194
2008	5,154,194	412,336	(2,000,000)	3,566,529
2009	3,566,529	285,322	(2,000,000)	1,851,852
2010	1,851,852	148,148	(2,000,000)	-

Schedule of asset before lease modification

YEAR	NBV OPENING (1 JAN)	DEPRECIATION	NBV CLOSING (31 DEC)
2001	13,420,163	(1,342,016)	12,078,147
2002	12,078,147	(1,342,016)	10,736,130
2003	10,736,130	(1,342,016)	9,394,114
2004	9,394,114	(1,342,016)	8,052,098
2005	8,052,098	(1,342,016)	6,710,081
2006	6,710,081	(1,342,016)	5,368,065
2007	5,368,065	(1,342,016)	4,026,049
2008	4,026,049	(1,342,016)	2,684,033
2009	2,684,033	(1,342,016)	1,342,016
2010	1,342,016	(1,342,016)	(0)

Note that

20,000,000	Total payments
13,420,163	Depreciation expense
6,579,837	Discounting expense
20,000,000	Total expense

Assuming a lease modification is made on 1 January 20X7 and both parties agree to lower annual lease payments amounting to Ugx. 1,500,000. The lease term and lease scope remain unchanged. The Entity determines that the discount rate at the modification date increases to 9%.

Entity A calculates new present value of lease liability taking into account updated amounts of lease payments and revised discount rate:

1 January 2006 – Liability after decrease in consideration with a modification in discount rate to 9%

	PAYMENT	DATE OF PAYMENT	DISCOUNT FACTOR	DISCOUNTED AMOUNT
1	1,500,000	12/31/2007	0.9174	1,376,146.8
2	1,500,000	12/31/2008	0.8417	1,262,520.0
3	1,500,000	12/31/2009	0.7722	1,158,275.2
4	1,500,000	12/31/2010	0.7084	1,062,637.8
		Total		4,859,579.8

The amount calculated above is lower than the lease liability before the modification (Ugx. 6,624,254), the difference is accounted for as follows:

Entries made at the lease modification date		
DR	CR	
	1,764,674	Right-of-use asset
1,764,674		Lease liability

Accounting for the lease liability and the right-of-use asset in the years following the modification will be as follows:

Lease liability - Schedule after reassessment of lease term

YEAR	OPENING (1 JAN)	DISCOUNT	PAYMENT (31 DEC)	CLOSING (31 DEC)
2007	4,859,580	437,362	(1,500,000)	3,796,942
2008	3,796,942	341,725	(1,500,000)	2,638,667
2009	2,638,667	237,480	(1,500,000)	1,376,147
2010	1,376,147	123,853	(1,500,000)	-

Right-of-use asset: - Schedule after reassessment of lease term gross book value – Ugx. 3,603,391 (5,368,065 – 1,764,673.9)

YEAR	NBV OPENING (1 JAN)	DEPRECIATION	NBV CLOSING (31 DEC)
2007	3,603,391	(900,848)	2,702,543
2008	2,702,543	(900,848)	1,801,696
2009	1,801,696	(900,848)	900,848
2010	900,848	(900,848)	-

Note that:

18,000,000	Total payments
11,655,489	Depreciation expense
6,344,511	Discounting expense
18,000,000	Total expense

9.0 Disclosures

9.1 Disclosure requirements for lessees [IFRS16.51-60]

There are significant new disclosure requirements with the objective of helping users better understand an entity's leasing activities and their impact on its financial position, financial performance and cash flows.

A lessee is required to disclose the following quantitative amounts:

- the depreciation charge for right of use assets, by class of underlying asset;
- interest expense on lease liabilities;
- the expense relating to short-term leases;
- the expense relating to leases of low-value assets;
- the expense relating to variable lease payments not included in the measurement of lease liabilities;
- income from sub-leasing right of use assets;
- total cash outflow for leases;
- additions to right of use assets;
- gains or losses arising from sale and leaseback transactions; and
- the carrying amount of right of use assets at the end of the reporting period, by class of underlying asset.

Additional disclosures are needed for right of use assets meeting the definition of an investment property and for any right of use assets measured using the revaluation model.

In addition, a lessee is required to disclose a maturity analysis of lease liabilities in accordance with *IFRS 7 Financial Instruments: Disclosures*.

Further qualitative and quantitative disclosures may also be necessary to meet the standard's overarching disclosure objective. This additional information may include, but is not limited to, information that helps users of financial statements to assess:

- the nature of the lessee's leasing activities;
- future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities eg, variable lease payments, extension options and termination options, residual value guarantees and leases not yet commenced to which the lessee is committed;
- restrictions or covenants imposed by leases; and
- sale and leaseback transactions.

Alert

The standard increases the disclosure burden for lessees. Additional time will need to be spent collecting the information required and drafting these disclosures; Changes to systems and processes may also be necessary to ensure that all the necessary information is readily available. More judgement will also be involved as lessees will need to assess what additional disclosures are needed to meet the standard's overarching disclosure objective.

In addition, whereas the list of disclosures required by IFRS 16 may appear to be quite onerous, entities should, however, bear in mind that IAS 1 Presentation of Financial Statements makes it clear that an entity need not provide specific disclosures required by other standards if the information is not material. For the avoidance of doubt, IAS 1 goes on to say that this is the case even if another standard contains a list of specific requirements or describes them as minimum requirements. Entities will need to apply judgement when determining whether certain disclosures are immaterial.

9.2 Disclosure requirements for lessors [IFRS16.89-92]

The standard contains detailed disclosure requirements relating to lessors – some of which are additional to those required under IAS 17. The overarching objective is to include information in the notes that gives a basis for users of the financial statements to assess the effects that leases have on the financial position, financial performance and cash flows of the lessor.

Lessors are required to disclose the following amounts for finance leases:

- selling profit or loss;
- finance income on the net investment in the lease; and
- income relating to variable lease payments not included in the measurement of the net investment in the lease.

Lessors must also:

- provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases;
- disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years; and
- reconcile the undiscounted lease payments to the net investment in the lease.

Lessors are required to disclose lease income from operating leases, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.

Lessors must also apply the relevant disclosure requirements of IAS 16, IAS 36, IAS 38, IAS 40 and IAS 41 when appropriate.

Lessors may also have to disclose additional qualitative and quantitative information about their leasing activities necessary to meet the disclosure objective described above.

10.0 The impact of the Standard

It is important to note that every industry uses leasing as a means to obtain access to assets. The type and volume of assets that they lease, and the terms and structures of these lease agreements differ significantly. For example, a professional services firm may lease cars and office space and other office equipment; a utilities company leases power plants; a retailer leases retail stores; a telecoms entity leases fibre optic cables and cell towers; and an airline leases aircraft – all with very different characteristics, terms, regulatory frameworks, pricing, risks and economics. As a result, different implications may arise for different industries when adopting the new leases standard [9]. Below are some of the notable impacts the business community would need to consider as implementation of the standard kicks off. Since most of the requirements for a lessor did not significantly change, the discussion below will highly skew to the transactions relating to a lessee.

10.1 A lack of symmetry

The IASB's decision to substantially retain IAS 17's requirements in relation to lessors means that there is a lack of symmetry between the lessee and lessor models. This can lead to some potentially confusing outcomes. For example, when a lessor classifies a lease as an operating lease the underlying asset will remain on the lessor's balance sheet but at the same time the lessee will recognise a right of use asset on its balance sheet. Some see this as double counting. Moreover, the lessee will be showing a lease liability on its balance sheet for its obligation to make lease payments but the lessor will not be showing an equivalent lease receivable. These inconsistencies were acknowledged by the IASB when it was finalising the standard but it nonetheless concluded that as most constituents felt that the lessor model wasn't broken, there was no need to fix it.

10.2 Financial, operational and business impacts

For lessees, the lease becomes an on-balance sheet liability that attracts interest, together with a new asset on the other side of the balance sheet. In other words, lessees will appear to become more asset-rich but also more heavily indebted. The impacts are not limited to the balance sheet. There are also changes in accounting over the life of the lease. In particular, entities will now recognise a front-loaded

[9] Pwc (2016) IFRS 16 – The new leases standard

pattern of expense for most leases, even when they pay constant annual rentals. The table below highlights the potential impact of the standard on a number of financial and operational metrics.

Initial recognition and measurement		Record right of use (ROU) asset and lease liability at present value of minimum lease payments
Subsequent measurement	ROU asset	Depreciate ROU asset based on IAS 16, or use alternative measurement bases under IAS 16 and IAS 40
	Liability	Accrete liability based on the effective interest method, determined at least commencement. Reduce the liability by payments made.
Profit and loss (P&L)	EBITDA	Likely to increase due to reduced operating expenses
	Interest	Likely to increase due to increased interest expenses
	PBT	Broadly neutral impact over time, except for FX impact of FCY leases (revalued to closing spot rate per IAS 21)

10.3 Tax Implications

Under IFRS 16, both finance as well as operating leases need to be reported on the balance sheet of lessees, with some exceptions. The balance sheet of lessees would, for the first time, show an operating lease as a 'Right of Use' (ROU) asset with the associated liability for future payments. Depreciation on ROU and interest expense on the liability will be charged to the income statement instead of showing the operating lease payment as an expense. There is nevertheless a risk that the tax authority might disregard a claim as shown in the income statement and instead allow deductions only for the periodical operating lease rental payments.

Other challenges that will arise include the classification for ROU assets (intangible assets) and therefore the rate of tax depreciation (applying over the period of benefit or right of use) and the applicability of the interest deduction restriction to not more than thirty percent of the tax earnings before interest, tax, depreciation and amortisation with respect to the operating lease liability, if the lessor and lessee are related parties.

If the tax authority considers the form of the transaction to take precedence over its substance, it would allow deductions for lease rental payments and disregard depreciation on ROU and interest on lease liability for tax purposes. This would give rise to temporary differences.

10.4 Interest expense and OPEX

IFRS 16 will lead to an increase in net debt; a higher EBITDA and a higher invested capital for the lessee. All this will lower the ROI. The impact on net debt and EBITDA is obviously the largest for entities with many operating leases, for example in sectors like retail & wholesale and transportation.

We also observe - on average – an increase in net debt / EBITDA ratios. The impact depends on the remaining duration of the lease (and current leverage ratio). The incremental net debt / EBITDA on the lease liability will generally be high at start of the lease term, gradually decreasing to zero at the end of the lease term.

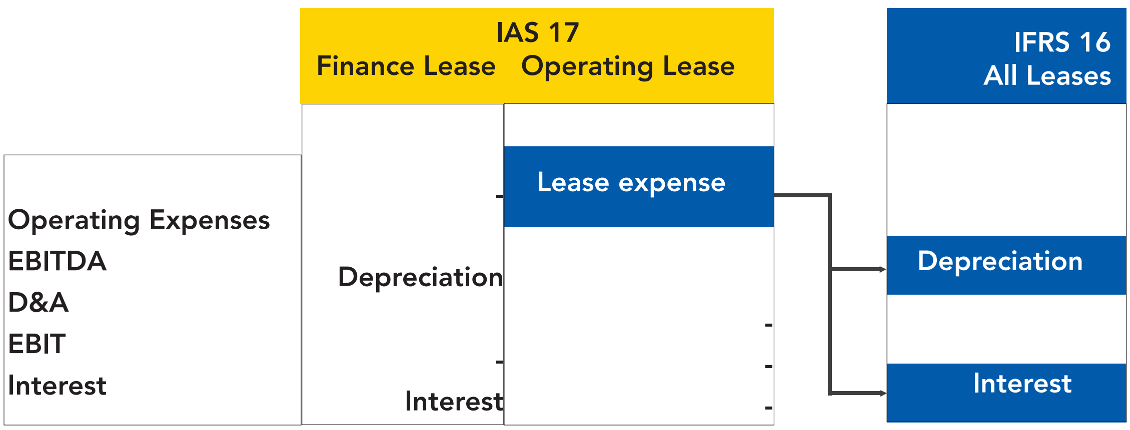
10.5 IFRS 16 impact on lessee financial statements

10.5.1 Balance sheet

With IFRS 16, almost all leases will be reported on corporate balance sheets. The impact on the balance sheet will be twofold, the recognition of a right-of-use asset and a lease liability. As a result, entities that previously had significant off-balance sheet leases will now show higher assets and higher liabilities.

10.5.2 Profit and loss statement

IFRS 16 impacts the lessee's P&L where they have previously classified leases as operating leases. Entities must report a depreciation charge for leased assets within the operating costs section of the profit or loss statement. An interest expense must be reported for lease liabilities within the finance costs section of the profit or loss statement. Under the old standard, IAS 17, entities reported a straight-line lease expense that was typically the same in each period of the lease. With IFRS 16, the expenses for leases are front-loaded as the amount of interest is reduced over the term of the contract. As a result of implementing IFRS 16, operating expenses will be lower, interest expense will be higher, and EBITDA and EBIT will be higher.



10.5.3 Cashflow statement

The total cashflows of an entity will not change as a result of implementing IFRS 16. However, IFRS 16 is expected to impact the classification of cash flows generated through operating and financing activities. Compared to IAS 17, cash from operating activities is expected to increase under IFRS 16 as cash outflows related to operating leases will no longer be included within cash from operating activities. The increase in cash from operating activities will be offset by a decrease in cash from financing activities as cash outflows related to principal repayments and interest (interest can be recognised under financing activities under IFRS) on lease liabilities will be recognised within cash from financing activities.

10.6 Forex differences resulting from lease in foreign currency

Undoubtedly IFRS 16, will have potentially material FX impact for entities whose operating lease exposures are denominated in a foreign currency. The need to recognise the present value of all future lease payments as opposed to just those relating to current periods could significantly increase the FX translation risk and in turn reported earnings. Whilst the impact on cash flow and PBT should be broadly neutral (as discussed above), if the lease contract is denominated in a foreign currency, there could be a significant and asymmetric P&L impact from FX. Newly recognised foreign currency liabilities could create FX volatility in earnings which will not be offset by a corresponding revaluation of the ROU asset. One would expect on average to have an increase in gross debt and potential negative earnings impacting on EBITDA for a given unit of foreign currency appreciation/ depreciation against their local currencies due to the potential FX losses/gains arising on the revaluation of any new foreign currency liabilities.

10.7 IFRS 16 and Capital Commitment

IFRS 16 requires lessees to capitalize virtually all leases; the only optional exemptions are for certain short-term leases and leases of low-value assets. For regulated banking institutions, the recognition of right-of-use assets on the balance sheet may impact the calculation of regulatory capital ratios by increasing the assets in the denominator of the risk-based capital ratios (risk-weighted assets) and leverage capital ratio (adjusted asset). All other things being equal, a higher denominator will result in lower capital ratios for the financial institution.

On April 6, 2017, the Basel Committee on Banking Supervision issued a "frequently asked questions" (FAQ) press release related to lease accounting. The FAQ made it clear that right-of-use assets related to underlying tangible assets should not be deducted from Regulatory capital. They are not akin to intangible assets and should be included in risk-based capital and leverage denominators at 100% risk weighting, similar to the treatment for tangible assets.

Such entities will thus need to assess the extent of the standard's impacts so that they can address the wider business implications.

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