NAKISA
LeaseAdministration

Adopting IFRS 16

Frequently asked questions and additional perspective on the IFRS 16 lease accounting standard

Topics

Intro

There's a great deal of uncertainty surrounding the impact of IFRS 16 and questions about how to interpret and apply the standard. Nakisa's technical accountants work closely with our customers to address the complexities they are facing. The goal of this document is to provide accountants and other financial professionals with additional perspective on the IFRS 16 rule changes regarding accounting for leases.

Grey Areas of the Standard

If you've read through the IFRS 16 standard, you have likely noticed that it is filled with legal terminology that may have made it difficult to interpret or draw concrete conclusions. Although accountants have interpreted the standard differently, they have usually arrived at the same conclusions.

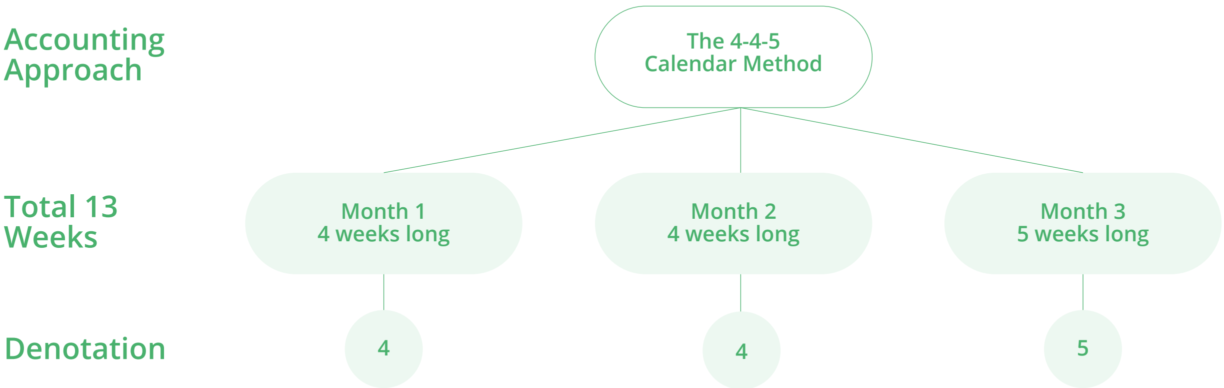
We are committed to providing information about the best practices for lease accounting under all the standards. Through discussions with customers, we have noticed some common areas of confusion and uncertainty. In this guide, we look to address the most common questions and provide additional insight on IFRS 16.

Non-Calendar Fiscal Periods

What are non-calendar fiscal periods?

While alignment with core business flows can be a benefit of using a 4-4-5 calendar, users often need to adapt systems and processes to address certain hurdles. The most common conflicts and questions involve how to allocate costs across periods of different lengths (i.e., a four-week period vs. a five-week period).

For instance, consider leases, utilities, and twice-monthly payrolls, which are services with regular monthly billing cycles. Charging these costs as they are billed may lead to a five-week period having two rent charges, two utility bills, or three payrolls. This approach overloads the five-week period with costs, distorting the margins earned on sales in those times. On the other hand, smoothing these costs evenly in each period causes a five-week period to have higher margins than one with four weeks. The same issue exists for dividing lump sums across several periods, such as depreciating fixed assets and amortizing prepaid expenses.



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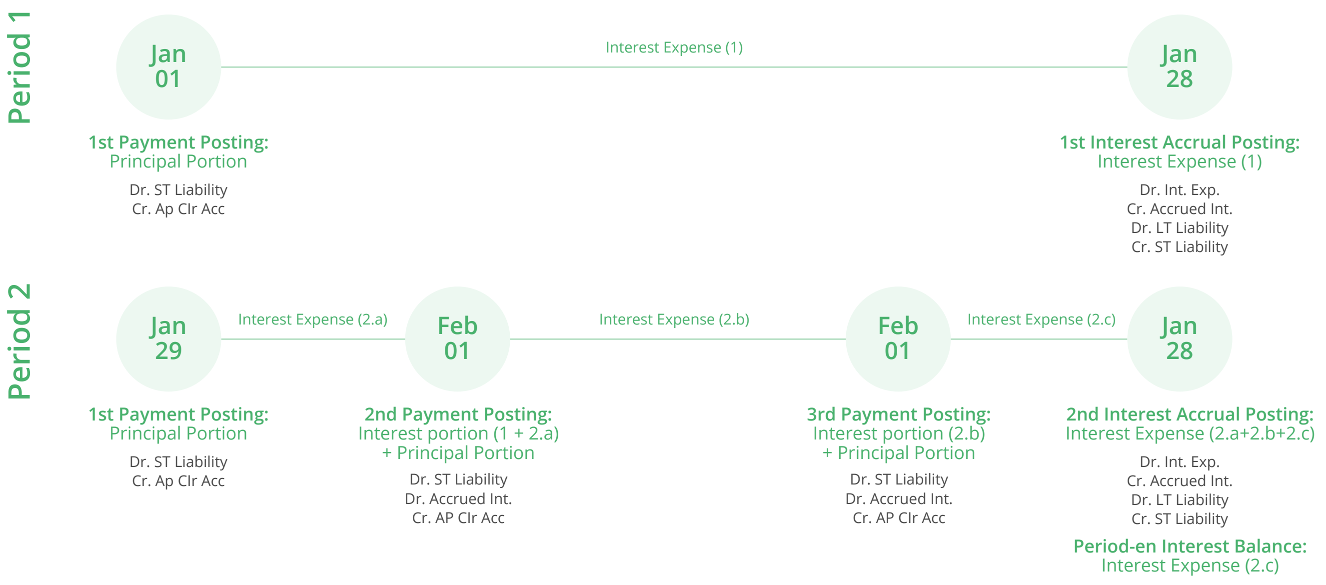
Except for a guiding principle that a business should allocate costs in a systematic and rational manner, there are no set accounting rules for these issues. Each company has room to choose their accounting policy based on the amounts involved. In practice, a common method of addressing the issue is to allocate costs based on the number of days in the period.
Example posting schedule for 4-4-5 calendar:



As illustrated in the diagram, a lease payment takes place on the first day of each month, in a calendar which has a 4-5-4 setup. Expenses such as interest and depreciation will be recorded as per the fiscal year set up; where as the payments and accrual will be recorded as per the calendar year.

Restoration Cost

What is restoration cost?

Definition of restoration cost:
“An estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease.”

Embedded Leases

What is an embedded lease?

An embedded lease, a term not defined in IFRS 16, refers to the components of a contract that identify assets that can be used and controlled, and how. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, a reporting entity should consider all of the terms of an arrangement to determine whether it contains a lease. Two key points help explain why these components are the source of uncertainty for many organizations. First, they fall outside of the standard lease identification processes for many groups. Second, under the leasing standards, companies face restatement and internal control risk if they fail to identify and account for contracts with embedded lease components.

How do I identify embedded leases?

In order to determine if a contract is or contains a lease, one must identify an asset and the associated control of said asset. To put it simply—no asset, no lease. No control, no lease. To help with your lease determination, consider the following three simple questions:

1 Is there an identified asset?

Typically, when reviewing a contract, you’ll notice that the asset involved and its intended use has been made explicitly clear. For example, a transportation contract that provides a manufacturer the right to use ten specific rail cars to ship widgets. Another example might be a concession agreement that provides a coffee company the right to use a certain space to sell lattes and pastries.

2 Is there a right to obtain substantially all of the identified asset’s economic benefits?

To control an asset, one must have the right to obtain "substantially all" of its economic benefits during the contract term. Consider the case of a factory that makes shirts. It has the capacity to make twice as many shirts as a retailer has agreed to buy, then the retailer has not obtained the right to substantially all of the factory’s economic benefits. If, however, the promised volume is over 90 percent of the plant’s capacity, the rules would indicate that the retailer has secured substantially all of the asset’s economic benefits. Still, keep in mind, this does not mean that the contract is or contains a lease. There is a third question to consider.

3 Who has the right to direct the use of the identified asset?

To control an asset, one must have the right to direct its use. When assessing whether the lessor or lessee has the right to direct the use of the identified asset, the key question is which party—that is, the lessee or lessor—has the right to direct how and for what purpose the identified asset is used throughout the period of use.

When the answer to any of these three questions is no, the contract does not contain a lease. When the answer to all three questions is yes, the contract is or contains a lease. For embedded leases, the arrangement will require further evaluation to separate the lease and non-lease components. Regardless, the customer will have to record its right to use the leased asset and book a liability for its payment obligations for that contract.

Evergreen Leases

How are evergreen leases defined by the standards?

Definition of evergreen leases:

- Automatically renew until either party terminates the agreement
- No fixed contractual end data

Evergreen leases are those that are automatically renewed until one party—either the lessor or lessee—terminates the lease contract. Much like how an evergreen tree never loses its leaves, evergreen leases have no fixed contractual end date. For example, a lessee might be leasing vehicles from a lessor which are being renewed on month-to-month basis. The end date is not predetermined; the lease may terminate in one month or one year.

As with many other issues under IFRS 16, reporting requirements for evergreen leases are not explicitly laid out in the standards. This leaves figuring out exactly how and where to report on evergreen leases up for interpretation. Your organization will need to make their best determinations as to how to report evergreen leases based on best practices and your situation.

However, there are common understandings among subject matter experts on how evergreen leases should be handled under IFRS 16.

What has been determined as the accounting requirement for evergreen leases?

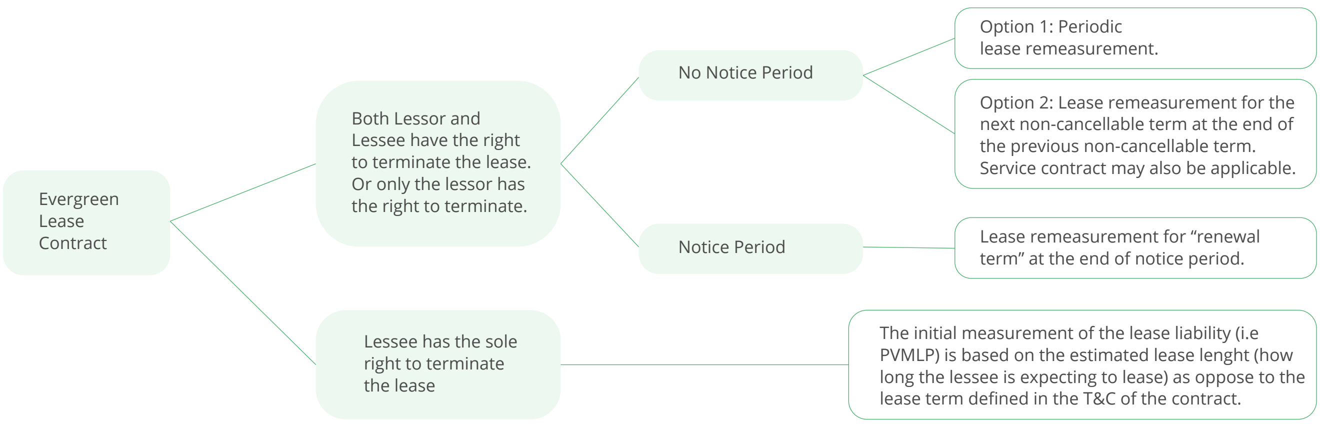
The first step in determining the process of reporting an evergreen lease is to determine whether the lessee (the person who holds the lease), the lessor (the person who leases the property or equipment to the lessee), or both have the right to end the lease. Based on this determination, accounting strategies will vary.

If the lessee has the sole right to terminate the lease, the initial measurement of the lease liability is based on how long the lessee is expecting to lease, rather than the lease term defined in the terms and conditions of the current contract.

If both lessor and lessee have the right to terminate the lease, or only the lessor has the right to terminate, the following would occur:

1 At the end of the non-cancellable term, the lease contract is automatically renewed with both parties—lessor and lessee. This auto-renewal is for an indefinite period of time until either party decides to end the lease. In this case, a lease modification may be applied in order to reflect a lease extension on the last day of the non-cancellable period.

2 Periodic lease remeasurement, like month-to-month, will also occur. In this case, the lease liability and ROU asset will be re-measured each month. If you are concerned about impacting your balance sheet because of this particular month-to- month renewal scenario, then a service contract may be entered in your lease accounting solution.



Decrease in Lease Term

What is the accounting treatment for a decrease in lease term?

- In the event of a modification whereby solely the lease term has decreased there is a separate accounting treatment for IFRS16.

- Decrease the carrying amount of the ROU asset to reflect the partial or full termination of the lease for the lease modification that decrease the scope of the lease. The lessee shall recognize in P&L any gain/loss relating to the partial or full termination of the lease.

Disclosure Reports

What are disclosure reports?

Disclosure reports help organizations produce the notations in a financial statement that provide important, necessary facts about leases being used by an organization. The overarching objective of these disclosures is to provide the basis for users of those financial statements to assess the effect that leases have on the financial statements.

The authors of the standards wanted to ensure that these disclosures would go beyond simple "boilerplate" language. Specificity is required within these disclosures, but they also wanted to provide flexibility as to what exactly is included in the disclosures, depending on the nature of the leases used on a financial statement.

While the standards do outline a series of disclosure requirements, the spirit of the standard is to ensure that the information provided fulfills the overall disclosure objective of providing information to assess the effect leases have on a financial statement, rather than simply meeting an arbitrary checklist of disclosures. Depending on your lease portfolio, you will need to include specific disclosure requirements on your financial statement.

What are the quantitative disclosure requirements under the standards?

List of Quantitative Disclosures	IFRS 16
Lease Cost	
Finance Lease Cost	
Amortization of right-of-use assets	✓
Interest on lease liabilities	✓
Operating lease cost	
Short-term lease cost	✓
Low-value asset lease cost (IFRS 16)	✓
Variable lease cost	✓
Subleasing income	✓
Quantitative Disclosures - Other	
Cash paidfor amounts included in the measurement of lease liabilities	
Operating cash flows from finance leases	✓
Operating cash flows from operating leases	
Financing cash flows from finance leases	✓
Total cash outflow for leases	✓
Additions of all Right-of-use assets during the period, inclusive of ROU in exchange for Cash (Prepaid leases) - IFRS 16	✓
Right-of-use assets obtained in exchange for new Finance lease liabilities	
Right-of-use assets obtained in exchange for new Operating lease liabilities	
Carrying amount of Right-of-use assets disclosed by underlying asset classes (IFRS 16)	✓
Weighted-average remaining lease term - finance and operating leases	
Weighted-average discount rate - finance and operating leases	
Maturity Analysis of finance and operating lease liabilities for each of the first five years after the balance sheet date and in total thereafter (undiscounted cash flows reconciled to the amounts presented in the balance sheet)	✓
Future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities	
Variable lease payments	✓
Extension options and termination options	✓
Residual value guarantees	✓
Leases not yet commenced to which the lessee is committed	✓

Excel vs. Lease Accounting Software

Can I use Excel for lease accounting?

"It is surprising how many companies are still planning to rely on spreadsheets and manual solutions. As the scale of the work required becomes clearer as projects advance, this proportion may drop. In particular, views may change as the reality strikes that lease information needs to be continually updated, with regular reassessments performed."

KPMG 2019 Lease Accounting Change Survey

The flexibility that a spreadsheet offers is compelling and it's no wonder it's the first solution that comes to mind when thinking of complex calculations. It is then no surprise that businesses have been looking to spreadsheet solutions for transitioning to the lease standards. However, the impact of the regulations on lease processes are profound and businesses will need to be aware of the requirements before trying to tackle lease compliance for IFRS 16 with a spreadsheet solution.

The lease accounting standards specify how organizations must recognize, measure, present, and disclose leases. The overall impact and effort is far more expansive than simply centralizing contract data and handling the initial recognition of right-of-use asset and lease liability. It requires subsequent measurement which involves amortization of the right-of-use asset and lease liability, accounting for lease modifications and providing quantitative disclosures. If an organization adopts the full retrospective method under IFRS 16 without the transition relief, comparative numbers will need to be changed and there would be a need for parallel reporting. During the transition to the standard, the lessee would need to know the overall liability—and ROU asset—balance they currently have under existing leases, and what the balance would be when they assess and classify theses leases under the standard. It's important that any software solution incorporates the necessary functionally to produce the comparative reports—a functionality that Excel is lacking.

Calculating the undiscounted cash flows and reconciling that back with the lease liability can be extremely challenging to do at scale without specialized software. It becomes far more complicated for an asset intensive portfolio, when trying to aggregate a number of leased assets with different starting dates.

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Nakisa Center of Excellence

The contents in this document were contributed by Nakisa's Center of Excellence Team. This team is comprised of a group of technical accountants with expertise in IFRS 16. They develop best practices to enable organizations to plan, transition, and comply with financial regulations. Nakisa's Center of Excellence has played an instrumental role in the development of Nakisa Lease Administration by advising and ensuring compliance with IFRS 16.

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Need help implementing the IFRS 16 leasing standard?

Learn how Nakisa Lease Administration can help in all four implementation phases.

Contact us

About Nakisa

Nakisa empowers companies to thrive in a fast-changing world with a flexible, scalable, cloud-based platform for organizational design and lease accounting that makes managing global business operations simple. Our easy-to-use, enterprise-grade software solutions, Nakisa Hanelly and Nakisa Lease Administration, provide visibility and analytics for global enterprises allowing users to unlock real-time insights and make faster, more informed business decisions.

↗ Contact us

Please visit www.nakisa.com for more information or email info@nakisa.com to arrange a consultation with a product expert.