1. Overview

The IASB issues its new lease standard, IFRS 16 with effect for annual periods beginning on or after January 1, 2019. The new standard is expected to provide a more transparent and comparable approach to accounting for leases.

IFRS 16 will bring most leases on-balance sheet, requiring entities to recognize a long-term asset and corresponding lease liabilities. This is achieved through a shift from the current framework which focuses on categorizing the ‘type’ of lease contained in a contract in order to determine accounting treatment, toward a new framework which simply assesses whether a contract is a lease or not. This assessment of whether a contract contains a lease will alone determine whether lease accounting will apply. IFRS 16 embodies only a single model for accounting for lease contracts, in contrast with current guidance which provides for a dual model of accounting for contracts, applied according to the ‘type’ of lease (i.e. as operating or financing).

It is expected that the new standard could result in a significantly altered financial statements for some entities, with broad implications for items such as covenant compliance, financial performance indicators, borrowing capacity, and beyond.

Entities will need to gather a significant amount of information in order to execute their implementation of IFRS 16 and make decisions regarding the transition and application elections available to reporting entities. IFRS 16 also contains areas that will require careful evaluation and / or the application of judgment in arriving at a determination of how the criteria apply to the adopting entity’s unique fact pattern.

Scope exclusions

There are a number of lease types that are scoped out of IFRS 16, including:

IFRS 16.3

- Leases to explore for minerals, oil, natural gas, and similar non-renewable resources;
- Leases of biological assets
- Service concession arrangements
- Licenses of intellectual property and other rights under certain licensing agreements

2. Identifying a lease

IFRS 16.9 A contract is, or contains, a lease if it conveys the right to control the use of an identified asset (the underlying asset) to the lessee for a period of time, in exchange for consideration.

IFRS 16.B9 The right to control the underlying asset is conveyed to the customer if both of the following criteria are met throughout the term of the lease:

- The customer has the right to obtain substantially all of the economic benefits from the use of the identified asset
- The customer has the right to direct the use of the identified asset

The three criteria that must be evaluated in order to conclude on whether a contract is, or contains, a lease are therefore as follows:

A. Is there an identified asset?
B. Does the customer have a right to substantially all economic benefits from use of the asset?
C. Does the customer have a right to direct the use of the underlying asset?

A. Is there an identified asset?

IFRS 16.13 The need for an identified asset to exist is a central and necessary component of the definition of a lease. A contract is considered to be, or to contain, a lease only if an asset is either:

- Explicitly specified in the contract; or
- Implicitly specified at the time it is made available for use to the lessee.

Substantive right to substitute

IFRS 16.B14 If the supplier maintains a 'substantive right to substitute' the specified asset throughout the period of use, the customer is not considered to have the right to use an identified asset. The right to substitution is considered substantive if the supplier has both:

- The practical ability to substitute; and
- There will be economic benefit to the supplier as a result of exercising its right to substitute the asset.

For example, in a contract for the transport of goods by a shipping contractor, is a particular vessel specified, or is the contractor able to deploy any one of its vessels of a certain size in a certain territory from its fleet to carry out the contract? In the case of the latter, a customer will have to evaluate whether the supplier has a substantive right to substitute.

IFRS 16.B16 The supplier's substantive right to substitute the identified asset is assessed at the inception of the lease based on facts and circumstances available at the time of the assessment. This will include an assessment of likely future events.

IFRS 16.B19 If the customer can not readily determine whether the supplier has a substantive substitution right, the customer presumes any substitution right is not substantive.

Portion of an asset

IFRS 16.20 A 'portion' of an asset can constitute the identified asset if:

- It is physically distinct (e.g. the floor of a building); or
- If not physically distinct (e.g. a portion of available capacity in a storage tank), it represents substantially all of the capacity of an entire asset.