

## Application Guidance Notes on SLFRS 16 - Leases

### Background:

The Urgent Issues Task Force (UITF) ruling issued in 1995 for leases was subsequently replaced by the Statement of Alternative Treatment (SoAT) in 2013. With the adoption of SLFRS 16 Leases, an entity shall apply this Standard for annual reporting periods beginning on or after 1<sup>st</sup> January 2019. The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) has analysed the provisions in the prevailing SoAT and the way forward in that context and wishes to withdraw the SoAT going forward along with the following guidance for initial application of SLFRS 16 at the transition. Application of this guideline by the companies which followed the SoAT issued by CA Sri Lanka is treated as a change in the accounting policies due to issuance of SLFRS 16 and therefore this guideline is prepared to help the transition of such companies consistently.

### Areas of Consideration:

- Reassessment of the Lease Liability
- Incremental Borrowing Rate (IBR)
- Transition Adjustments
- Previous Revaluation Surplus

### Analysis and the Recommendations:

#### 1. Reassessment of the lease liability

##### **Analysis:**

##### **Paragraph 39 of SLFRS 16**

After the commencement date, a lessee shall apply paragraphs 40–43 of SLFRS 16 to remeasure the lease liability to reflect changes to the lease payments. **A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset (ROUA).** However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.

##### **Paragraph 27 of SLFRS 16**

At the commencement date, 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:

- (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;
- (b) **variable lease payments** that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);
- (c) amounts expected to be payable by the lessee under residual value guarantees;
- (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs B37–B40); and
- (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

### **Paragraph 28 of SLFRS 16**

**Variable lease payments** that depend on an index or a rate described in paragraph 27(b) include, for example, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates.

### **Paragraph 40 of SLFRS 16**

A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

- (a) there is a change in the lease term, as described in paragraphs 20–21 of SLFRS 16. A lessee shall determine the revised lease payments on the basis of the revised lease term; or
- (b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20–21 of SLFRS 16 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

### **Paragraph 41 of SLFRS 16**

In applying paragraph 40, a lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the date of reassessment, if the interest rate implicit in the lease cannot be readily determined.

### **Paragraph 42 of SLFRS 16**

A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:

- (a) there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee.
- (b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

### **Paragraph 43 of SLFRS 16**

In applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

### **Recommendation:**

If the lease agreement includes an annual adjustment on a variable such as GDP Deflator, the entity shall annually reassess the liability considering such variable (applying paragraph 27 of SLFRS 16) and **recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.**

## 2. Lessee's Incremental Borrowing Rate (IBR)

### **Analysis:**

#### **Appendix A of SLFRS 16:**

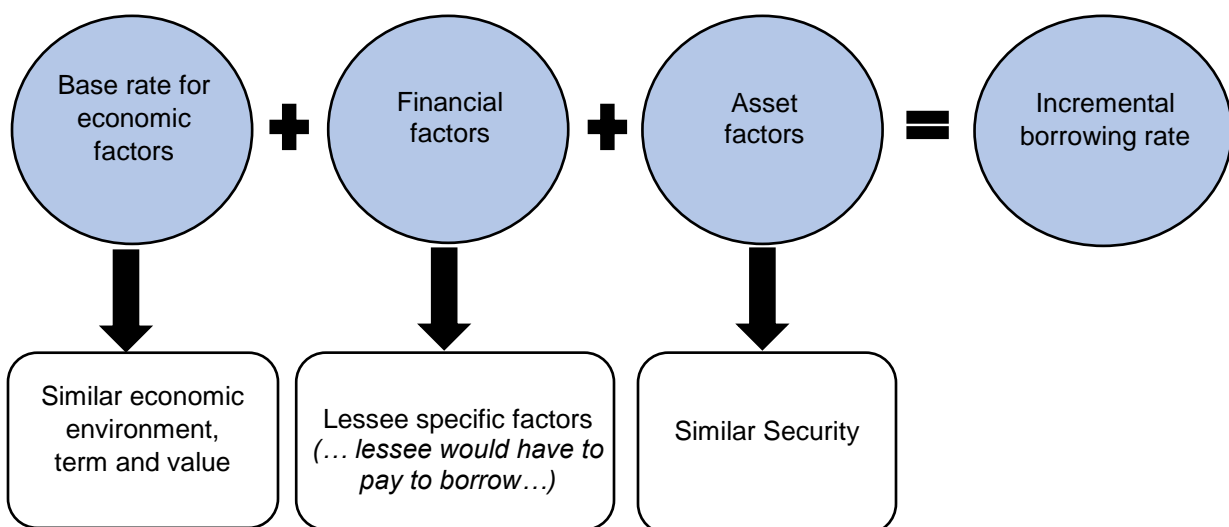
**Lessee's Incremental Borrowing Rate (IBR)** is the rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.

SLFRS 16 doesn't contain significant guidance on how to determine the incremental borrowing rate beyond the definition provided.

Accordingly, in the absence of specific requirements in SLFRSs, preparers will have to apply judgment in determining the IBR. For entities with relatively small lease portfolios that are not material in the context of the entity's financial statements, then the work effort involved in determining the IBR for those leases may be lower. For entities with significant lease portfolios, the determination of the discount rate may have a very material impact on the statement of financial position as well as financial performance. Determining the IBR is more complex than simply determining the weighted rate that an entity pays on its current borrowings. Such borrowings may have economic characteristics entirely dissimilar to the definition of the lessee's IBR as noted above.

### **Recommendation:**

The following methodology may provide a reasonable basis for determining the IBR for a lease, as it incorporates the key elements denoted.



In this regard, each company needs to build up an IBR with other observable data and the following provides the guidance to consider:

- 1) Risk free rate;
- 2) Current borrowing rates (Weighted Average Cost of Capital, excluding cost of Equity) of the company;
- 3) Credit rating of the company;
- 4) Borrowing rates of the comparable companies with a similar term.

### 3. Transition Adjustments

#### **Analysis:**

#### **Paragraph C5 of SLFRS 16**

A lessee shall apply this Standard to its leases either:

- (a) retrospectively to each prior reporting period presented applying LKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
- (b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application in accordance with paragraphs C7–C13.

#### **Paragraph C7 of SLFRS 16**

If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall not restate comparative information. Instead, the lessee shall **recognise the cumulative effect** of initially applying this Standard **as an adjustment to the opening balance of retained earnings** (or other component of equity, as appropriate) at the date of initial application.

#### **Paragraph 60 of LKAS 36 Impairment of Assets**

An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in LKAS 16). Any **impairment loss of a revalued asset shall be treated as a revaluation decrease** in accordance with that other Standard.

#### **Paragraph 19 of LKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors**

Subject to paragraph 23:

- (a) an entity shall account for a change in accounting policy resulting from the initial application of a SLFRS in accordance with the specific transitional provisions, if any, in that SLFRS; and
- (b) when an entity changes an accounting policy upon initial application of a SLFRS that does not include specific transitional provisions applying to that change, or changes an accounting policy voluntarily, it shall apply the **change retrospectively**.

#### **Paragraph 23 of LKAS 8**

When retrospective application is required by paragraph 19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

#### **Paragraph 24 of LKAS 8**

When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding **adjustment to the opening balance of each affected component of equity for that period**.

#### **Recommendation:**

Application of paragraph C5(a) might be impracticable for these entities and as such entities may elect to apply paragraph C5(b) at the date of transition which permits to recognise the cumulative effect of initial application as an adjustment to the opening balance of retained earnings.

Under this approach, the right-of use-asset is measured at an amount equal to the lease liability, adjusted by prepayments or accrued lease payments relating to that lease at the date of initial application. If the

carrying value of the underlying lease asset as of the date of initial application of SLFRS 16 is greater than the adjusted lease liability as at the transition date, such carrying value of the lease asset shall be considered as the deemed cost for ROUA. Further, the asset is subject to impairment testing in terms of LKAS 36 and adjusted in the financial statements as appropriate.

An illustrative example is stated in the Annexure 1.

Subsequent to the initial application of SLFRS 16, the entity may follow the cost model or revaluation model following the guidance given in the standard and impairment testing is to be applied continuously.

#### **4. Revaluation Surplus for the Lease Asset**

***Recommendation:***

The existing revaluation reserve reflected in the revaluation surplus of such asset shall be transferred to the opening retained earnings as part of the transition adjustment.

**Annexure 1 - Modified Retrospective Approach**
**Application of Paragraph C5(b) of SLFRS 16(SLFRS 16 - C5 (b))**
**General Information:**

In Rs. 000's	Scenario 1				Scenario 2			
	Lease Liability	ROUA	Revaluation Surplus	Retained Earnings	Lease Liability	ROUA	Revaluation Surplus	Retained Earnings
As at 1/1/2019 (before initial application of SLFRS 16)	8,000,000	6,000,000	1,500,000	20,000,000	8,000,000	9,500,000	1,500,000	20,000,000
Transfer of Revaluation Reserve as part of the transition adjustment			(1,500,000)	1,500,000			(1,500,000)	1,500,000
Transition Adjustment due to Initial Application of SLFRS 16	1,000,000	3,000,000		2,000,000	1,000,000	-		(1,000,000)
<b>Adjusted balance as at 1/1/2019 at the Initial Application of SLFRS 9</b>	<b>9,000,000</b>	<b>9,000,000</b>	<b>-</b>	<b>23,500,000</b>	<b>9,000,000</b>	<b>9,500,000</b>	<b>-</b>	<b>20,500,000</b>
Case Highlights	Lease liability is remeasured as at the transition date and equated to the ROUA. Difference together with the revaluation surplus is adjusted to the opening retained earnings as a transition adjustment.				Lease liability is remeasured as at the transition date and adjusted to the opening retained earnings, since the ROUA is greater than the adjusted lease liability together with the revaluation surplus as a transition adjustment.			

**Journal Entries at the date of the transition:**

ROUA	Dr	3,000,000		Revaluation Reserve	Dr	1,500,000	
Revaluation Reserve	Dr	1,500,000		Lease liability	Cr		1,000,000
Opening Retained Earnings			Cr	Opening Retained Earnings	Cr		500,000
Lease liability			Cr				

Step 1: Lease liability as at 1/1/2019 at the date of transition	Calculate the present value of minimum lease payments (till the end of the lease term) as at 1/1/2019, considering the lease rental payable for the year 2019 (assuming that it will continue for the remaining period) and take the resulting value as the lease liability as at 1/1/2019. GDP deflator need to be taken into consideration when assessing the present value of minimum lease payments, to the extent corresponding data is available for public.
Step 2: ROUA as at 1/1/2019 at the date of transition	Scenario 1: Adjust the ROUA based on the value of the remeasured lease liability. Scenario 2: Value of the ROUA will remain and would be considered as the deemed cost.
Step 3: Revaluation Reserve appearing under reserves	Transfer the Revaluation Reserve appearing in the Statement of Financial Position as a result of previous revaluations (on or before 1/1/2012) to Opening Retained Earnings as a transition adjustment.
Step 4: Impairment Testing at the date of the transition	At the date of transition, the ROUA is subject to impairment testing as per LKAS 36. If there is an impairment loss as at the date of the transition, that amount shall be adjusted to the Opening Retained Earnings, unless as a revaluation decrease, to the extent of the revalued amount.