



# Insights on SLFRS 16 Leases

## Insights on SLFRS 16 Leases

### 1. Overview

- SLFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases
- This standard provides a single lease accounting model requiring lessees to recognise assets and liabilities for all leases unless a lessee makes use of optional exemptions for short-term leases and leases for which the underlying asset is of low value
- Categorisation of leases as either finance or operating leases will no longer be applicable in the books of lessees, but remains in the books of lessor without a significant difference with the previous accounting treatment.

### 2. Effective Date

SLFRS 16 is effective from annual reporting periods beginning on or after 01<sup>st</sup> January 2019.

### 3. Definitions

- **Lease** is 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.
- **Lessee** is an entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.
- **Lessor** is an entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.
- **Short-term lease** is a lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.
- **Underlying asset** is an asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

### 4. Withdrawal of Other SLFRSs and Interpretations

- LKAS 17 - Leases
- IFRIC 4 - Determining whether an arrangement contains a Lease
- SIC 15 - Operating Leases - Incentives
- SIC 27 - Evaluating the substance of transactions involving the legal form of a Lease

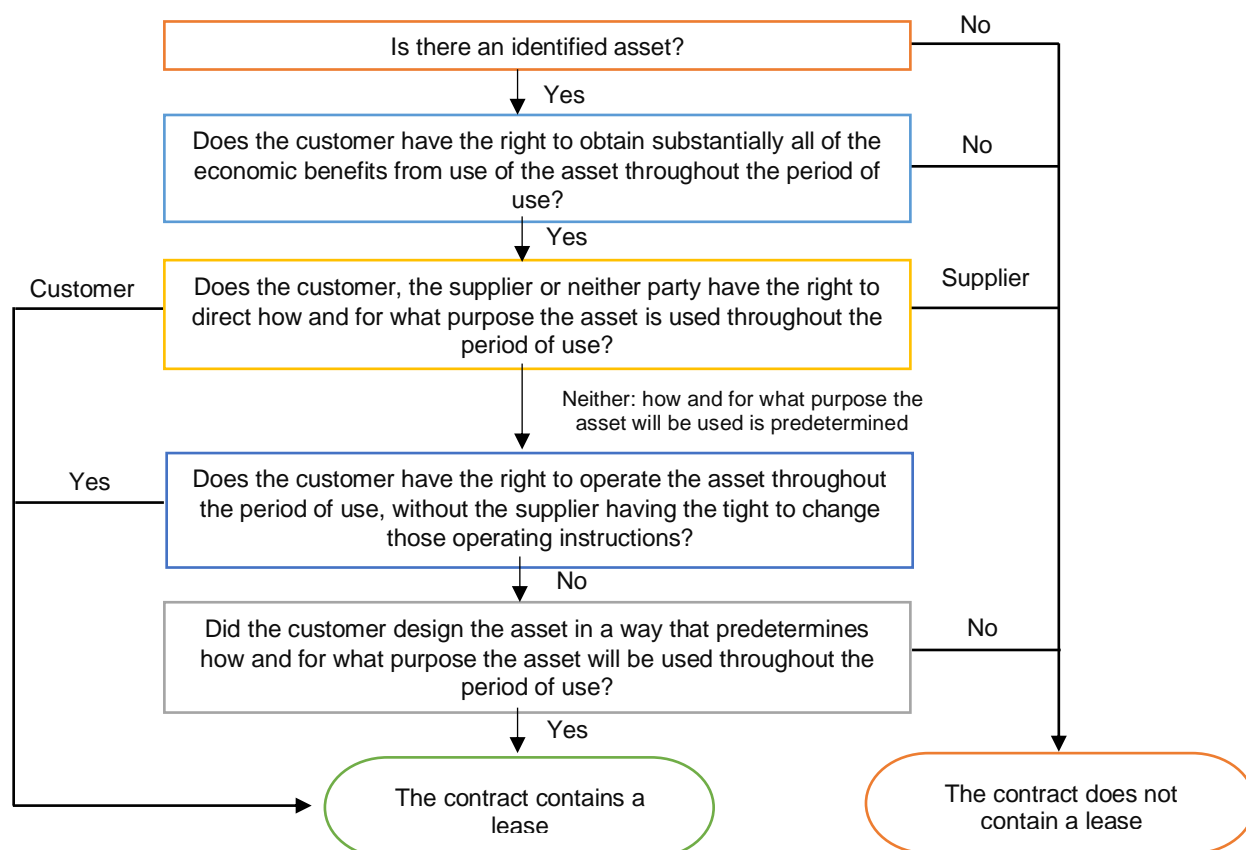
### 5. Scope Exclusions of SLFRS 16

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- Leases of biological assets within the scope of LKAS 41 *Agriculture* held by a lessee;
- Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*;
- Licenses of intellectual property granted by a lessor within the scope of SLFRS 15 *Revenue from Contracts with Customers*; and
- Rights held by a lessee under licensing agreements within the scope of LKAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

## 6. Key Changes

Principals	LKAS 17	SLFRS 16
Accounting model for Lessee	Leases are recognized as either finance lease or operating leases based on whether it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.	Single lease accounting model requiring lessees to recognise assets and liabilities for all leases unless a lessee makes use of optional exemptions for short-term leases and leases for which the underlying asset is of low value .
Initial measurement of sublease in the books of Lessor	LKAS 17 requires a lessor to classify leases as either operating or finance based on the extent to which the lease transfers the risks and rewards incidental to ownership of an underlying asset.	In addition to LKAS 17 requirements, SLFRS 16 contains an additional paragraph (i.e. B58) requiring an intermediate lessor to classify a sublease as a finance or operating lease. Accordingly, if the head lease is accounted for as a short-term lease, the sublease is classified as an operating lease and otherwise, the sublease is classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset.

## 7. How to determine whether Contract contain a lease?



## 8. Books of the lessee

### 8.1 Initial Assessment

The following measurement requirements apply to all leases, unless a lessee makes use of optional exemptions for short-term leases (those having a term of 12 months or less, including the effect of extension options) and leases for which the underlying asset is of low value (eg telephones, laptop computers, and office furniture). The election for short term leases is by class of asset, and for low value leases can be made on a lease-by-lease basis

#### How to determine Low Value:

There is no specific threshold provided in Sri Lanka Accounting Standards to define "low value" since standards are principle base. Accordingly, management has to exercise the professional judgment to determine whether lease value is low value since this concept is entity specific.

#### How to determine Lease Term:

An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

- (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

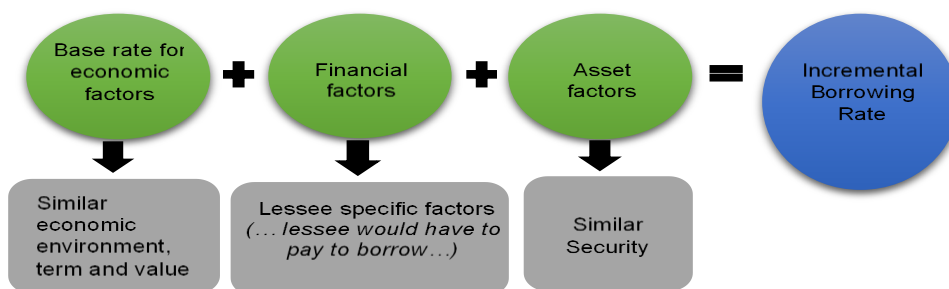
Accordingly, it is recommended to assess whether the contract includes options. If so, the lease term shall consider the exercise of the options to determine the lease term.

If options are not included in the lease agreement, it is appropriate to refer and apply the contractual terms of the agreement. Based on the management judgment, it is recommended to see additional facts and circumstances as well in determining the lease term and such facts and circumstances shall be disclosed based on the materiality.

#### How to calculate Incremental Borrowing Rate (IBR):

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 does not include descriptive guidance on how to determine the IBR beyond the definition provided. Accordingly, preparers will have to apply judgment in determining the IBR.

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

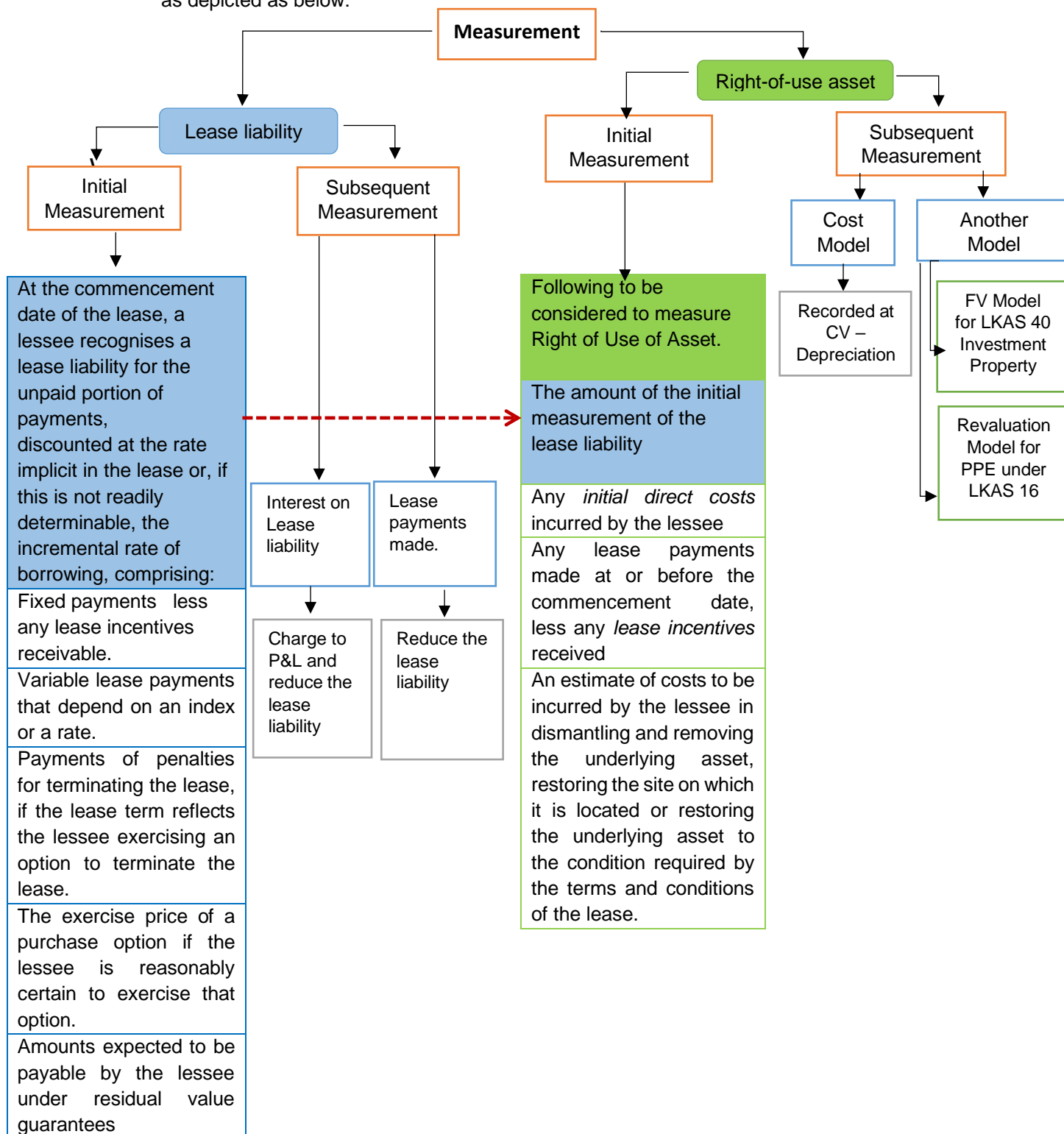


In this regard, each company needs to build up an IBR with other observable data and the following provides the guidance to consider:

- 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.

## 8.2. Measurement of Right of use of asset and Lease Liability

At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability as depicted as below:



### 8.3 Presentation

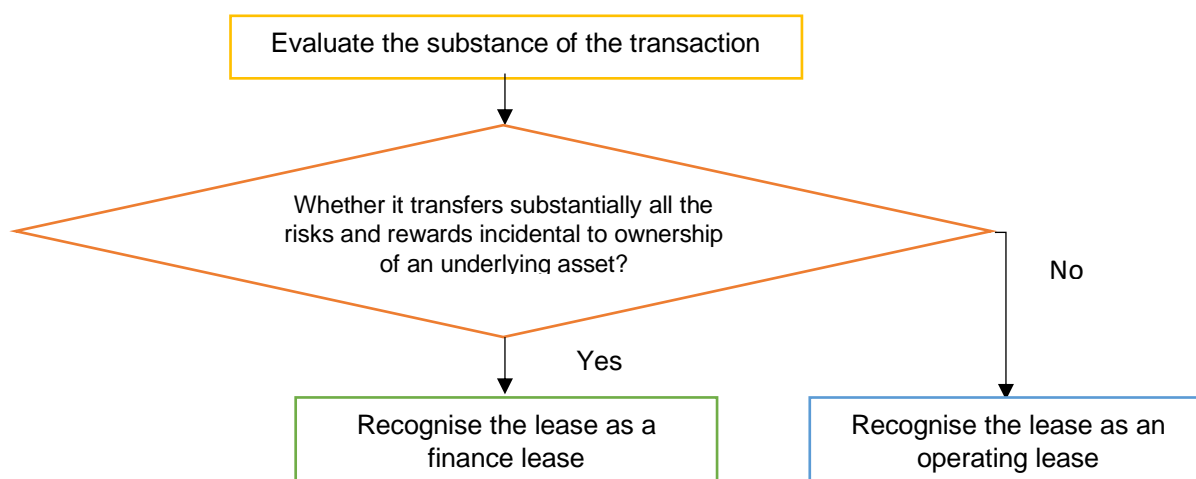
Financial Statements	Items to be included
<b>If the lease is considered to be a right of use of asset</b>	
Statement of financial position	<ul style="list-style-type: none"> <li>▪ Right-of-use assets</li> <li>▪ Lease liabilities</li> </ul>
Statement of Cash flows	<ul style="list-style-type: none"> <li>▪ Principal payments on the lease liability as financing activities.</li> <li>▪ Payments of interest either under operating or financing cash flows.</li> </ul>
<b>If the lease is not considered to be a right of use of asset</b>	
Statement of Cash flows	<ul style="list-style-type: none"> <li>▪ Short-term and low-value asset leases and variable lease payments that are not included in the measurement of lease liabilities are classified under the operating cash flows.</li> </ul>

### 8.4 Disclosure

<b>If the lease is considered to be a right of use of asset</b>	
a)	Depreciation charge for right-of-use assets by class of underlying asset
b)	Interest expense on lease liabilities
c)	The expense relating to variable lease payments not included in the measurement of lease liabilities
d)	Income from subleasing right-of-use assets
e)	Total cash outflow for leases
f)	Additions to right-of-use assets
g)	Gains or losses arising from sale and leaseback transactions and
h)	The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.
i)	Separate maturity analysis from the other financial liabilities
<b>If the lease is not considered as a right of use of asset</b>	
a)	The expense relating to short-term leases.
b)	The expense relating to leases of low-value assets.

## 9. Books of the lessor

### 9.1 Initial Assessment



### Recognition of Lease as a Finance lease

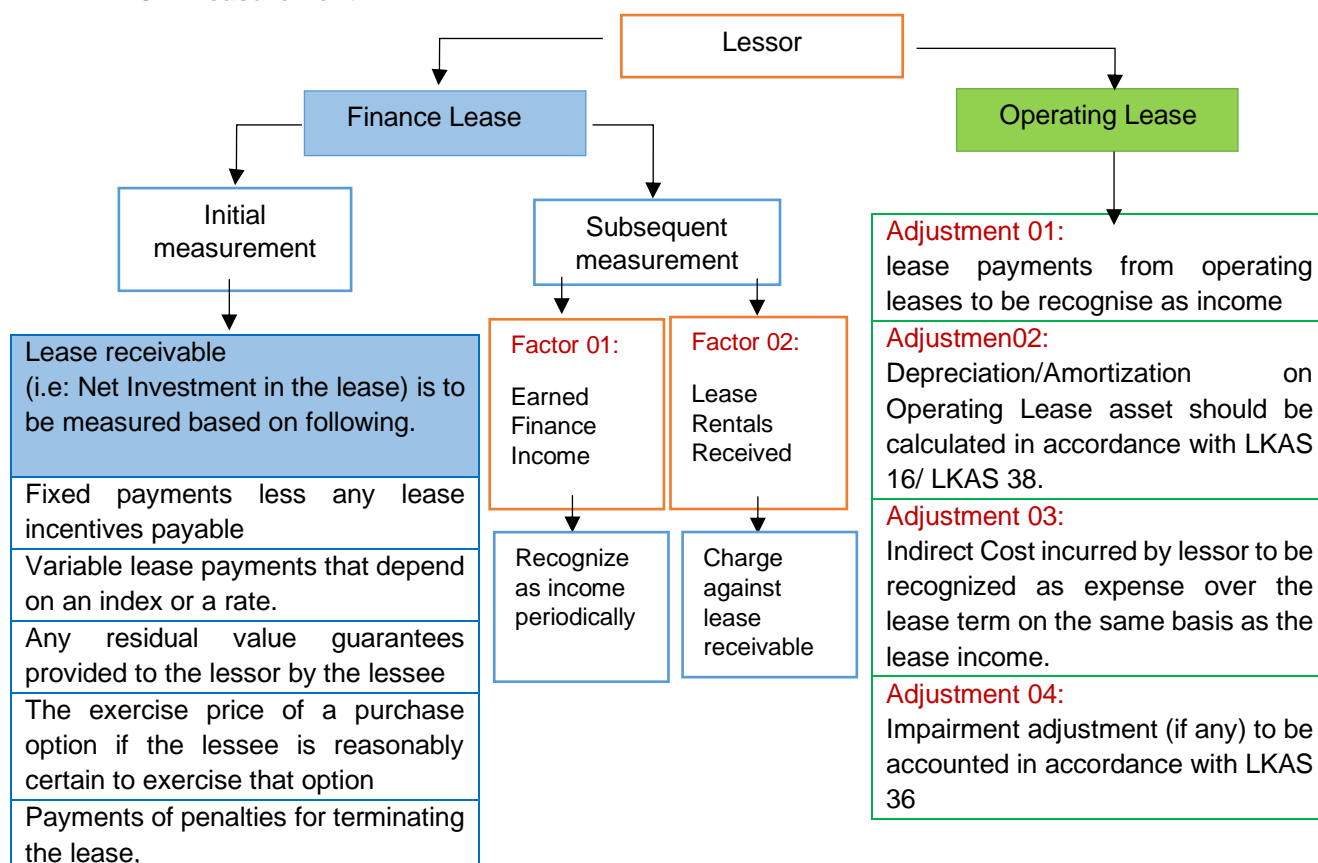
- A lease is classified as a finance lease, if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.
- Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.
- Examples of situations and indications of situations that lead to a lease being classified as a finance lease are given below:

Examples of situations	Indicators of situations:
a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term;	a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
b) The lessee has the option to purchase the underlying asset at a price lower than the fair value	b) Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee.
c) The lease term is for the major part of the economic life of the underlying asset.	c) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.
d) At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset	
e) The underlying asset is a specialised nature.	

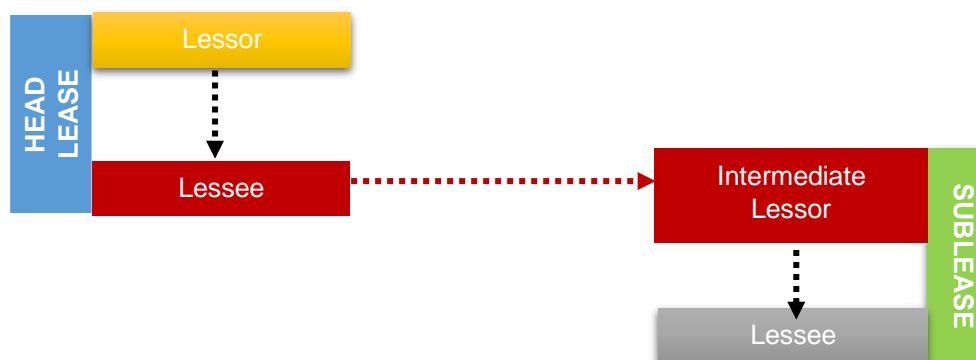
### Recognition of Lease as Operating lease

A lease is classified as an operating lease, if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

## 9.2 Measurement



## 9.3 Sublease:



SLFRS 16 requires an intermediate lessor to classify the sublease as a finance lease or an operating lease as follows:

- If the head lease is a short-term lease that the entity, as a lessee, has accounted for by recognising the lease payments as an expense on a straight-line basis over the term of the lease, the sublease shall be classified as an operating lease.
- Otherwise, the sublease must be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the economic useful life of the underlying asset (eg: item of PPE that is the subject of the lease) by applying the general principles (and the associated examples and indicators) for classification of a lease as an operating or a finance lease



## 9.4 Presentation

Financial Statements	Item(s) to be included
Finance Lease	
Statement of financial position	Net lease receivables (i.e: Net investment in the lease)
Operating Lease	
Statement of financial position	Underlying assets subject to operating leases

## 9.5 Disclosure

Finance Leases	Operating Leases
<ul style="list-style-type: none"><li>a) Selling profit or loss</li><li>b) Finance income on the net investment in the lease</li><li>c) Income relating to variable lease payments not included in the measurement of the net investment in the lease</li><li>d) A maturity analysis on the lease payments receivable.</li></ul>	<ul style="list-style-type: none"><li>a) Lease income</li><li>b) Depreciation</li><li>c) Impairment</li><li>d) Initial direct cost incurred by the lessor</li></ul>

## 10. Transition

An entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application.

### In the books of lessee:

A lessee shall apply SLFRS 16 to its leases either:

- a) retrospectively to each prior reporting period presented applying LKAS 8; or
- b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application:

### *Leases previously classified as operating leases*

1. recognise a lease liability at the date of initial application for leases previously classified as an operating lease applying LKAS 17. The lessee shall measure that lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.
2. recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying LKAS 17. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:
  - (i) its carrying amount as if the standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or

- (ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.
3. apply LKAS 36 to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient in terms of paragraph C10(b).

### ***Leases previously classified as finance leases***

If a lessee elects to apply this standard in accordance with paragraph C5(b), for leases that were classified as finance leases applying LKAS 17, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying LKAS 17. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this standard from the date of initial application.

CA Sri Lanka has issued an Application Guidance Notes on SLFRS 16 for the companies which followed the Statement of Alternative Treatment (SoAT) on Right-to-use of Land on Lease issued in 2013.

Accordingly, the application of paragraph C5(a) might be impracticable for these entities and they 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 the right of use asset which is subject to impairment testing in terms of LKAS 36 and adjusted in the financial statements as appropriate. Subsequent to the initial application of SLFRS 16, the entity may follow the cost model or revaluation model and impairment testing is to be applied continuously.

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.

### ***In the books of lessor:***

A lessor is not required to make any adjustments on transition for the leases provided and shall account for those leases applying this standard from the date of initial application.