UHY M.L. Aguirre & Co. CPAs

# ADVISORY

**UHYMAC-2019-0015**

**Subject** : **IFRS 16 Leases: Right of Use Asset and Lease Liability in Lien of Operating Lease and Finance Lease**

**Effectivity** : **For annual periods beginning on or after January 1, 2019**

**Date** : **July 24, 2019**

The IASB published **IFRS 16 Leases** in January 2016 which brings significant changes in accounting requirements for lease accounting, primarily for lessees. This standard is effective for annual periods beginning on or after January 1, 2019, with early adoption is permitted only if **IFRS 15 Revenue from Contracts with Customers** is adopted at the same time.

IFRS 16 states a lease 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. A lease exists when a customer controls the right to use an identified item, which is when the customer:

- Obtain substantially all of the economic benefits from the use of the asset.
- The right to direct the use of the asset throughout the period of use.

The new standard requires lessees to recognize **right of use asset** (representing the leased item for the lease term) and **a lease liability** (representing the obligation to pay rentals) for all leases with a term of more than 12 months, unless the underlying asset is of low value and for short term leases (i.e. those with a lease term of 12 months or less). Leases will no longer be classified as operating lease or finance lease as they currently cover under IAS 17.

The initial measurement of the right-of-use asset is based on the lease liability, with adjustments for any prepaid rents, lease incentives received and initial direct costs incurred and is accounted subsequently in accordance with the cost or revaluation model in IAS 16 Property, Plant and Equipment or as investment property under IAS 40 Investment Property. The lease liability, on the other hand, is initially measured at the present value of future lease payments which includes fixed, non-cancellable payments for lease elements, amounts due under residual value guarantees, certain types of contingent payments and amounts due during optional periods to the extent that extension is 'reasonably certain. This is accounted subsequently similarly to a financial liability using the effective interest method. The initial lease asset equals the lease liability in most cases.

Lessor accounting remains substantially unchanged from IAS 17 Leases. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. Operating leases continue to be recorded as assets in the statement of financial position and lease income is recognised on a straight line basis over the lease term. For finance leases, a lessor is required to derecognise the underlying asset and record a receivable equal to the net investment in the lease, with a gain or loss on sale. Finance income is subsequently recognised at the rate inherent in the lease over the lease term.

A lessee has to choose either a full retrospective approach (i.e. restating comparatives as if IFRS 16 had always been in force) or retrospective application without restatement of prior year comparatives to transition to the new standard. The selected approach has to be applied to the entire lease portfolio.

Enclosed is the required IFRS 16 disclosures for your reference and copy of the full standard text may be obtained upon request.

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