



IFRS 16 Leases

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In January 2016, the International Accounting Standard Board ("IASB") issued IFRS 16 Leases ("IFRS 16"), which effectively replaced IAS 17 Leases, SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease and IFRIC 4 Determining whether an Arrangement contains a Lease, SIC-15 Operating Leases - Incentives.

IFRS 16 sets out the accounting requirements for the recognition, measurement, presentation, and disclosure of leases for lessees and lessors. The Saudi Organization of Chartered and Professional Accountants ("SOCPA") endorsed IFRS 16 with additional required disclosures, which is applicable for the annual period beginning from 1 January 2019 onwards.

The objective of IFRS 16 is to ensure that lessees and lessors provide pertinent information that faithfully represents lease transactions, which shall provide a basis for users of financial statements to assess the effect of leases on the financial position, financial performance, and cash flows of an entity. IFRS 16 establishes a single accounting model for the lessee, whereby assets and liabilities are recognized in an entity's statement of financial position.

Our experience working with clients globally, particularly in the Kingdom of Saudi Arabia, indicates that companies face challenges applying or implementing this standard's accounting requirements. Therefore, we have sought to produce this publication to support our clients in identifying the complexities of this standard to avoid audit adjustments and/or undesirable observations stemming from regulator reviews.



Identifying a Lease - Determining Whether an Arrangement Contains a Lease

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. The right to control the use of an identified asset means having the right to direct and obtain all the economic benefits from the use of that asset throughout the period of use.

Identifying whether a contract includes a lease is complex and challenging, especially when leases form part of larger service agreements. This involves determining if the customer has the right to control the use of an identified asset by examining decision-making authority and exclusivity. Deciding whether a contract conveys the "right to control" an identified asset versus mere "access" (service) involves evaluating decision-making authority and benefits derived from the identified asset. For example, a logistics contract granting exclusive use of specific trucks may qualify as a lease, while general access to a shared fleet does not. Such determinations are complex and often require significant time and extensive analysis for contracts with pooled assets. Consequently, in making this determination, a wholistic analysis should be conducted incorporating all of the following considerations:

- Is there an identified asset, either explicitly or implied, in the contract. In certain cases, the customer may not have the right to the entire asset but only to a portion of the asset's capacity.
- Does the supplier have a substantive substitute right over the asset? Does the supplier benefit economically from its right to substitute? This will be further discussed later in this publication.
- Who has the right to direct the use of the asset? Generally, if the customer has the right to direct the use, the contract is a lease. If the supplier has the right to direct the use, the contract is not a lease. If the use is predetermined, additional analysis of the specific facts and circumstances will be required.

Lease Term - Inception of a Contract and Extension Options

IFRS 16 requires an entity to ascertain whether a contract is or contains a lease at its inception. The inception date of a lease is defined as the earlier of either date the lease agreement is executed or the date the parties commit to the main terms and conditions of the lease. This is different to the commencement date of the lease which refers to the date on which the underlying asset is available for use.

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

- The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- The periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

Assessing the lease term involves predicting the likelihood of exercising extension or termination options based on all relevant facts and circumstances that create economic incentives, penalties, and uncertainties. Ambiguities in contract language or changing business strategies add complexity. For example, a retailer leasing a store for 5 years with a 3-year renewal option must decide if renewal is "reasonably certain," affecting liability calculations. Incorrect assumptions can lead to frequent adjustments and audit challenges. One example of such a challenge stems from accounting for leasehold improvements, which was a topic identified by the Capital Market Authority ("CMA"), whereby entities are amortizing leasehold improvements for a longer duration than the lease term, which indicates that the lease term might have been incorrectly estimated.

Lessee Accounting

A lessee applies a single accounting model on leases under which it recognizes leases in the statement of financial position unless it elects to apply the recognition exemptions of this standard (i.e., short-term leases and low-value assets). A lessee recognizes a right-of-use asset signifying its entitlement to use the underlying asset and a lease liability to make payments. At the commencement date, a lessee measures the right of use asset at cost and the lease liability at the present value of the future lease payments using the interest rate implicit in the lease if it is readily determinable. When an implicit interest rate in the lease is not readily available, the lessee shall use its incremental borrowing rate. This is the rate that a lessee would have to pay at the commencement date of the lease to borrow an amount equal to the lease payments over a similar term and with similar security to obtain an asset of similar value to the right-of-use asset in a similar economic environment.

Determining the discount rate, especially the incremental borrowing rate (IBR), is a significant challenge when the implicit rate is unavailable. Entities must estimate IBR based on lease-specific factors like terms, payment schedules, and economic conditions. For example, a start-up leasing equipment for 10 years without borrowing history must use external benchmarks, which can lead to inconsistent calculations. Managing varying discount rates across multiple leases adds operational complexity.

Another complexity arises in relation to large Groups. Some lessees conduct all their financing at a consolidated level; therefore, for the subsidiaries, their only source of financing is the parent company. In such situations, the subsidiaries cannot automatically default to using the IBR of their parent and, consequently, should use this rate only as a starting point and adjust for their own circumstances to derive an entity-specific IBR. It should be noted that the rate determined should purely reflect the entity's cost of debt, i.e., rates like Weight Average Cost of Capital ("WACC"), which includes debt and equity, cannot be used.

Remeasurement and Modification of Lease

IFRS 16 has specific requirements to remeasure the lease liability to reflect any changes to the lease payments. A lessee shall recognize the remeasurement amount of the lease liability as a consequential adjustment to the right-of-use asset. However, suppose 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. In that case, a lessee recognizes the remaining remeasurement amount directly in profit or loss.

Lessees remeasure the lease payments upon a modification (i.e., a change in the scope of a lease or the consideration for a lease that was not part of the original terms and conditions) that is not accounted for as a separate contract. Lessees are also required to remeasure lease payments upon a change in any of the following:

- The lease term
- The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset
- The amounts expected to be payable under residual value guarantees
- Future lease payments as a result of the change in an index or rate
- In-substance fixed lease payments

Lease modification involves deciding if the modification is a separate lease or an adjustment to the existing one. A lessee shall account for a lease modification as a separate lease if both:

- a. The modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- b. The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

If either of the conditions is not met, the modified lease shall not be accounted for as a separate lease. Determining whether a lease modification is a separate lease or an adjustment to the existing one can be time-consuming. For instance, a tenant negotiating a rent reduction to extend the lease term by 2 years must remeasure liabilities and assets. Frequent renegotiations make this a recurring challenge.

Sub-leases

A sub-lease is a transaction in which an identified asset is re-leased by a lessee (“original lessee” or “intermediate lessor”) to a third party (“sub-lessee”) and the lease (“head lease”) between the head lessor and original lessee remains in effect.



IFRS 16 applies to all leases of right-of-use assets in a sub-lease. The original lessee/intermediate lessor accounts for the head lease and the sub-lease as two distinct arrangements, applying both the lessee and lessor accounting requirements under this standard. Sub-lease arrangements require the original lessee/intermediate lessor to classify the sub-lease as either finance or operating lease while managing dual reporting as both lessee and lessor. Different terms for head leases and subleases may lead to mismatches. For example, suppose a company subleases part of its office space, and the sublease transfers most risks and rewards. In that case, it must be classified as a finance lease, requiring detailed analysis and complex accounting.

Sale and Leaseback Transaction

In a sale-and-leaseback transaction, an entity (the seller-lessee) sells an underlying asset to another entity (the buyer-lessor) and then leases it back from the buyer-lessor.

Apply IFRS 15 to assess whether sale has taken place



Apply IFRS 16 for accounting

A sale-and-leaseback transaction involves determining if the transfer qualifies as a "sale" under IFRS 15. If it doesn't, the leaseback is treated as a financing arrangement, adding complexity to accounting. For instance, an entity sells a building and leases it back for exclusive use. If the seller-lessee retains significant control, such as fixed repurchase rights, it's accounted for as financing rather than a sale, requiring additional judgment and disclosures. This could lead to inconsistencies between accounting and legal interpretation of the sale agreements. One such instance was observed in the case of the sale of Telecommunications Towers whereby certain towers were sold, but control for accounting purposes was not passed onto the purchaser, and consequently, the arrangement was recognized as a financing arrangement rather than a sale and purchase.

Given the complexity of this matter, we have produced an illustrative example below to showcase how the gain/ loss on sale should be recognized practically in the seller's accounting records.

Example

Company A sells an office building to Company B for SAR 2,000,000 (which represents the fair value of the building). Prior to the sale, the building is carried at SAR 1,000,000. At the time of sale, Company A enters into a contract with Company B to lease the building for a period of 15 years with annual rental payments of SAR 90,000 payable at the end of each year. It is assumed that the transfer qualifies as a sale under IFRS 15. Company B's incremental borrowing rate is noted to be 5.0% per annum. Consequently, the present value of the annual payments is SAR 934,169, corresponding to 15 yearly payments of SAR 90,000 discounted at 5% per annum. On this basis, Company A records the transaction as follows:

1. Company A recognizes the right of use retained through the leaseback at a portion of its previous carrying amount, i.e., SAR 467,085 ($\text{SAR } 934,169 / \text{SAR } 2,000,000 \times \text{SAR } 1,000,000$)
2. The total gain on the sale of the building amounts to SAR 1,000,000 ($\text{SAR } 2,000,000 - \text{SAR } 1,000,000$), of which SAR 532,915 ($\text{SAR } 1,000,000 - \text{SAR } 467,085$) is the portion of the gain relating to the rights transferred to Company B.

Business Combination

The acquirer shall recognize right-of-use assets and lease liabilities for leases identified in which the acquiree is the lessee. Acquired leases in a business combination require recognizing liabilities and ROU assets at fair value and identifying favorable or unfavorable lease terms. For example, if a company acquires another business with office leases below market rates, the acquirer must adjust for favorable terms as part of the purchase price allocation. Embedded leases in acquired contracts add further complexity, requiring detailed reviews.

Other Matters

Local Regulatory Clarification: In November 2023, SOCPA published a clarification (no. 166) related to the capitalization of depreciation of right-of-use assets in relation to leased land to the cost of building during the construction period. It was clarified that depreciation expense for the right-of-use asset is not charged to the cost of the building. This clarification released by SOCPA resulted in restatements of the financial statements of various entities in the Kingdom of Saudi Arabia.

Applying IFRS 16 with other Standards: Entities face challenges in applying IFRS 16 alongside other standards, such as IFRS 15 Revenue, regarding what constitutes a lease or transfer of control and the accounting of sale and leaseback transactions. For example, a lease with rent tied to sales revenue involves distinguishing the fixed and variable components, with fixed components accounted for under IFRS 16, while variable components are accounted for under IFRS 15. Similarly, impairments of right-of-use assets or embedded derivatives in leases must align with other relevant standards, adding complexities to an entity's financial reporting.

For IFRS 9 Financial Instruments, the question arises as to whether the finance income should be calculated based on the gross lease receivable or the net amount of the lease receivable less than expected credit loss and how a lessor applies the ECL model to an operating lease receivable. While for IAS 36 Impairment of Assets, the guidance is viewed as complex and cannot be applied, particularly when determining whether the right-of-use asset is impaired. Entities may need to make complex judgments and estimates of future performance and value assets for which observable prices are often unavailable.

Substantive substitution rights: No identified asset if the supplier has a substantive substitution right. A substitution right is substantive when both of the following conditions are met: a) The supplier has the practical ability to substitute alternative assets throughout the period of use; and b) The supplier would benefit economically from exercising its right to substitute the asset. Entities may find it challenging to ascertain whether the supplier has a substantive substitution right.

Disclosure requirements: The IASB and SOCPA mandate detailed disclosures for lessee about the nature, amount, timing, and uncertainty of cash flows arising for leases. Meeting these requirements can particularly be challenging, especially for entities with complex lease portfolios. This standard requires significant judgment, especially when determining the lease term and discount rates, which can impact the accuracy of disclosures to the financial statements.

Subsurface rights: In certain sectors like telecommunications, power, and utilities, it is common to run cables and pipeline networks underground. For example, a water pipeline operator (the customer) may enter into a contract with the landowner to lay an underground water pipeline through his land in exchange for consideration. No one except the water pipeline operator is permitted access to the pipeline, but the landowner can use the land above it. The pipeline operator has the right to perform inspections, repairs, and maintenance work and replace damaged sections of the water pipeline where necessary. This resulted in a topical issue that was highlighted during the implementation of IFRS 16: how an entity should account for a contract containing the right to place a pipeline, for example, in a specified underground space (subsurface rights). The IFRS Interpretations Committee issued an agenda decision highlighting that the specified underground space is physically distinct and tangible. Therefore, as the contract contains a lease, IFRS 16 applies to that contract.



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