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THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF CYPRUS

TECHNICAL CIRCULAR:	**6/2021 [TC 6_2021]**
To:	**ALL MEMBERS OF THE INSTITUTE**
From:	**Accounting Standards Committee**
Date:	**31 March 2021**
Subject:	**IFRS 16 Leases - Practical considerations**

IFRS 16 *Leases* is effective for annual reporting periods starting on or after 1 January 2019 and affects most companies that report under IFRS Standards and are involved with leasing. IFRS 16 replaces the existing standards and interpretations on leases:

- IAS 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*

The purpose of this technical circular is to provide guidance in key areas of judgement of the new standard and to present practical examples tailored to encounter the challenges faced in the local market when applying IFRS 16.

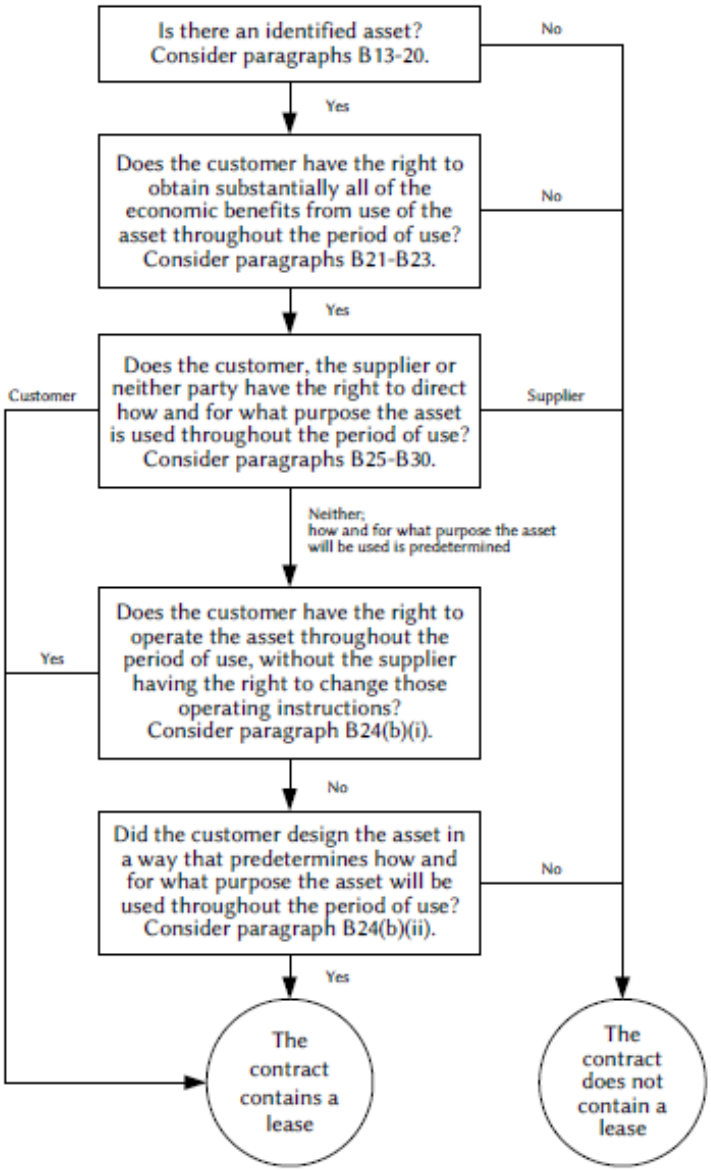
The following areas are considered:

- **Identification of a lease**
- **Determination of lease term**
- **Discount rate**
- **Lease payments**
- **Tax accounting considerations**
- **COVID-19-Related Rent Concessions**
- **Disclosures**

The information below is not exhaustive, it is purely indicative, and it does not constitute endorsement of any specific view/position. We acknowledge that there could be alternative views and methodologies adopted as long as they remain compliant with the provisions of IFRS 16.

Identification of lease

IFRS 16 defines a lease as 'a contract, or part of a contract, that conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration'. The determination of whether an arrangement contains a lease is performed at the inception of the contract.



Each element of the definition, being the presence of an identified asset, and the right to control the use of this asset, along with relevant considerations, are analysed below:

Right to control the use of an identified asset

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity assesses whether, throughout the period of use, the customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset. There is no defined threshold in IFRS 16 for substantially all and therefore, judgement is required. Both the primary output and any other benefits (like by-products that accrue to the customer) need to be considered to determine whether the criterion is met. However, benefits that only accrue to the legal owner of an asset (e.g., some tax advantages like capital allowances) are not considered; and
(b) the right to direct the use of the identified asset.

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

Identified asset

An arrangement only contains a lease if there is an identified asset. An asset is typically identified by being explicitly specified in a contract, for example, the specific registration number for a hire car. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

A capacity portion of an asset which is physically distinct (e.g., a floor of a building) is also an identified asset. Even if the capacity portion of an asset is not physically distinct, it can still be an identified asset if it represents substantially all of the capacity of the asset (e.g., 95% of a fiber optic cable). This is because such a portion of the capacity will provide the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Substantive substitution rights

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the practical ability to substitute the asset with an alternative one throughout the period of use, and the exercise of such right would provide the supplier with an economic benefit (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset). It should be noted that, if the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive.

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur (e.g., the introduction of new technology that is not substantially developed at inception of the contract).

Right to direct the use of the identified asset

A customer has the right to direct the use of an identified asset throughout the period of use when the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

In certain contracts, the relevant decisions about how and for what purpose an asset is used are predetermined. In such cases, the customer has the right to direct the use of the asset when:

- the customer either has the right to operate the asset, or to direct others to operate the asset in a manner that it determines, throughout the period of use, without the supplier having the right to change those operating instructions; or

- the customer designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Protective rights

A contract might include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract might (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset, (ii) require a customer to follow particular operating practices, or (iii) require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

Reassessment

An entity assesses whether there is a lease at inception of the contract and, if there is a lease, will apply the IFRS 16 model for lessees. An entity shall reassess whether a

contract is, or contains, a lease only if the terms and conditions of the contract are modified.

The IFRS 16 model for lessees

The basic principle of IFRS 16 and change compared to its predecessor, IAS 17, is that almost all leases are brought on the balance sheet, as a right of use asset with a corresponding lease liability.

A lessee may, by way of exemption which is similar to an accounting policy choice, elect not to apply the requirements of IFRS 16 to:

- short-term leases (leases that, at the commencement date, have a lease term of 12 months or less, and do not contain a purchase option). This is an accounting policy choice, and the standard requires that this should be applied consistently for all underlying assets of the same class; and
- leases for which the fair value of the underlying asset is of low value when new (indicated in the Basis for Conclusions at a value of <US$5,000) e.g., tablets and personal computers. This is also an accounting policy choice, but on this exemption, a lessee can apply it on a lease-by-lease basis. The last point is that the exemption cannot be used (1) for assets that are subject to a sub-lease; (2) if an underlying asset is highly dependent on, or interrelated with, other underlying assets or (3) if the lessee cannot benefit from an underlying asset on its own or together with other readily available resources.

For short-term leases or leases of low-value items to which this exemption is applied, lease payments are recognised as an expense over the lease term.

For all other leases, on initial recognition:

- the lease liability is measured at the present value of future lease payments.
- the right of use asset is measured at cost, being (a) the value of the lease liability on initial recognition, as adjusted for (b) any lease payments made at or before the commencement date, less any lease incentives received; (c) any incremental costs of obtaining a lease that would otherwise not have been incurred by the lessee; and (d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

The key inputs in measuring the lease liability are the lease term, lease payments and the discount rate. Each of these inputs are explained in detail below.

Determination of lease term

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

- periods covered by an option to extend the lease or purchase the underlying asset if the lessee is reasonably certain to exercise that option; and
- periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

The phrase 'reasonably certain', which was also used in IAS 17, is generally interpreted as a high threshold.

The above assessment is performed at commencement date (the date on which a lessor makes an underlying asset available for use by a lessee), were the initial recognition and measurement takes place, by considering all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option. Such factors include, but are not limited to, the following:

- the level of lease payments over the optional period compared with market rates;
- the price under a repurchase option compared to the estimated market price of the underlying asset at the time of exercise;
- significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract;
- costs relating to the termination of the lease (e.g., negotiation costs, relocation costs etc.);
- the importance of that underlying asset to the lessee's operations (e.g., specialized underlying assets); and
- conditions associated with exercising the option and the likelihood of those conditions being met.

The longer the period from commencement of the lease to the exercise date of an option, the more difficult it will be, in certain cases, to determine whether the exercise of the option is reasonably certain.

When assessing the lease term, entities need to consider whether local laws and regulations create enforceable rights and obligations that need to be included in the evaluation of the lease term. That is, local laws and regulations might give the lessee legal renewal options not stated in the lease contract.

It should be noted that subsequently, a lessee reassesses whether it is reasonably certain to exercise an extension option or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee and affects the lessee's initial assessment of whether it was reasonably certain or not to exercise the above options.

Non-cancellable period

For the determination of the non-cancellable period of a lease, an entity determines the period for which the contract is enforceable (i.e., it creates enforceable rights and obligations to the two parties). A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

For instance, if there is a perpetual contract, which is automatically renewed beyond the non-cancellable period, until one party gives notice to terminate the contract, if both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then the lease term is limited to the non-cancellable term. The Interpretation Committee has clarified in November 2019 that penalty in the context of this paragraph should be interpreted after considering the broader economics of the contract and not only contractual termination payments.

Therefore, any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. An entity determines the non-cancellable period and the enforceable period to determine the lease term.

Discount rate

For lessees, lease payments are discounted using the interest rate implicit in the lease, unless that rate cannot be readily determined*, in which case the lessee should use the lessee's incremental borrowing rate.

The interest rate implicit in the lease is defined as the rate that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

The lessee's incremental borrowing rate 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 (not the underlying asset) in a similar economic environment.

Example:

In a five-year property lease, the lessee considers borrowings with a similar term to the five year right-of-use asset, not the property itself, which might have a significantly longer life. Observable rates, such as a property yield can be used as a starting point to determine the incremental borrowing rate, but adjustments need to be considered for an asset with a value similar to the right-of-use asset. Other potential sources of adjustment might include:

- the credit profile of the lessee;
- the borrowing currency; and
- the length of the lease term.

Therefore, the determination of the lessee's incremental borrowing rate clearly requires the exercise of (significant) judgement.

A number of methodologies to determine the incremental borrowing rate are possible.

*: when the interest rate implicit in the lease can only be determined by using estimates and/or assumptions.

Lease payments

Lease payments are payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

(a) fixed payments (including in-substance fixed payments*), less any lease incentives**;
(b) variable lease payments that depend on an index or a rate;
(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
(d) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

*: In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable (e.g. there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic or there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In this case, an entity considers the set of payments that aggregates to the lowest amount to be lease payments.

**: Lease incentives are defined as 'payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee'. For example, lease incentives include, amongst other things, an upfront payment to the lessee or payment of costs for the lessee (e.g., moving expenses).

Variable lease payments that depend on an index or rate

Variable lease payments that depend on an index or a rate 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.

The payments are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement) and should not reflect estimations of future increases in the rate.

Lessees subsequently remeasure the lease liability if there is a change in the future payments, resulting from a change in index or rate used to determine lease payments.

In performing such remeasurement of lease liability, the lessee uses the original discount rate.

Example: Variable lease payment that depends on an index or rate

Entity A enters into a 10-year lease of property. The lease payment for the first year is € 1,000. The lease payments are linked to the consumer price index (CPI). The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

Analysis: At the lease commencement date, the lease payments are € 1,000 per year for 10 years. Entity A does not take into consideration the potential future changes in the index. At the end of year one the payments have not changed, so the liability is not updated. At the end of year two, when the lease payments change, Entity A updates the remaining eight lease payments to € 1,080 per year (€ 1,000 / 100 × 108) and does not change its discount rate to remeasure the lease liability.

Tax accounting considerations

IFRS 16 could affect lessees' accounting for income taxes. For lessees, IFRS 16 requires recognition of lease-related assets and liabilities and could change the measurement of other lease-related assets and liabilities. These changes affect certain aspects of accounting for income taxes such as the following:

- Recognition and measurement of deferred tax assets and liabilities.
- Assessment of the recoverability of deferred tax assets.

Under the assumption that the Cyprus tax Framework will allow an entity to claim a tax deduction based on the amount of lease payments, then this will result in the following:

- A taxable temporary difference on the right-of use asset equal to its carrying amount (as the tax base is zero).
- A deductible temporary difference on the lease liability equal to its carrying amount (as the tax base is zero).

The above creates the following possible accounting treatments, for which there is divergence in practice:

1. No recognition of deferred tax because the initial recognition exemption applies i.e., the transaction is not a business combination and upon initial recognition it neither affects accounting profit (full cost is recognised as Right-of-use asset and lease liability) nor taxable profit/ loss.
2. Recognise a net deferred tax asset.
3. Recognise deferred tax liability (on the Right-of-use asset) and a separate deferred tax asset on lease liability.

IASB proposal to amend IAS 12 Income Taxes

In view of the above divergence, the IASB proposed a revision to IAS 12, through the issue of Exposure Draft ED/2019/5 "Deferred tax relating to assets and liabilities arising from a Single Transaction".

The amendment is to add to the existing initial recognition exemption that if equal amounts of deductible and taxable temporary differences are created (as in the case of a lease contract), then the IASB is proposing to:

- Recognise a deferred tax asset in relation to the deductible temporary differences (to the extent that is probable that an entity will have available future taxable profits, against which the deductible temporary differences will be utilised).

- Recognise a deferred tax liability in relation to the taxable temporary differences, which should not exceed the deferred tax asset recognized above.

COVID-19-Related Rent Concessions

The COVID-19 pandemic resulted in a number of lessors granting rent concessions to lessees. Therefore, applying IFRS 16 requirements in the current environment raises a number of practical issues.

The IASB has issued an amendment to IFRS 16 in May 2020 to make it easier for lessees to account for COVID-19-related rent concessions, such as rent payment holidays, temporary rent reductions for a period of time and a deferral of payments to a later date. A concession might also include a change to the lease term. Access Part A of the *COVID-19-Related Rent Concessions* describing the amendment to IFRS 16 (it is freely available with a Basic subscription).

If certain conditions are met, the amendment permits lessees, as a practical expedient, not to assess whether a particular COVID-19 related rent concession is a lease modification. Instead, lessees that apply the practical expedient would account for the rent concessions as if it was not a lease modification. Lessees would instead apply paragraph 38 of IFRS 16.

The amendment does not affect lessors and therefore lessor accounting for rent concessions is based on the current guidance in IFRS 16. Lessors should continue to assess if the rent concessions are lease modifications. The IASB issued educational material in April 2020 to assist.

Some practical examples of where the practical expedient might be used are when lease payments are:

1. partly forgiven;
2. deferred in one period and increased at a future date; and
3. forgiven.

Practical example 1– accounting for partly forgiven lease payments

A lessee is paying monthly lease payments of €1000. In June 2020, the lessor has agreed to provide a 50% discount for three months, July 2020 to September 2020, with no adjustment to future rentals. Assume interest accrues at €50 per month. Monthly depreciation is €100.

The rent concession satisfies the criteria to apply the practical expedient because:
(1) It is a rent concession occurring as a direct consequence of the COVID-19 pandemic;
(2) The change in lease payments results in revised consideration for the lease that is less than the consideration for the lease immediately preceding the change;
(3) It reduces lease payments originally due on or before 30 June 2021*; and
(4) There is no substantive change to other terms and conditions of the lease.

*: As noted in paragraph "Transition and effective date" below the IASB has published for consultation a proposal to extend the time period over which the practical expedient is available for use to cover rent concessions that reduce lease payments due on or before 30 June 2022.

Monthly journal entries during the period of discount of payments

The cash paid is:
Dr Lease liability 1000
Cr Cash 500
Cr Profit or loss 500

The interest charged for the period is:
Dr Interest - profit or loss 50
Cr Lease liability 50

The depreciation expense is:
Dr Depreciation expense 100
Cr Right of Use Asset-depreciation 100

Practical example 2– accounting for lease payments deferral

As at 30 June 2020, a lessee is paying monthly lease payments of €5.000 in advance, with a remaining term of 6 months and a discount rate of 10% p.a. On 30 June 2020 the lease liability is €29.387 (present value of the remaining lease payments discounted using a 10% p.a. rate).

In June 2020, the lessor has agreed to provide a rent concession to the lessee as a consequence of Covid-19. The lessee is now not required to pay the rentals of €5.000 for July, August and September, but is instead required to proportionally increase the payment of future rentals for the remaining 3 months (October, November, December), i.e., make a payment of €10.000 in each of these months instead.

The lessee applies the rent concessions guidance and remeasures the lease liability by discounting the revised lease payments using the original discount rate of 10% p.a., at €29.021. The difference of €366 arising from the time difference in payments is immediately recognised on profit or loss.

The journal entries are:
Dr Lease liability 366
Cr Profit or loss 366

Transition and effective date[1]

The amendment is effective for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements not yet authorised for issue at 28 May 2020.

Lessees are expected to apply the practical expedient retrospectively, recognising the cumulative effect of initially applying the amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of the annual reporting period in which the lessee first applies the amendment. In the reporting period in which a lessee first applies the amendment, a lessee is not required to disclose the amount of the adjustment for each financial statement line affected and earnings per share as required by paragraph 28(f) of IAS 8.

Endorsement in Europe

The European Union has published a Commission Regulation endorsing the Amendment to IFRS 16 *Leases Covid 19-Related Rent Concessions*. The Amendments are effective for annual periods beginning on or after 1 June 2020 as indicated above, with early application permitted.

Refer here to the publication in the Official Journal of the European Union.

Disclosures

IFRS 16 requires different and more extensive disclosures about leasing activities than IAS 17 in both a qualitative and quantitative form.

Below we provide guidance issued by regulators and links to illustrative disclosures issued globally which can be helpful in implementing IFRS 16 requirements focusing on the information that is relevant to the users of financial statements.

Guidance issued by regulators

ESMA common enforcement priorities for 2019 and 2020 annual financial reports

The European Securities and Markets Authority (ESMA), the EU's securities markets regulator, published the priorities that European enforcers will consider when examining the 2019 and 2020 annual financial reports of listed companies. The 2019 and 2020 enforcement priorities discuss the application of certain financial reporting standards, including specific issues related to IFRS 16. Although both publications are

[1] With respect to the criteria that should be met to apply the practical expedient, the IASB has published for consultation a proposal (refer here) to extend the time period over which the practical expedient is available for use to cover rent concessions that reduce only lease payments due on or before 30 June 2022 (from the original date of 30 June 2021)

addressed to listed companies, it is considered relevant to all companies preparing financial statements under IFRS.

According to the 2019 enforcement priorities, preparers of the financial statements are expected to disclose qualitative and quantitative entity-specific disclosures (e.g. the nature of the leases and their main characteristics) and the significant judgements and assumptions made when applying IFRS 16.9. These judgements might include:

- determining the lease liability (e.g. lease term (to comply also with the requirements in paragraphs 122 and 125 of IAS 1 *Presentation of Financial Statements)*, discount rate used); and
- assessing whether a contract meets the definition of a lease under IFRS 16.

Moreover, ESMA underlines disclosure requirements related to low-value leases, short-term leases and carrying amounts of RoU assets by class of underlying assets in accordance with paragraph 53 of IFRS 16 and to sale and leaseback transactions in accordance with paragraph B52 of IFRS 16.

Read more about ESMA's 2019 recommendations towards the effective implementation of IFRS 16 (Lease Term, Discount Rate, Presentation, Impairment of RoU asset, Transition).

In the 2020 enforcement priorities, ESMA notes that paragraph 60A of IFRS 16 requires specific disclosures by lessees which have applied the IASB's amendment providing relief to lessees when accounting for rent concessions.

ESMA emphasises that lessors which have granted rent concessions, particularly in sectors for which the impact of the COVID-19 pandemic has been most severe, should provide adequate disclosures reflecting the risks that the current market conditions may result in significant changes in the assets subject to operating lease agreements.

Once more ESMA reminds lessees to disclose the information required by paragraph 53 of IFRS 16. ESMA also highlights the importance of the disclosures required for lessees by paragraph 58 of IFRS 16 in relation to the maturity analysis of lease liabilities and by paragraph 59 in relation to future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities.

ESMA also recommends that lessees carefully consider the disclosure of additional information as indicated in paragraph B48 of IFRS 16 which, particularly in the context of the COVID-19 pandemic, may complement the information already available to users of financial statements on the impact of the pandemic on an issuer's financial position, performance and cash flows.

Finally, for both lessees and lessors, ESMA emphasises the importance of providing clear disclosures on the accounting policy applied when accounting for any relief measures granted or benefitted from.

IFRS 16 Thematic Review: Review of Interim Disclosures in the First Year of Application

The UK Financial Reporting Council (FRC) has reviewed the interim reports of 20 companies applying IFRS 16 for the first time. While the FRC is mindful that the interim disclosure requirements are less extensive than those for full-year accounts, they note that some companies did not sufficiently explain the impact of adopting IFRS 16. The areas highlighted in the report where FRC expects companies to provide more comprehensive disclosure in their annual reports are the following:

- information about key accounting judgments made; for example, on the identification of lease, or on assessing their length;
- clearer explanations of the specific transition choices made;
- a detailed reconciliation between the operating lease commitment under the previous standard and the new lease liability, with clear explanations for reconciling items; and
- where companies use alternative performance measures (APMs) to help users of the accounts to understand the effect, these measures should be properly labelled, reconciled and explained, and not give more prominence than the IFRS measures.

It is noted that the FRC found several examples of good practices, which tended to be those disclosures that were tailored to the company's circumstances and provided more than the minimum requirements.

IFRS 16 Illustrative Disclosures

The links below are provided purely as indicative reference points:

- Presentation and disclosure requirements of IFRS 16 Leases
- IFRS 16 Illustrative Disclosures
- IFRS 16 - Illustrative Financial Statements *Implementing the change in the primary statements and the notes*

Other useful reading

- **IFRS Interpretations Committee (IFRIC)**

  Agenda Decisions

  - Lease Term and Useful Life of Leasehold Improvements (IFRS 16 *Leases* and IAS 16 *Property, Plant and Equipment*)
  - Definition of a Lease—Decision-making Rights (IFRS 16 *Leases*)

- Sale and Leaseback with Variable Payments (IFRS 16 *Leases*)

- IFRS IN PRACTICE 2019 IFRS 16 *Leases, BDO*

- Leases – a guide to IFRS 16