IFRS 16 *Leases*

Skopje, North Macedonia

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Aims

» Develop a more cohesive understanding of accounting and reporting of leases by **lessees** in accordance with IFRS 16 *Leases.*

» Develop a more cohesive understanding of accounting and reporting of leases by **lessors** in accordance with IFRS 16 *Leases.*

» Enhance capacity to make/audit/regulate the **judgements** made in applying IFRS 16 *Leases.*

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Overview

» Lessees applying IFRS 16

» Greggs mini-case study

» Lessors applying IFRS 16

» Appendix: Regulatory updates

» Q&A session

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Lessees applying IFRS 16

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Scope

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Lessee: assets and liabilities

Classification		Reference
Liability	Present obligation of the reporting entity to transfer an economic resource.	Conceptual Framework 4.26
Lease liability	Present obligation arising from a lease agreement (a contract).	IFRS 16
Asset	Present economic resource (ie a right that has the potential to produce economic benefits) controlled by the Reporting Entity	Conceptual Framework 4.3 and 4.4
Right of use asset (RoU asset)	An asset that represents a lessee's right to use an underlying asset for the lease term.	Appendix A to IFRS 16

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Definition of a lease

» A contract is, or contains, a lease if the contract (IFRS 16.9):

» conveys the right to control the use of an **identified asset** for a period of time

» in exchange for consideration.

» The lessee must have both (IFRS 16.B9):

» the **right to obtain substantially all the economic benefits** from use of an identified asset throughout the period of use; and

» the right to direct use of the identified asset throughout the period of use.

IFRS 16.B13-B20 specify mandatory guidance on an identified asset. A 'capacity portion of an asset is an identified asset if it is **physically distinct**'. (B20) However, 'a customer does not have the right to use an identified asset if the supplier has the **substantive right to substitute** the asset throughout the period of use' (B14).

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Example 1: definition of a lease

» A pipeline operator **(Customer)** obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration.

» The contract specifies the **exact location and dimensions (path, width and depth) of the underground space** within which the pipeline will be placed.

» The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use.

» Customer has the **right to perform inspection, repairs and maintenance work** (including replacing damaged sections of the pipeline when necessary).

Source: IFRIC Agenda Decision: Subsurface Rights (IFRS 16 Leases)—June 2019 (**emphasis** added)

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Example 1: definition of a lease 'Decision tree'

» **Does the contract contain a lease as defined in IFRS 16?** Choose one of: 1) Yes; or 2) No?

» **Sub-questions that must all be answered yes for there to be a lease:**

A. **Is there an identified asset?** Choose one of: 1) Yes; or 2) No?

B. **Does Customer have the right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use?** Choose one of: 1) Yes; or 2) No?

C. **Does Customer have the right to direct the use of the identified asset throughout the period of use?** Choose one of: 1) Yes; or 2) No?

Source: IFRIC Agenda Decision: Subsurface Rights (IFRS 16 Leases)—June 2019

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Example 1: definition of a lease
What do you think?

Sub-question A—is there an identified asset? Choose one of: 1) Yes; or 2) No?

Example 1: definition of a lease
What do you think?

» **Sub-question B—does Customer have the right to obtain substantially all the economic benefits from use of the identified asset (the specified underground space) throughout the period of use?** Choose one of: 1) Yes; or 2) No?

Example 1: definition of a lease
What do you think?

» **Sub-question C—does Customer have the right to direct the use of the identified asset (the specified underground space) throughout the period of use?** Choose one of: 1) Yes; or 2) No?

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Example 1: definition of a lease
What do you think?

» **Does the contract contain a lease as defined in IFRS 16?** Choose one of: 1) Yes; or 2) No?

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Example 2: definition of a lease

» **Customer** contracts the use of a ship throughout the five-year term of a contract.

» There is an identified asset (the ship) applying IFRS 16.B13–B20.

» **Customer** has the right to obtain substantially all the economic benefits from use of the ship throughout the five-year period of use applying IFRS 16.B21–B23.

» Many, but not all, decisions about how and for what purpose the ship is used are predetermined in the contract. **Customer** has the right to make the remaining decisions about how and for what purpose the ship is used throughout the period of use. [**Customer** has determined that this decision-making right is relevant because it affects the economic benefits to be derived from use of the ship.]

» **Supplier** operates and maintains the ship throughout the period of use.

Source: IFRIC Agenda Decision: Definition of a Lease—Decision-making Rights (IFRS 16 Leases)—January 2020 (**emphasis** added)

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Example 2: definition of a lease ‘Decision tree’

» **Does the contract contain a lease as defined in IFRS 16?** Choose one of: 1) Yes; or 2) No?

» **Sub-questions:**

A. **Is there an identified asset? Yes! (Assumed)**

B. **Does Customer have the right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use? Yes! (Assumed)**

C. **Does Customer have the right to direct the use of the identified asset throughout the period of use?** Choose one of: 1) Yes; or 2) No?

Source: IFRIC Agenda Decision: Definition of a Lease—Decision-making Rights (IFRS 16 Leases)—January 2020

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Example 2: definition of a lease
What do you think?

Sub-question C—does Customer have the right to direct the use of the identified asset throughout the period of use? Choose one of: 1) Yes; or 2) No?

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Example 2: definition of a lease
What do you think?

» **Does the contract contain a lease as defined in IFRS 16?** Choose one of: 1) Yes; or 2) No?

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Example: boundaries of RoU asset and lease liability

» In 2024 Entity leases (as lessee) a distribution centre, 20-year lease term.

» **Capitalises to the RoU asset** the alterations it makes to the distribution centre, including installing an acquired sprinkler system and refrigeration plant.

» **Recognises a provision liability** (IAS 37) for its obligation under the lease agreement to remove the building alterations (ie the installed sprinkler systems and refrigeration plant) at the end of the lease.

» **Capitalises to the RoU asset** the obligation to remove the alterations it made to the distribution centre.

» **Depreciates the RoU asset** (including the amounts capitalised for the alterations made and the obligation to remove them) on the straight-line method over the term of the lease.

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Example: boundaries of RoU asset and lease liability What do you think?

» **Is Entity's capitalization of the building alteration expenditures to the RoU asset likely consist with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example: boundaries of RoU asset and lease liability
What do you think?

» **Is Entity’s depreciation of the RoU asset likely consistent with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example: boundaries of RoU asset and lease liability
What do you think?

» **Is Entity’s capitalization of the obligation to remove the building alterations to the RoU asset likely consistent with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example: boundaries of RoU asset and lease liability
What do you think?

» **Is Entity's accounting for the obligation to remove the building alterations as a provision liability (IAS 37) likely consistent with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Recognition

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Lease: lessee perspective recognition criteria: requirements

Recognition criteria

Principle: 'all' leases on-balance sheet from commencement date (IFRS 16.22).

Optional recognition **exceptions** (rules):

- **short-term** leases, ie not 'reasonably certain' that the term will be >12 months, considering the likelihood of exercise of extension options and termination options (IFRS 16.5-8)
- **low-value** asset leases, typically <USD5,000 (IFRS 16.5, 6 and 8)
- include in lease accounting a **related service components** of a multiple element contract (instead of separating the service component from the lease component) (IFRS 16.12-16)

Mandatory measurement **exceptions** (exclude from RoU asset / lease liability):

- lease payments **based on future performance or use of the underlying asset**.
- other **lease renewal option < 'reasonably certain'.** (IFRS 16.26-28)

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Example 1: short-term and low value leases exemptions What do you think?

"The Group **applies the short-term lease recognition exemption** to those leases that have a lease term of 12 months or less from the commencement date and do not contain a purchase option. It also **applies the low value assets recognition exemption to leases of assets below £5,000.** Lease payments on short-term leases and leases of low-value assets are recognised as an expense on a straight-line basis over the lease term."

National Express Group PLC, Annual Report 2019, p151

» **Does use of a £5,000 threshold for the low value asset exemption likely contravene IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

Source: FRC, *IFRS 16 Thematic Review (2020)*, p6 (**emphasis** added)

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Example 2: short-term and low value leases exemptions
What do you think?

» Using the short-term and low value leases exemptions Entity avoids including material RoU assets and lease liabilities in its 2024 statement of financial position.

» **Does Entity's use of the short-term and low value asset exemptions likely contravene IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example 2A: short-term and low value leases exemptions
What do you think?

» Using the short-term and low value leases exemptions Entity avoids including material RoU assets and lease liabilities in its 2024 statement of financial position.

» **Would your answer to the question above be different if Entity did not disclose in its lease accounting policy its use of the short-term and low value leases exemptions?** Choose one of: 1) Yes; or 2) No.

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Example 3: low value leases exemption
What do you think?

» Entity uses the low value item exemption with regard to its leases (as lessee) of a machine that is near the end of its economic life.

» At the commencement of the lease the fair value of the machine is $4,000.

» When new, the fair value of the machine is $100,000.

» **Does Entity's use of the low value asset exemption likely comply with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example 4: low value leases exemption
What do you think?

» Entity accounting policy for use of the **low value leases exemption** is specified as on a lease-by-lease basis.

» **Does Entity's use of the low value leases exemption likely comply with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example 5: short-term leases exemption
What do you think?

» Entity accounting policy for use of the **short-term leases exemption** is specified as on a lease-by-lease basis .

» **Does Entity's use of the short-term leases exemption likely comply with IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

Example 6: lease recognition
What do you think?

» North Macedonia's biggest and most profitable company (A) enters into a lease for the first (and only) time in 2024.

» Lease terms:

  » A acquires the **right of use of a photocopier** for three years and, at the end of the lease term, legal ownership of the machine automatically passes to A.

  » **Obliges** A to make, to the lessor, equal monthly cash payments.

    » The present value of the 36 payments = $10,000 = cash cost of the machine at the inception of the lease.

Example 6: lease recognition
What do you think?

» **Accounting:** A does not recognise the lease in its statement of financial position. Instead, it recognises lease payments as an expense of the period in which they are paid in accordance with the lease agreement.

» **Does A's expensing of the lease payments when they are paid likely contravene IFRS Accounting Standards?** Choose one of: 1) Yes; or 2) No.

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Example 6A: lease recognition
What do you think?

» **Accounting:** A does not recognise the lease in its statement of financial position. Instead, it recognises lease payments as an expense of the period in which they are paid in accordance with the lease agreement.

» **Would you answer change if recognising the right of use asset and lease liability would have resulted in A breaching a loan covenant at 31/12/2024?** Choose one of: 1) Yes; or 2) No.

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Measurement

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Lease: lessee perspective overview of measurement requirements

MEASUREMENT AT INITIAL RECOGNITION	SUBSEQUENT
Present value of future lease payments during the lease term, including: • variable lease payments that depend on an index or a rate for the lessee; • Exercise price of 'reasonably certain' bargain purchase options and lease renewal options; and • guaranteed residual value provided by the lessee. **Discount rate** = interest rate implicit in the lease (IRIL). If cannot determine IRIL discount using the lessee's incremental borrowing rate. **However:** **must exclude** variable lease payments linked to future performance or use of the underlying asset.	**Asset:** models in other IFRSs. For example, PPE's cost and revaluation models. **Liability:** amortised cost using the interest rate implicit in the lease.

Source: IFRS 16.23-38

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Better practice example: discount rates

"The discount rate used to calculate the lease liability is the rate implicit in the lease, if it can be readily determined, or the lessee's incremental borrowing rate if not. Management uses the **rate implicit in the lease where the lessor is a related party** (such as leases from joint ventures) and the lessee's incremental borrowing rate for all other leases. Incremental borrowing rates are determined monthly and depend on the term, country, currency and start date of the lease. **The incremental borrowing rate is determined based on a series of inputs including: the risk-free rate based on government bond rates; a country-specific risk adjustment; a credit risk adjustment based on Tesco bond yields; and an entity-specific adjustment where the entity risk profile is different to that of the Group**."

Tesco PLC, Annual Report and Financial Statements 2020, p89

Source: FRC, *IFRS 16 Thematic Review (2020)*, p5 (**emphasis** added)

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IASB's road to 'reasonably certain' threshold for lease renewal options

1. **Rejected:** componentisation principle (ie bifurcate the lease option from the underlying lease)
2. **Rejected:** non-recognition rule (ie disclosure only approach that otherwise ignores the lease option)
3. **Rejected:** recognition with probability weighted measurement principle (ie akin to fair value measurement)
4. **Rejected:** recognition trigger: qualitative assessment of the lease term notion
5. **Rejected:** recognition trigger: most likely lease term notion
6. **Rejected:** recognition trigger: economic incentive notion
7. **Specified:** **reasonably certain probability threshold notion**.

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Determining lease term
Regulatory observations

» "IFRS 16 requires companies to **determine the lease term**, taking account of the minimum enforceable period and options to terminate or extend it. **Judgement** is often involved in assessing the likelihood of renewing leases or remaining in premises with indefinite lease terms. This affects not only lease accounting – whether the short-term lease exemption is applicable, or how to quantify the lease liability – but also fixed asset accounting.

» We found **different approaches** to **accounting for leases beyond the end of their contractual term, where occupation continues**, including when the Landlord and Tenant Act 1954 applies. Preparers should be clear about the policy they have selected and consider whether this decision involves a significant judgement that should be disclosed.

  » Some companies treated such leases as short term, expensing the rental cost where they have taken the relevant exemption.

  » Others treated the tenancy as a term lease, on the same basis as the expired lease, where eventual renewal is considered reasonably certain. The **approach was not explained** by all companies, although not all had ongoing tenancies."

Source: FRC, *Annual Review of Corporate Reporting* 2023/24, p48 (**emphasis** added)

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Assessing the 'reasonably certain' threshold for lease renewal options and options to terminate a lease

» **When:** (i) lease commencement-date; and (ii) **reassessed when** significant event/s or circumstance/s within the lessee's control and affects whether the lessee is reasonably certain to:

  » exercise an option not previously included in its determination of the lease term; or

  » not to exercise an option previously included in its determination of the lease term.

» **Reassessment triggers** include **the occurrence of** anticipated (at commencement-date) significant improvements or modifications to the underlying asset, and leasehold improvements that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable.

Source: IFRS 16. 26-28 and B37-B41

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Overview of assessing the 'reasonably certain' threshold for lease renewal options and lease termination options

- **How:** consider all relevant facts and circumstances that create an **economic incentive** for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease, including:
  - contractual terms and conditions for the optional periods compared with market rates;
  - leasehold improvement economic considerations for exercising option to extend/terminate, and option to purchase at end of extension term;
  - termination related costs, like negotiation costs and relocation costs;
  - importance of that underlying asset to the lessee's operations and availability of alternative assets;
  - option-conditionality, and the likelihood that those conditions will exist.

Source: IFRS 16.B37-B41

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Example: significant judgement—reasonably certain (1)

"The Partnership has applied judgement to determine the lease term for those lease contracts that include a renewal or break option. ***The assessment of whether the Partnership is reasonably certain to exercise a renewal option or reasonably certain not to exercise a break option significantly impacts the value of lease liabilities and right-of-use assets recognised on the balance sheet.***

Extension options and break clauses are included in a number of the Partnership's leases. These are used to maximise flexibility in terms of managing the assets used in the Partnership's operations. In determining the lease term, management considers all facts and circumstances that create an economic incentive to exercise an extension option, or not utilise a break clause. Extension options (or periods after break clauses) are only included in the lease term if the lease is ***reasonably certain*** *to be extended (or break clause not utilised)."*

…

Source: FRC, *IFRS 16 Thematic Review (2020)*, p9 (***emphasis*** added)

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Example: significant judgement—reasonably certain (2)

*"For leases of branches, distribution centres, offices and vehicles, the following **factors are considered the most relevant**:*

- *If there are significant penalties to break leases (or not extend), the Partnership is typically reasonably certain to extend (or not to utilise the break clause);*
- *If any leasehold improvements are expected to have significant remaining value, the Partnership is typically reasonably certain to extend (or not utilise the break clause); and*
- *The Partnership considers other factors including the **likely value of future rentals**, the **importance of the underlying assets** to the Partnership's operations, whether the **asset is specialised** in nature and the **costs and business disruption** required to replace the leased asset."*

John Lewis Partnership plc, Annual Report and Accounts 2020, p126

Source: FRC, *IFRS 16 Thematic Review (2020)*, p9 (***emphasis*** added)

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Example: significant judgement—reasonably certain (3) What do you think?

- **Is John Lewis Partnership's disclosures about the judgements it made in determining when the 'reasonably certain' recognition threshold is met for lease renewal options (and break clauses) consistent with the requirements of IAS 1.122-124?** Choose one of: 1) Yes; or 2) No.

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Presentation

Lease: lessee perspective overview of presentation requirements

Financial position	Financial performance
Excluding investment property, present **RoU asset** in a separate line-item or disclose which line-item included in (e.g. PPE). **Lease liability** separate line-item or disclose which line-item included in.	Present interest expense on the lease liability as a component of finance costs, and separately from the depreciation charge for the right-of-use asset.

Statement of cash flows
Financing activities: payments for the principal portion of the lease liability. **Operating activities:** payments on short-term leases, low-value leases and variable lease payments not included in the measurement of the lease liability

Source: IFRS 16.47-50

Example 1: lessee's statement of cash flows
What do you think?

» **Which part of the cash flow statement must cash outflows from the lessee related to the repayment of the principal portion of lease liabilities be classified?**

» Choose one of:

1) Operating;
2) Investing;
3) Financing; or
4) It depends on the Lessee's accounting policy.

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Example 2: lessee's statement of cash flows
What do you think?

» 31/12/2024, Manufacturer commenced a lease (as lessee) for a new factory.

» No lease payments are made in 2024.

» Statement of Financial Position at 31/12/2024 reflects RoU asset and lease liability = $2 billion.

» **Which part of lessee's cash flow statement for 2024 is affected by the lease?** Choose one of: 1) Operating; 2) Investing; 3) Financing; 4) Note disclosure only (non-cash transactions); or 5) It depends on the Lessee's accounting policy.

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Example 3: lessee disclosure related materiality judgements
What do you think?

- At 31/12/2024 Entity's RoU assets > 10% of total assets.
- In 2024 Entity signed a new lease agreement related to the new office premises and sold the former headquarters. At 31/12/2024 the new lease agreement forms >90% of the recognised RoU assets.
- Because Entity consider the information immaterial, Entity's 2024 financial statements omitted:
  - information regarding the additions to RoU assets (IFRS 16.53(h)); and
  - the total cash outflow for leases (IFRS 16.53(g)).
- **Are the omitted disclosures likely material?** Choose one of: 1) Yes; or 2) No.

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Disclosure

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Disclosure
overview of the requirements

» **Disclosure objective:** enable primary users to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

» IFRS 16.52–60 specify requirements on how to meet this objective.

Source: IFRS 16.51-60

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Regulatory observation 1

'Top ten most frequent areas of FRC findings–and how to address them

9. Leases

All material aspects of leasing arrangements need to be covered by **entity-specific accounting policies. Judgements** about whether the arrangements **meet the definition of a lease** and **the length of a lease** should be disclosed.

Information in the notes, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, should **enable users to assess the effect of leases on the financial position, financial performance and cash flows.** This could include **information about variable payment features** in leases and disaggregated information about future cash flows."

Source: FRC (UK) *Annual Review of Corporate Reporting 2020/21*, p5 (**emphasis** added)

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Regulatory observation 2 (1)

"**Accounting policies** Many companies relied on **boilerplate language**, with insufficient entity-specific information, when explaining their accounting policy for leases. **Better examples** explained the policy using language specific to the company's circumstances. In some cases companies did not specify an accounting policy for apparently material items.

Judgements **Descriptions of judgements** made by management in the application of the company's accounting policy were **absent or inadequate.** For example, judgements made about the lease term or scope of the standard.

In several instances, **significant differences were identified from the IAS 17 'Leases' disclosure of lease commitments** with little or no explanation for these, even though some appeared to reflect potentially significant judgements."

Source: FRC, *IFRS 16 Thematic Review (2020)*, p3 (**emphasis** added)

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Regulatory observation 2 (2)

"**Disclosures** **Few companies** provided the broader disclosures required by paragraph 59 to help readers understand the exposure to future cash outflows from leases.

Such information includes the **nature of variable lease payments**, or the impact of **extension options not recognised** in the lease liability.

Explanations were not given even where the exercise of **extension options was identified as a significant judgement** made by management.

Most of the disclosures mandated by paragraph 53 of the standard, relating to amounts recognised for leases, were provided but these were often not in a single note or cross referenced, as is required by the standard."

Source: FRC, *IFRS 16 Thematic Review (2020)*, p3 (**emphasis** added)

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Regulatory observation 3

- "Accounting policies for determining the lease term in other circumstances tended to be **boilerplate**, without company-specific disclosure of factors affecting whether the company was **reasonably certain** to continue in occupation beyond the effective dates of renewal or termination options.
  - In some cases, it was unclear whether exercise of options was a **default assumption** or the disclosure **simply repeated wording from IFRS 16**.
  - Some companies also referred to remeasuring lease liabilities when relevant circumstances changed in the year, without indicating the extent of this (for example, a change affecting a significant number of properties) in the current or prior period.
- **Explicit and specific disclosure** of these factors, of how continuing tenancies are treated, and of any related significant judgements, would assist users' understanding of the company's position and aid comparability of accounting policies despite the differing circumstances."

Source: FRC, *Annual Review of Corporate Reporting 2023/24*, p48 (**emphasis** added)

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Greggs mini-case study

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (1)

"**Key estimates and judgements**

The leases typically run for a period of ten or 15 years. In England and Wales, the majority of the Group's property leases are protected by the Landlord and Tenant Act 1954 ('LTA') which affords protection to the lessee at the end of an existing lease term.

Judgement is required in respect of those property leases where the current lease term had expired but the Group had not yet renewed the lease. Where the Group believes **renewal to be reasonably certain** and the lease is protected by the LTA it will be treated as having been renewed at the date of termination of the previous lease term and on the same terms as the previous lease. Where **renewal is not considered to be reasonably certain** the leases are included with a lease term which reflects the anticipated notice period under relevant legislation. The lease will be revalued when it is renewed to take account of the new terms. As at 1 January 2022 the financial effect of applying this judgement was an increase in recognised lease liabilities of £41.7 million (2020: £31.9 million).

In addition, where a **shop is refurbished within two years of the contractual lease end date and the Group therefore expects to renew the lease**, the lease liability is revised to reflect an additional lease term. The impact of this judgement as at 1 January 2022 is an additional lease liability of £7.7 million."

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (2)

"Significant accounting policies

(g) Leases

(i) Lease recognition

At inception of a contract the Group assesses whether a contract is or contains a lease. A contract is, or contains, a lease if the contract conveys a right to control the use of an identified asset for a period of time in exchange for consideration. To assess whether a contract conveys the right to control the use of an identified asset, the Group uses the definition of a lease in IFRS 16. For leases of properties in which the Group is a lessee, it has applied the practical expedient permitted by IFRS 16 and will **account for each lease component and any associated non-lease components as a single lease component.**" …

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (3)

"Significant accounting policies

(g) Leases

(ii) Right-of-use assets

The Group recognises right-of-use assets at the commencement date of the lease. Right-of-use assets are measured at **cost, less accumulated depreciation and impairment losses** and adjusted for any remeasurement of lease liabilities. The cost of right-of-use assets includes the amount of lease liabilities recognised, adjusted for any lease payments made at or before the commencement date, less any lease incentives received. Right-of-use assets are **depreciated** over the shorter of the asset's useful life or the lease term on a **straight-line basis**. Right-of-use assets are subject to, and reviewed regularly for, impairment. Depreciation on right-of-use assets is included in selling and distribution costs in the income statement." …

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (4)

"Significant accounting policies

(g) Leases

(iii) Lease liabilities

At the commencement date of the lease, the Group recognises lease liabilities measured at the present value of the lease payments to be made over the lease term. Lease payments include fixed payments less any lease incentives receivable and variable lease payments that depend on an index or rate. Any **variable lease payments that do not depend on an index or rate are recognised as an expense in the period in which the event or condition that triggers the payment occurs**.

In calculating the present value of lease payments, the **Group uses its incremental borrowing rate at the lease commencement date** if the interest rate implicit in the lease is not readily determinable. Generally the Group uses its incremental borrowing rate as the discount rate. When there are no external borrowings, judgement would be required to determine an approximation, **calculated based on UK Government gilt rates of an appropriate duration and adjusted by an indicative credit premium**.

After the commencement date, the lease liability is increased to reflect the accretion of interest and reduced for lease payments made. In addition, the carrying amount of lease liabilities is remeasured if there is a modification, a change in the lease term or a change in the fixed lease payments. The remeasured lease liability (and corresponding right-of-use asset) is calculated using a revised discount rate, based upon a revised incremental borrowing rate at the time of the change. Interest charges are included in finance costs in the income statement.

." …

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (5)

"Significant accounting policies

(g) Leases

(iv) Short-term leases and leases of low-value assets

The Group has elected not to recognise right-of-use assets and lease liabilities for short-term leases of machinery and equipment that have a lease term of less than 12 months and leases of low-value assets. Lease payments relating to short-term leases and leases of low-value assets are recognised as an expense on a straight-line basis over the lease term.

(v) Variable lease payments

Some property leases contain variable payment terms that are linked to sales generated from a shop. For individual shops, up to 100% of lease payments are on the basis of variable payment terms. These payments are recognised in the income statement in the period in which the condition that triggers them occurs. Under existing lease arrangements, where variable payment terms exist, the expected future cash outflow on an annual basis is expected to be immaterial." …

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (6)

11. Leases

Amounts recognised in the balance sheets

The balance sheets show the following amounts relating to leases:

Group and Parent Company

	2021 £m	2020 £m
Right-of-use assets		
Land and buildings	**260.4**	267.8
Plant and equipment	**3.2**	2.3
	263.6	270.1

	2021 £m	2020 £m
Lease liabilities		
Current	**49.3**	48.6
Non-current	**233.9**	243.1
	283.2	291.7

The remaining maturities of the lease liabilities, which are gross and undiscounted, are as follows:

	2021 £m	2020 £m
Less than one year	**53.0**	54.4
One to two years	**47.1**	49.3
Two to three years	**43.1**	43.6
Three to four years	**38.3**	39.2
Four to five years	**31.0**	34.1
More than five years	**92.6**	94.9
Total undiscounted lease liability	**305.1**	315.5

Additions to right-of-use assets during the 52 weeks ended 1 January 2022 as a result of entering into new leases (either as a result of acquiring new shops or completing a lease renewal for an existing shop) were £49.6 million (2020: 26.2 million).

A further net decrease of £9.1 million to right-of-use assets has also been recognised during the 52 weeks ended 1 January 2022 as a result of lease modifications and assumptions relating to lease term once a lease has become expired (2020: increase of £31.9 million).

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Extracts from the notes in Greggs plc's 2021 Annual Financial Statements, p128, p130, p131, p146 and p147 (7)

Amounts recognised in the income statement

	2021 £m	2020 £m
Depreciation charge on right-of-use assets		
Land and buildings	**47.7**	50.2
Plant and equipment	**1.0**	1.7
	48.7	51.9
Impairment (reversal)/charge	**(1.6)**	8.8
Interest expense (included in finance cost)	**6.3**	6.5
Expense included for short-term leases (included in cost of sales and administrative expenses)	**0.1**	0.2
Expense related to leases of low-value assets that are not shown above as short-term leases (included in administrative expenses)	**0.1**	0.2
Expense related to variable lease payments not included in lease liabilities (included in distribution and selling costs)	**2.1**	0.6

The impairment (reversal)/charge is (credited)/charged to distribution and selling costs in the income statement and arises due to changes in the trading performance of the shops.

The total cash outflow for leases in 2021 was £55.3 million (2020: £48.6 million).

The components of the movement in the total lease liability were as follows:

	2021 £m
Opening total liability	**291.7**
Additions in respect of new leases	**49.6**
Lease modifications	**(9.1)**
Interest on lease liabilities	**6.3**
Rental payments	**(55.3)**
Closing total liability	**283.2**

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Greggs mini-case study
What do you think? (Question 1A)

Are all short-term leases that Greggs plc is subject to (as lessee) on its consolidated balance sheet at 1 January 2022? Choose one of: (a) Yes; or (b) No.

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Greggs mini-case study
What do you think? (Question 1B)

Are all leases of low-value assets that Greggs plc is subject to (as lessee) on its consolidated balance sheet at 1 January 2022? Choose one of: (a) Yes; or (b) No.

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Greggs mini-case study
What do you think? (Question 1C)

Are some variable lease payments in the form of lease renewal options that Greggs plc is subject to (as lessee) likely off-balance sheet? Choose one of: (a) Yes; or (b) No.

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Greggs mini-case study
What do you think? (Question 1D)

Are some variable lease payments that are linked to sales generated from a shop that Greggs plc is subject to (as lessee) likely off-balance sheet? Choose one of: (a) Yes; or (b) No.

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Greggs mini-case study
What do you think? (Question 1E)

Are all leases that Greggs plc is subject to (as lessee) at 1 January 2022 on its consolidated balance sheet at 1 January 2022? Choose one of:

(a) No, short-term leases are likely off-balance sheet;

(b) No, leases of low-value assets are likely off-balance sheet;

(c) No, some variable lease payments in the form of lease renewal options are likely off-balance sheet;

(d) No, variable lease payments that are linked to sales generated from a shop are likely off-balance sheet; or

(e) No, because all of (a)-(d) above.

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Greggs mini-case study
What do you think? (Question 2)

Which asset/liability recognition threshold applies to Greggs plc's variable lease payments in the form of lease renewal options (as lessee)? Choose one of:

(a) >0% probability that Greggs plc will renew the lease;

(b) more likely than not (ie >50% probability that Greggs plc will renew the lease);

(c) highly likely (ie significant more likely than >50% probability that Greggs plc will renew the lease);

(d) reasonably certain that Greggs plc will renew the lease; or

(e) certain that Greggs plc will renew the lease (ie when the lease is renewed).

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Greggs mini-case study
What do you think? (Question 3)

Which liability recognition threshold applies to Greggs plc's variable lease payments in the form of variable lease payment terms that are linked to sales generated from a shop (as lessee)? Choose one of:

(a) >0% probability that Greggs plc will make the lease payment;

(b) more likely than not (ie >50% probability that Greggs plc will make the lease payment);

(c) highly likely (ie significant more likely than >50% probability that Greggs plc will make the lease payment);

(d) reasonably certain that Greggs plc will make the lease payment; or

(e) certain that Greggs plc will make the lease payment (ie when the condition that triggers the obligation to make the payment is fulfilled).

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Greggs mini-case study
What do you think? (Question 4)

Which IFRS measurement model/s is/are available to Greggs plc to account for its recognised (ie on-balance sheet) right of use assets held under lease agreements? Choose one of:

(a) Cost model;

(b) Fair value model;

(c) Revaluation model;

(d) Cost model or fair value model (depending on its accounting policy); or

(e) Cost model or revaluation model (depending on its accounting policy).

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Greggs mini-case study
What do you think? (Question 5)

Which depreciation method likely best reflects how Greggs plc consumes the service potential of its recognised (ie on-balance sheet) right of use assets held under lease agreements? Choose one of:

(a) None (because the rights are indefinite and consequently are neither consumed through use nor over time);

(b) Reducing balance method;

(c) Straight-line method;

(d) Units of production method on the basis of distance travelled; or

(e) Double declining method.

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Greggs mini-case study
What do you think? (Question 6)

Which IFRS Accounting Standard specifies how to perform impairment testing of Greggs plc's recognised (ie on-balance sheet) right of use assets held under lease agreements? Choose one of:

(a) IAS 2 *Inventories* (ie impair to net realisable value model);

(b) IAS 36 *Impairment of Assets* (ie recoverable amount model—higher of: (i) fair value less costs to dispose; and (ii) value in use)*;*

(c) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (ie onerous contract model)*;*

(d) IFRS 9 *Financial Instruments* (ie expected credit loss model); or

(e) IFRS 16 *Leases* (ie derecognition model).

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Greggs mini-case study
What do you think? (Question 7)

Which IFRS Accounting Standard specifies accounting (ie recognition and measurement) for Greggs plc's unrecognised (ie off-balance sheet) lease agreements (in which Greggs is the lessee) that are not onerous contracts? Choose one of:

(a) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;*

(b) IFRS 9 *Financial Instruments*;

(c) IFRS 15 *Revenue from Contracts with Customers;*

(d) IFRS 16 *Leases*; or

(e) IFRS 16 and IAS 37.

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Greggs mini-case study
What do you think? (Question 8)

Which IFRS Accounting Standard specifies accounting (ie recognition and measurement) for Greggs plc's unrecognised (ie off-balance sheet) lease agreements (in which Greggs is the lessee) that are onerous contracts? Choose one of:

(a) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;*

(b) IFRS 9 *Financial Instruments*;

(c) IFRS 15 *Revenue from Contracts with Customers;*

(d) IFRS 16 *Leases*; or

(e) IFRS 16 and IAS 37.

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Lessors applying IFRS 16

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IFRS 16's Lessor accounting

- **The economics**: A lease is an agreement whereby the lessor conveys to the lessee in return for payment or a series of payments the right to use an asset for an agreed period of time.
- **Notion:** Lessor differentiates **operating leases** from **finance leases**.
  - **Finance lease: transfers substantially all the risks and rewards of ownership of the leased item from the lessor**.
- **Finance lease accounting principle:** Lessor derecognises the leased item and recognises a finance lease receivable (asset) on its statement of financial position.
- **Operating lease rule:** Lessor does not derecognise the leased item and does not recognise a receivable asset on its statement of financial position.

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Lessor classifying leases:
finance lease or operating lease?

- Situations that individually or in combination normally indicate a finance lease:
  - lease transfers ownership of the asset to lessee
  - from inception lessee reasonably certain to exercise bargain purchase option
  - lease term is for the major part of asset's economic life
  - at inception PV of MLPs = substantially all asset's fair value
  - specialised asset (only lessee can use without major modifications)

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Lessor classifying leases: finance lease or operating lease?

» Situations that individually or in combination could indicate a finance lease
  - » lessee can cancel the lease but compensates the lessor's for associated losses
  - » gains or losses from the fluctuation in the residual value of the leased asset accrue to the lessee
  - » lessee can continue the lease for a secondary period at a rent that is substantially lower than market rent

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Lessor accounting selected judgements

Lessor accounting: selected judgements

- Classification:
  - determining whether some arrangements contain a lease
  - determining whether some leases are a finance lease or an operating lease
  - determining whether some finance leases are material (if entity seeks to account for 'immaterial' finance leases as operating leases)
- Measurement: measuring the fair value of some leased asset

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Lessor: mini-case studies

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Lessor accounting
What do you think?

» Group consists of Parent, Subsidiary A and Subsidiary B .

» In its financial statements, Subsidiary A classifies a factory building it leases to Subsidiary B as investment property measured at fair value under IAS 40 *Investment Property*;

» **Which IFRS Accounting Standard does Group apply to the factory in its consolidated financial statements?** Choose one of: 1) IAS 16 Property, Plant and Equipment; 2) IAS 40 Investment Property; 3) IFRS 16 Leases; or 4) IAS 38 Intangible Assets; 5) It depends on Group's accounting policy.

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Regulatory mini-case study 1

"Matter 1 Lessor accounting for covid-19 lease concessions (2021 focus area)

In its first set of interims published after the covid-19 outbreak, a property entity included the following, limited commentary, when referring to tenant relief measures: "Negotiations with tenants on covid-19 related arrears are ongoing". This limited disclosure triggered a series of enquiries which unravelled to expose a recognition error.

At their interim reporting date, **no rent concessions had been granted** by the issuer **and no tenant contracts had been terminated.** Given what **the issuer regarded as significant uncertainty regarding the collectability of rent during the hard lockdown, rental income for this period was recognised only to the extent it was probable that it would be received.** This resulted in a significant portion of 'unrecognised rental income' not being recorded in the 2020 interims. During our enquiry process the issuer explained that they intended to recognise at least 25% of this amount in their AFS as the probability of collection had subsequently increased. Their view was that IFRS 16 *Leases* does not contain a collectability threshold for the recognition of lease income, and **they therefore developed a new accounting policy based on IFRS 15 *Revenue from Contracts with Customers*."**

Source: Combined findings of the JSE proactive monitoring of financial statements (27 October 2023), p84-85 (**emphasis** added)

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Regulatory mini-case study 1
What do you think? (Question 1)

Which IFRS Accounting Standard specifies accounting for a lessor's operating leases with its tenants? Choose one of:

(a)IFRS 9 *Financial Instruments*;

(b)IFRS 15 *Revenue from Contracts with Customers;*

(c)IFRS 16 *Leases*;

(d)IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;* or

(e)IAS 40 *Investment Property*.

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Regulatory mini-case study 1
What do you think? (Question 2)

What income recognition does IFRS Accounting Standards specify for a lessor's operating leases with its tenants? Choose one of:

(a) recognise lease payments as income on either a straight-line basis or another systematic basis;

(b) recognise lease payments that are more likely than not to be received as income on either a straight-line basis or another systematic basis;

(c) recognise lease payments that are highly probable to be received as income on either a straight-line basis or another systematic basis;

(d) recognise lease payments that are reasonably certain to be received as income on either a straight-line basis or another systematic basis; or

(e) recognise lease payments as income when they are received.

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Regulatory mini-case study 1
What do you think? (Question 3)

Which IFRS Accounting Standard specifies impairment requirements for a lessor's recognised operating lease receivables? Choose one of:

(a) IFRS 9 *Financial Instruments*;

(b) IFRS 15 *Revenue from Contracts with Customers;*

(c) IFRS 16 *Leases*;

(d) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;* or

(e) IAS 40 *Investment Property*.

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Regulatory mini-case study 1
What do you think? (Question 4)

Was the issuer justified in using the IAS 8 hierarchy to develop and apply its accounting policy for operating lease rentals? Choose one of:

(a) Yes; or

(b) No.

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Regulatory mini-case study 1
What do you think? (Question 5)

Which IFRS Accounting Standard specifies disclosures for a lessor's operating leases with its tenants? Choose one of:

(a)IFRS 9 *Financial Instruments*;

(b)IFRS 15 *Revenue from Contracts with Customers;*

(c)IFRS 16 *Leases*;

(d)IAS 37 *Provisions, Contingent Liabilities and Contingent Assets;* or

(e)IAS 40 *Investment Property*.

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Regulatory observation
Better practice example

"Pendragon PLC, 2017 Annual Report, page 80

Judgements The Group applies judgement in how it applies its accounting policies, which do not involve estimation, but could materially affect the numbers disclosed in these financial statements. The key accounting judgements, without estimation, that have been applied in these financial statements are as follows:

Contract hire vehicles: …

Source: FRC, *Corporate Reporting Thematic Review: Reporting by Smaller Listed and AIM Quoted Companies (2018)*, p31

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Regulatory observation
Better practice example

Source: FRC, *Corporate Reporting Thematic Review: Reporting by Smaller Listed and AIM Quoted Companies (2018)*, p31

Key judgements	Effect on Financial Statements	Alternative accounting judgement that could have been applied	Effect of that alternative accounting judgement
The Group leases vehicles to third party customers under undisclosed agency agreements. In legal terms, the Group has disposed of vehicles to third party banks, leases those vehicles as undisclosed agent of the bank to third party customers and agrees to repurchase those vehicles from the bank at the end of the lease term. The Group has determined that it has retained substantially all of the significant risks and rewards of ownership so recognises in full the related assets and liabilities.	Sale of vehicle to third party bank derecognised; recognition of contract hire vehicles within fixed assets – carrying value £153.7m; recognition of contract hire buyback commitments within trade and other payables of £79.5m and £74.9m within deferred income. Profit on disposal to third party bank deferred over term of lease.	If the Group had determined that substantially all of the significant risks and rewards of ownership had been transferred then there would have been full recognition of the sale of the asset.	No recognition of asset or related liabilities and no deferral of income.

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Appendix: Regulatory updates

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Q&A session

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