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INSIDE THIS ISSUE

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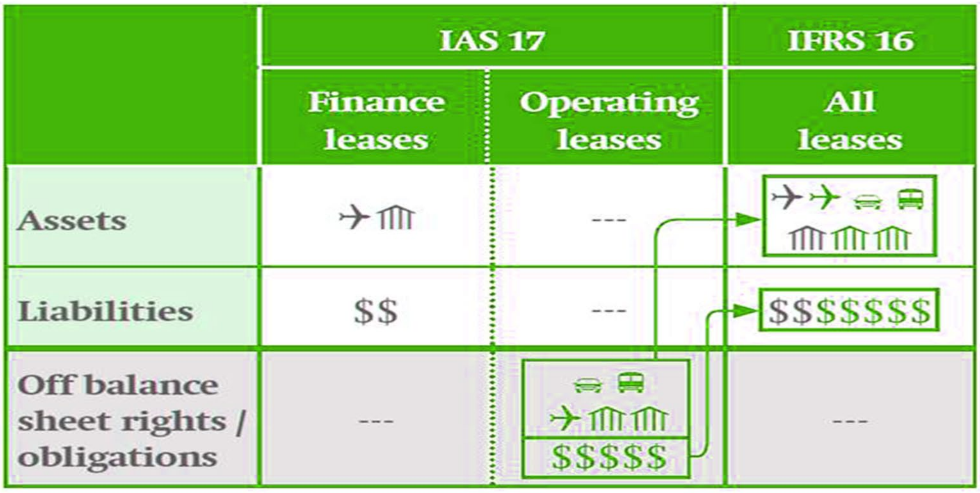
EDITORIAL NOTE

In 2016, the International Accounting Standards Board issued the IFRS 16- Leases as a replacement of IAS 17. The standard introduces a change to the definition and accounting of leases. Subject to early adoptions permitted in certain cases, the Standard became effective for reporting periods beginning on or after 1 January 2019. The importance and implications of the new standard are summarised to guide members in complying with the requirements.

IFRS 16: LEASES



Preamble

In January 2016, the IASB issued new guidance on the treatment of leases. The new standard IFRS 16 'Leases' replaces 'IAS 17' and takes effect from 1 January 2019. With the introduction of this standard, lessees will now experience significant changes in the treatment of leases it enters into. This standard did not significantly affect the treatment of leases by lessors.

INTRODUCTION

While IAS 17 required lessees to differentiate finance from operating leases, IFRS 16 does not. Instead, it requires lessees to recognise a lease liability which represents the present value of the outstanding lease payments and a 'right-of-use assets' for almost all lease arrangements. IFRS 16 also gives allowance for lessees to apply an optional exemption for short term leases and low-value assets.

IFRS 16 gives new guidelines on the definition of a lease. The accounting treatment of leases will also be significantly impacted by the combination and separation of contracts. At a minimum, the new model for leases is expected to influence contract negotiations between lessors and lessees. We have already seen a number of these contracts renegotiated! Under IFRS 16, 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.

IMPACT

The financial statements of most lessees will be most impacted by IFRS 16. This includes:

Statement of financial position

Lessees will now recognise a right-of-use asset and a lease liability on its statement of financial position. As such, financial ratios such as debt/equity ratios, EBITDA (earnings before interest, tax, depreciation and amortisation), will be impacted by the new standard. This impact will vary based on industries and the number of operating lease arrangements an entity has. This is because of the lease liability (debt) that will be introduced on the balance sheet.

Statement of comprehensive income

Lessees will recognise interest expense on the lease liability and depreciation on the right-of-use asset in the statement of comprehensive income. In the earlier period of the lease term, companies will record a higher depreciation and interest expense charge than at the later periods of the lease term.

Statement of cash flows

Operating cashflows relating to operating leases will no longer be fully represented as operating cashflows in the cashflow statement, rather, the portion that reflects interest expense on the lease liability will be presented as operating cashflows (depending on the entity's policy choice on presenting interest expense within operating and financing activities). Cash payments for the principal portion of the lease liability will be presented within financing activities. Payments for leases not included in the lease liability (such as short-term leases, leases of low-value assets and variable lease not dependent on index) will be presented within operating activities.

TRANSITION

The new standard is mandatory for annual reporting periods beginning on or after 1 January 2019. Entities can adopt either a "simplified approach' or a full retrospective approach on transition. The simplified approach provides some relief as it does not require a restatement of comparatives. In addition, entities can adopt the practical expedient to 'grand-father' their lease contracts by not reassessing whether the contract is, or contains, a lease on initial application.

INSIGHT:
Start Preparing Now

It is pertinent that entities implement systems and processes to identify all lease contracts, accurately gather the information required by IFRS 16, and prepare appropriate disclosures for financial reporting.

IFRS 16 substantially retains the lessor accounting requirements in IAS 17. Accordingly, a lessor will continue to recognise and classify its leases as operating leases or finance leases.

Financial ratios and performance metrics:

Companies with significant off-balance sheet lease commitments may encounter material changes in their key financial ratios and performance measures like asset turnover, interest cover, leverage, current ratio, operating cash flows amongst others. Nonetheless, some performance metrics such as EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation), EBIT would increase, with no corresponding changes in cash flow.

The impact on financial ratios (such as gearing) may trigger breaches of loan covenants unless an entity makes a 'frozen GAAP' provision in its financing arrangements. A frozen GAAP clause allows an entity to calculate financial covenants at a pre-transition date or as they are at the date of debt agreement without effecting changes in the accounting standards.

An increase in interest expenses may also trigger interest based covenants such as interest cover. Furthermore, these changes may affect credit ratings and possibly stakeholders' perception of entities. Financial institutions should consider the impacts on regulatory capital requirements, as the new leases standard might increase the assets in the denominator of risk-based capital ratios (risk-weighted assets) and leverage capital ratio (adjusted asset).

Lastly, entities need to consider the effect of these changes to remuneration packages that are linked to financial ratios, as these redefined performance metrics will affect many existing arrangements and stakeholders.

Tax considerations

Nigerian tax legislation is lagging when compared to the rate at which changes are being made to accounting frameworks. For instance, the Companies Income Tax Act (CITA) which regulates the taxation of companies in Nigeria (other than those involved in 'upstream petroleum operations) was last amended in 2007! Hence, the introduction of IFRS 16 throws up some tax concerns, particularly for the lessees.

Although IFRS 16 requires the recognition of right-of-use (ROU) on leased assets, the Standard will have very minimal tax impact for the lessor who has always treated leases as balance sheet items. However, the lessee who is now required to capitalize operating leases will be concerned about issues such as the appropriateness or otherwise of the claim of capital allowance on ROU, tax deductibility of recognized depreciation and interest cost, the withholding tax (WHT) and value-added tax (VAT) implications of the actual lease payments.

It is not clear cut who is entitled to claim capital allowances on the leased asset since both the lessor and the lessee are required to capitalize such asset. Previously, the lessor claims capital allowance at the prescribed rate on assets on operating lease while the lessee claims capital allowance on assets on finance lease. Also, based on extant provisions of the CITA, depreciation expense is not an allowable expense. Given that the substance of an operating lease remains constant regardless of the recognition of an ROU, it is arguable whether depreciation costs (and interest expense) which are recognized in place of lease rentals should be allowable for tax purpose. It will amount to double jeopardy where the lessee is unable to take the deduction and yet unable to claim capital allowance on the ROU. A practical solution in this instance is for the lessee to take the actual lease payment in each year as tax-deductible. Further, interest recognized in the books in any year may be different from actual interest paid. The matter arising will be a determination of the appropriate amount on which to compute WHT for any relevant year.

VAT is another area of concern given the Federal Inland Revenue Service's (FIRS) request for companies to account for VAT on additions to fixed assets. Since lessees may now have to capitalize the present value of future unavoidable payments as opposed to actual payments, it will be wrong to compute VAT on any ROU capitalized in the balance sheet. Taxpayers will, therefore, need to maintain proper documentation.

	IAS 17		IFRS 16
	Finance leases	Operating leases	All leases
Revenue	x	x	x
Operating costs (excluding depreciation and amortisation)	---	Single expense	---
EBITDA			⇧⇧
Depreciation and amortisation	*Depreciation*	---	*Depreciation*
Operating profit			⇧
Finance costs	*Interest*	---	*Interest*
Profit before tax			⇔

Therefore, pending the amendment of tax legislation to align with the IFRSs, or the issuance of clarification circular by the tax authority on the treatment of the assets recognized as ROU, taxpayers will continue to evaluate the substance of each lease transaction to guide the appropriate tax treatments under each circumstance.

Implementation and future outlook

Entities should evaluate the likely implications of IFRS 16 at an early stage, make an inventory of relevant contracts and develop a strategy to manage stakeholders' perception. Terms of contracts should be reviewed to ensure that they meet intended operational and financial goals.

Lastly, organisational functions like information technology, treasury, and investor relations should be informed about the new requirements.