IFRS 16 Leases

A Comprehensive Guide for CTA, PGDA & ITC Students

Prepared for postgraduate accounting students

South Africa

IFRS STUDY GUIDES

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IFRS 16 Leases - Part 1: Scope & Key Definitions

Introduction: The Economic Substance of a Lease

Before we dive into the mechanics, let's understand WHY IFRS 16 exists.

Under the old IAS 17, companies could structure leases as "operating leases" to keep massive liabilities off their balance sheets. An airline could fly 200 aircraft and show virtually no aircraft assets or lease liabilities on its balance sheet. This was a form of "off-balance sheet financing" that obscured the true financial position of entities.

IFRS 16 changed everything for lessees by requiring virtually ALL leases to be recognized on the balance sheet. The principle is simple: if you have the right to use an asset, you have an asset. If you have an obligation to pay for that right, you have a liability.

What is a Lease?

The Definition

> *A lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. (IFRS 16.9)*

This definition has three critical elements:
1. A contract (or part of a contract)
2. Right to use an asset for a period of time
3. In exchange for consideration

The Key Question: Is There a Lease?

At contract inception, an entity must assess whether the contract IS, or CONTAINS, a lease. This is crucial because many contracts bundle services with the use of assets.

The Two-Condition Test (IFRS 16.B9)

A contract contains a lease if BOTH conditions are met:

Condition	Question to Ask

1. Identified Asset	Is there a specific asset that the contract relate
2. Right to Control	Does the customer have the right to control the us

Let's break these down.

Condition 1: Identified Asset

What Makes an Asset "Identified"?

An asset is typically identified by being:
- Explicitly specified in the contract (e.g., "Vehicle with registration ABC 123"), OR
- Implicitly specified when it's the only asset that can satisfy the contract

The Substitution Right Trap

> *Critical exam point: A supplier's substitution right can negate an identified asset.*

An asset is NOT identified if the supplier has the substantive right to substitute the asset throughout the period of use.

A substitution right is substantive if BOTH conditions are met:
1. The supplier has the practical ability to substitute alternative assets
2. The supplier would benefit economically from substitution

Example: Is There an Identified Asset?

Scenario 1: Fibre Optic Cables
Company A contracts for data transmission capacity using a specified fibre optic cable from Point X to Point Y. The supplier cannot substitute without Company A's permission.
- Result: Identified asset [OK] (specific cable, no substitution right)

Scenario 2: Cloud Storage
Company B contracts for 500GB of storage capacity. The supplier can move the data between any of its 50 data centres at any time.
- Result: No identified asset [X] (supplier can substitute freely)

Scenario 3: Aircraft
Airline X leases a specific Boeing 737 (tail number ZS-ABC). The lessor can only substitute if the aircraft needs maintenance.
- Result: Identified asset [OK] (substitution only for maintenance is a protective right, not a substantive right)

Portions of Assets

Can you lease part of an asset? Yes, IF that portion is physically distinct (e.g., one floor of a building, one wing of a warehouse).

A capacity portion that is not physically distinct (e.g., 50% of a pipeline's capacity) is generally NOT capable of being an identified asset.

Condition 2: Right to Control the Use

Having an identified asset is not enough. The customer must also have the right to control the use of that asset.

The Control Test (IFRS 16.B24)

A customer has the right to control the use if it has BOTH:

Element	Description
Right to obtain substantially all economic benefit	The customer gets substantially all the outputs, b
Right to direct the use	The customer can decide HOW and FOR WHAT PURPOSE t

Right to Direct the Use - Deep Dive

The right to direct the use exists if the customer can direct:
- How the asset is operated, OR
- What the asset is used for

Pre-Determined Use
Sometimes, HOW and FOR WHAT PURPOSE is pre-determined by the contract. In this case, ask:
- Does the customer operate the asset (or direct others to operate it) without the supplier having the right to change instructions? OR
- Did the customer design the asset in a way that predetermines how and for what purpose it will be used?

What Rights Don't Count?

The following are NOT decision-making rights that convey control:
- Protective rights (e.g., "you may not use the vehicle off-road")
- Rights that protect the supplier's interest in the asset

Example: Who Has Control?

Scenario: Dedicated Truck
Retailer contracts with a logistics company for exclusive use of a specific truck. The truck is branded with the retailer's logo. However, the logistics company:
- Determines which driver operates the truck
- Decides the routes and scheduling
- Maintains the vehicle

Analysis:
- Identified asset? [OK] (specific truck)
- Economic benefits? [OK] (retailer gets substantially all transport output)
- Right to direct use? [X] (logistics company decides how the truck is used)

Result: This is a SERVICE contract, NOT a lease. The retailer is paying for deliveries, not for the right to use a truck.

Separating Lease and Non-Lease Components

The Reality: Contracts Often Bundle Everything

A lease contract frequently includes:
- Lease component: The right to use the underlying asset
- Non-lease components: Services (maintenance, cleaning, security)

Lessee Accounting Choice

IFRS 16 gives lessees a practical choice:

Option A: Separate Components
- Allocate contract consideration to each component based on relative stand-alone prices
- Account for lease component under IFRS 16
- Account for service component under other standards (e.g., as an expense)

Option B: Practical Expedient
- Elect NOT to separate components
- Account for entire contract as a single lease
- This is a class-by-class election (e.g., all building leases, all vehicle leases)

> *Exam insight: Option B is simpler but results in HIGHER lease liabilities and ROU assets. Watch for questions testing whether you understand this trade-off.*

Example: Vehicle Lease with Maintenance

Company leases a vehicle. Monthly payment: R10,000
- Market rent for vehicle: R8,000/month
- Market price for maintenance: R2,500/month

If separating components:
Allocation based on relative stand-alone prices:
- Vehicle (lease): R10,000 x (8,000 / 10,500) = R7,619
- Maintenance (service): R10,000 x (2,500 / 10,500) = R2,381

If NOT separating:
- Entire R10,000 treated as lease payment

Scope Exclusions and Recognition Exemptions

What's Completely OUT of IFRS 16 Scope?

Excluded Item	Why?
Leases of intangible assets	Covered by IAS 38
Leases to explore for minerals, oil, gas, etc.	Covered by IFRS 6
Leases of biological assets (lessees)	Covered by IAS 41
Service concession arrangements	Covered by IFRIC 12

Recognition Exemptions (Lessee Only)

Even if a contract IS a lease, a lessee may ELECT not to apply the full IFRS 16 recognition model to:

1. Short-Term Leases
- Lease term of 12 months or less at commencement
- No purchase option
- Elect on a class-by-class basis
- Expense lease payments on straight-line basis (or other systematic basis)

2. Low-Value Assets
- Underlying asset has low value when NEW (guidance: ~USD 5,000 or less)
- Examples: tablets, small office furniture, laptops
- Elect on a lease-by-lease basis
- Expense lease payments on straight-line basis

Common pitfall: Students often forget that low-value is assessed when the asset is NEW, not its current value. A R2,000 second-hand car that cost R200,000 new is NOT a low-value asset.

Right-of-use assets that meet the low-value threshold must also be assessed for characteristics. Cars, for example, would generally NOT qualify even if below the monetary threshold, as they are not typically considered low-value by nature.

Common Student Pitfalls

Pitfall	How to Avoid
Confusing substitution rights	Ask: Is the substitution substantive? Can the supp
Ignoring embedded leases	Always check service contracts for identified asse
Misapplying short-term exemption	The 12-month period is from commencement, not rema
Confusing direction of use with operation	Operating an asset ? Directing HOW it's used. A dr
Forgetting protective rights don't count	Speed limits, maintenance requirements, and permit

Exam Technique

For "Identify Whether a Lease Exists" Questions

Step 1: State the definition of a lease (1 mark)

Step 2: Apply the two-condition test:
- Is there an identified asset? Check for substantive substitution rights.
- Does the customer control use? Check for directing HOW and FOR WHAT PURPOSE.

Step 3: Conclude clearly on each contract/scenario

Mark Allocation Tip

If a question is worth 4-6 marks, the examiner wants:
- Definition (1 mark)
- Application of identified asset (1-2 marks)

- Application of control test (1-2 marks)
- Clear conclusion (1 mark)

Key Takeaways

1. IFRS 16 exists to bring leases onto the balance sheet - understand the economic rationale
2. Two conditions must BOTH be met for a lease to exist: identified asset + right to control
3. Substitution rights can prevent an asset from being "identified"
4. Control means directing HOW and FOR WHAT PURPOSE - not just operating
5. Separate lease from service components unless electing the practical expedient
6. Short-term and low-value exemptions are available but are elections with consequences

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Practice Scenario

Question: Manufacturer Ltd enters into a contract with Logistics Co for the exclusive use of a warehouse section (1,000 m² of a 5,000 m² facility) for 5 years. Manufacturer Ltd stores its finished goods there. Logistics Co provides security officers, cleaning, and handles all incoming/outgoing goods based on Manufacturer's instructions. Manufacturer can access the warehouse 24/7 and decides which products are stored and in what configuration.

Required: Determine whether this contract contains a lease.

Model Answer

Next: Part 2 - Lessee Accounting Model ?

IFRS 16 Leases - Part 2: Lessee Accounting Model

The Core Principle

Under IFRS 16, a lessee recognizes:
1. A Right-of-Use (ROU) Asset - representing the right to use the underlying asset
2. A Lease Liability - representing the obligation to make lease payments

This single accounting model applies to virtually ALL leases (subject to the short-term and low-value exemptions discussed in Part 1).

> *The lessee accounting model treats all leases as if the lessee has acquired an asset and borrowed funds to pay for it. This is the economic substance that IFRS 16 seeks to reflect.*

Initial Recognition

When to Recognize?

Recognition occurs at the commencement date - the date the lessor makes the underlying asset available for use by the lessee.

> *Don't confuse:*
> *- Inception date: When the lease is agreed/signed*
> *- Commencement date: When the asset is made available for use*
> *Initial recognition happens at commencement, not inception.*

Initial Measurement of the Lease Liability

Formula

```
Lease Liability = Present Value of Lease Payments Not Yet Paid at Commencement
```

What Lease Payments Are Included?

Payment Type	Include?	Notes
Fixed payments	[OK] Yes	Less any lease incentives receivable
Variable payments based on index/rate	[OK] Yes	Using index/rate at commencement
Amounts expected under residual value gua	[OK] Yes	Lessee's expected payment
Purchase option price	[OK] Yes	Only if reasonably certain to exercise
Termination penalties	[OK] Yes	If lease term reflects exercising termination opti
Variable payments based on usage/performa	[X] No	Expensed as incurred

The Discount Rate

The lease liability is measured at present value using:

Option	When to Use
Interest rate implicit in the lease	If readily determinable (often available for lesso
Lessee's incremental borrowing rate	If implicit rate not readily determinable

Incremental Borrowing Rate (IBR) is the rate the lessee would have to pay to borrow funds:
- Over a similar term
- With similar security
- To obtain an asset of similar value
- In a similar economic environment

> *Exam technique: When a question gives you both rates, state which rate you're using and briefly justify why the implicit rate is or isn't readily determinable.*

Working Example: Initial Measurement of Lease Liability

Facts:
- Lease commencement: 1 January 20X1
- Lease term: 5 years
- Annual payment: R100,000 paid at year-end
- Incremental borrowing rate: 10% (implicit rate not determinable)
- No purchase option, residual guarantees, or incentives

Calculation:

Present value of lease payments:

Year	Payment	PV Factor @ 10%	Present Value
1	R100,000	0.9091	R90,909
2	R100,000	0.8264	R82,645
3	R100,000	0.7513	R75,131
4	R100,000	0.6830	R68,301
5	R100,000	0.6209	R62,092
Total			R379,078

Alternatively, using annuity factor:
R100,000 x 3.7908 = R379,078

Initial Measurement of the Right-of-Use Asset

Formula

```
ROU Asset = Lease Liability
          + Lease payments made at or before commencement
          - Lease incentives received
          + Initial direct costs
          + Estimated dismantling/restoration costs (IAS 37)
```

Component Breakdown

Component	Description	Example
Lease liability	As calculated above	R379,078
Payments made at/before commencement	Upfront payments, first month's rent paid in a	First month's rent of R8,000
Lease incentives received	Cash received or payable from lessor	Moving cost contribution of R20,000
Initial direct costs	Incremental costs to obtain lease (NOT pre-p	Legal fees R5,000, commission R10,000
Restoration costs	Obligation to restore asset at lease end	Estimated cost R15,000 at NPV

Working Example: Initial Measurement of ROU Asset

Continuing from above, with additional facts:
- First month's rent of R8,333 paid on signing (1 month of R100,000/12)
- Lessor contributed R20,000 toward lessee's moving costs
- Legal fees to negotiate lease: R15,000
- Obligation to restore premises at end: Present value R25,000

Calculation:

Component	Amount
Lease liability	R379,078
Add: Prepaid rent	R8,333
Less: Lease incentive received	(R20,000)
Add: Initial direct costs	R15,000
Add: Restoration provision	R25,000
ROU Asset	R407,411

Journal Entry at Commencement

```
Dr  Right-of-Use Asset                      407,411
Dr  Cash (lease incentive received)          20,000
    Cr  Lease Liability                                  379,078
    Cr  Cash (prepaid rent)                                8,333
    Cr  Cash (legal fees)                                 15,000
    Cr  Provision for Restoration                         25,000
```

Subsequent Measurement of the Lease Liability

The lease liability is subsequently measured using the effective interest method.

Effective Interest Method

Each period:
1. Calculate interest expense: Opening liability x Discount rate
2. Process the payment: Reduces the liability
3. Closing liability: Opening + Interest - Payment

Amortization Table

Continuing our example (R379,078 liability, 10% rate, R100,000 annual payments):

Year	Opening Balance	Interest (10%)	Payment	Closing Balance
1	379,078	37,908	(100,000)	316,986
2	316,986	31,699	(100,000)	248,685
3	248,685	24,868	(100,000)	173,553
4	173,553	17,355	(100,000)	90,908
5	90,908	9,092	(100,000)	0
Total		120,922	(500,000)	

Journal Entry - Year 1

```
Interest expense:
Dr  Finance Cost (P/L)                          37,908
    Cr  Lease Liability                                      37,908

Lease payment:
Dr  Lease Liability                            100,000
    Cr  Bank                                                 100,000
```

Closing lease liability after Year 1 = R316,986

Subsequent Measurement of the ROU Asset

Two Measurement Options

Option 1: Cost Model (Default)
- ROU asset measured at cost less accumulated depreciation and impairment losses
- This is the most common approach

Option 2: Revaluation Model
- If the underlying asset would qualify for revaluation under IAS 16
- Apply IAS 16 revaluation model requirements
- Rarely used in practice

Option 3: Fair Value Model

- If the underlying asset meets the definition of investment property
- Lessee applies fair value model under IAS 40

Depreciation of ROU Asset

Scenario	Depreciation Period
Ownership transfers to lessee at end of lease	Useful life of underlying asset
Purchase option reasonably certain to be exercised	Useful life of underlying asset
No transfer of ownership or purchase option	Shorter of: Lease term OR Useful life of asset

Working Example: Depreciation

Continuing our example:
- ROU Asset at commencement: R407,411
- Lease term: 5 years
- Useful life of building: 40 years
- No purchase option or transfer of ownership

Depreciation period = Shorter of 5 years or 40 years = 5 years

Annual depreciation = R407,411 / 5 = R81,482

Journal Entry - Year 1 Depreciation

```
Dr  Depreciation Expense (P/L)                  81,482
    Cr  Accumulated Depreciation - ROU Asset                 81,482
```

Summary: Year 1 Impact on Financial Statements

Statement of Financial Position (Extract)

Assets:

	R
Right-of-Use Asset (407,411 - 81,482)	325,929

Liabilities:

	R
Lease Liability - Non-current (248,685)	248,685
Lease Liability - Current (316,986 - 248,685)	68,301
Total Lease Liability	316,986

Statement of Profit or Loss (Extract)

	R
Depreciation expense	(81,482)
Finance cost	(37,908)
Total expense	(119,390)

Comparison with Operating Lease Under Old IAS 17

Under old IAS 17, if classified as an operating lease:
- P/L expense: R100,000 (straight-line rental)
- Balance sheet: Nothing!

Under IFRS 16:
- P/L expense: R119,390 (Year 1 - higher in early years, lower in later years)
- Balance sheet: ROU asset R325,929, Liability R316,986

> *Front-loading effect: Total expense over the lease term is the same (R500,000 in payments + restoration). However, IFRS 16 front-loads expenses due to higher interest in early years when the liability is larger. This affects profit trends but NOT total profit.*

Payments Made at Different Times

Payments in Advance vs Payments in Arrears

The timing of payments affects:
1. The present value calculation (annuity due vs ordinary annuity)
2. The first journal entry

Payments in Advance (Beginning of Period)

If R100,000 is paid at the START of each year:

Year	Payment Date	PV Factor @ 10%	Present Value
1	Start Year 1	1.0000	R100,000
2	Start Year 2	0.9091	R90,909
3	Start Year 3	0.8264	R82,645
4	Start Year 4	0.7513	R75,131
5	Start Year 5	0.6830	R68,301
Total			R416,986

First payment is NOT discounted - it's already "present"

Initial recognition with first payment on commencement:

```
Dr  Right-of-Use Asset                          416,986
    Cr  Lease Liability                                     316,986
    Cr  Bank (first payment)                                100,000
```

Lease Incentives

What Are Lease Incentives?

Payments made by the lessor to or on behalf of the lessee, such as:
- Cash payments to the lessee
- Reimbursement of lessee's costs (moving, fit-out)
- Lessor assuming lessee's obligations (e.g., paying off old lease)
- Rent-free periods

Accounting Treatment

Lease incentives reduce the ROU asset at initial recognition (as shown in our earlier example).

If the incentive is for costs the lessee incurs (e.g., moving costs):
1. Lessee recognizes and expenses the cost when incurred
2. Simultaneously reduces ROU asset by incentive amount

Practical Application: Payments Linked to an Index

Variable Payments Based on Index/Rate

Variable payments that depend on an index (e.g., CPI) or a rate (e.g., LIBOR) are included in the lease liability using the index or rate at commencement.

Example:
- Annual payment: R100,000 adjusted annually for CPI changes
- Current CPI: 100
- Lease term: 3 years

Initial measurement:
All three payments measured using current CPI = R100,000 each (then discounted)

Subsequent measurement:
If CPI increases to 105 in Year 2, the lease liability is NOT automatically remeasured. Remeasurement only occurs when cash flows actually change (i.e., at the payment adjustment date).

When CPI increases:

```
Year 2 payment = R100,000 x (105/100) = R105,000
```

Remeasure lease liability using revised payments and original discount rate.

Common Student Pitfalls

Pitfall	Correct Approach
Using the remaining lease term to depreciate ROU	Use lease term from commencement (or useful life i
Including variable usage-based payments in liabili	Only include if based on an index/rate; pure usage
Discounting at current market rates at reporting d	Keep using the original discount rate (unless reme
Confusing lease incentives with initial direct cos	Incentives REDUCE the ROU asset; initial direct co
Forgetting to split current/non-current liability	Amount payable within 12 months is current
Not recognizing the front-loading effect on profit	Early years = higher total expense; later years =

Exam Technique

Calculation Questions (High Mark Allocation)

Step 1: Calculate the lease liability (present value of payments)
- State the payments included
- State and justify the discount rate used
- Show the PV calculation clearly

Step 2: Calculate the ROU asset
- Start with lease liability
- Adjust for each component (± prepayments, incentives, direct costs, restoration)

Step 3: Prepare the amortization schedule (if required)
- Opening balance ? Interest ? Payment ? Closing balance
- Show at least 2-3 years

Step 4: Calculate depreciation
- State depreciation period with reasoning
- Calculate annual charge

Step 5: Prepare journal entries or extracts (as required)

Time-Saving Tips

1. Use annuity factors when payments are equal and timing is consistent
2. Don't round intermediate calculations - round only final answers
3. Label everything - examiners can't give marks for unexplained numbers
4. Present amortization tables clearly - easy marks if formatted properly

Comprehensive Example

Question:

On 1 January 20X1, ABC Ltd enters into a lease for office space with the following terms:
- Lease term: 4 years
- Annual payment: R200,000 payable at year-end
- Lessee's incremental borrowing rate: 8%
- Legal fees to obtain lease: R30,000
- Rent-free period: First 3 months (not reflected in R200,000)

- Obligation to restore premises at end: Estimated cost R50,000 (present value at 8%: R36,751)

Required:

1. Calculate the initial lease liability
2. Calculate the initial ROU asset
3. Prepare the lease amortization schedule
4. Calculate Year 1 depreciation
5. Calculate total expense in Year 1

Model Answer

? Previous: Part 1 - Scope & Key Definitions

Next: Part 3 - Lease Modifications ?

IFRS 16 Leases - Part 3: Lease Modifications

What is a Lease Modification?

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was NOT part of the original terms and conditions.

Examples of Lease Modifications

Modification Type	Example
Change in scope	Adding or terminating the right to use one or more
Change in lease term	Extending or shortening the contractual lease term
Change in consideration	Changing the amount of lease payments
Change in nature of lease	Adding or removing a purchase option

> *A modification requires an agreement between the lessor and lessee. Unilateral changes by one party or changes contemplated in the original contract are NOT modifications.*

The Key Question: Is the Modification a Separate Lease?

When a lease is modified, the first question is:

Does this modification result in a SEPARATE lease?

Conditions for a Separate Lease

A modification is accounted for as a separate lease if BOTH conditions are met:

Condition	Test
1. Increases scope	The modification increases the scope of the lease
2. Standalone price	The consideration for the increase is commensurate

If BOTH conditions are met ? Separate lease (account for it as a new lease)

If EITHER condition is not met ? NOT a separate lease (remeasure the existing lease)

Accounting for Modifications as a Separate Lease

Treatment

If the modification creates a separate lease:
- Account for the NEW lease independently
- Continue accounting for the ORIGINAL lease unchanged
- It's as if the lessee entered into TWO leases from the start

Example: Separate Lease

Scenario:
- Original lease: 1,000 m² of office space for R150,000 p.a. for 5 years
- After Year 2: Lessee agrees to also lease adjacent 500 m² for R80,000 p.a. for remaining 3 years
- Stand-alone price for 500 m² similar space: R75,000 - R85,000 p.a.

Analysis:

Condition	Assessment
Increases scope?	[OK] Yes - additional 500 m² added
Commensurate price?	[OK] Yes - R80,000 is within the range of stand-al

Result: The modification is a separate lease.

Accounting:
- Original lease for 1,000 m²: Continues as before
- New lease for 500 m²: Recognize new ROU asset and lease liability for 3 years at R80,000 p.a.

Modifications NOT a Separate Lease - Lessee Accounting

When the modification does NOT qualify as a separate lease, the lessee must:

1. Remeasure the lease liability using:
2. Revised lease payments

3. Revised discount rate (current rate at modification date)
4. Adjust the ROU asset (see detailed treatment below)

Step-by-Step Process

Step 1: Determine the revised lease term
- Consider all relevant facts and circumstances
- Reassess reasonably certain exercise of options

Step 2: Determine the revised discount rate
- Use the interest rate implicit in the lease for the remainder (if determinable)
- Otherwise, use the lessee's incremental borrowing rate at the modification date

Step 3: Remeasure the lease liability
- Present value of revised remaining payments using revised rate

Step 4: Adjust the ROU asset

The adjustment to the ROU asset depends on the TYPE of modification:

Modification Type	ROU Asset Treatment
Decrease in scope (partial termination)	Decrease ROU asset proportionately. Recognize gain
Other modifications (increase, extension, change i	Adjust ROU asset by the same amount as liability c

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Modification Type 1: Decrease in Scope (Partial Termination)

The Principle

When the lease scope is reduced (e.g., returning part of leased space), it's treated as a partial termination. The lessee derecognizes part of its position.

Calculation Steps

1. Remeasure the lease liability (revised payments, revised rate)
2. Calculate the PARTIAL derecognition of ROU asset proportionately
3. Recognize the difference as a gain or loss in profit or loss

Working Example: Partial Termination

Facts:
- Original lease: 2,000 m² office for 10 years
- After 6 years: Lessee returns 500 m² (25% of space), reducing rent from R200,000 to R160,000 p.a.
- Carrying amounts at modification date:
  - ROU Asset: R480,000
  - Lease Liability: R520,000
- Revised discount rate: 9%
- Remaining term: 4 years

Step 1: Remeasure the Lease Liability

New lease liability = PV of R160,000 p.a. for 4 years @ 9%
= R160,000 x 3.2397
= R518,352

Step 2: Calculate Proportionate Decrease in ROU Asset

Proportion terminated = 500 m² / 2,000 m² = 25%

Decrease in ROU asset = R480,000 x 25% = R120,000

New ROU asset = R480,000 - R120,000 = R360,000

Step 3: Proportionate Decrease in Lease Liability

The liability "allocated" to the terminated portion = R520,000 x 25% = R130,000

Step 4: Calculate Gain or Loss

Component	Amount (R)
Liability derecognized (for terminated portion)	130,000
Less: ROU asset derecognized	(120,000)
Gain on partial termination	10,000

Step 5: Account for Remaining Liability Change

	R
Old liability (remaining 75%)	390,000
New remeasured liability	518,352
Increase due to remeasurement	128,352

This increase adjusts the ROU asset:
New ROU asset = R360,000 + R128,352 = R488,352

Wait - let me recalculate this more carefully.

Corrected Approach:

Step	Calculation	Amount
Original lease liability		520,000
Proportionate derecognition (25%)	520,000 x 25%	(130,000)
Remaining liability (pre-adjustment)		390,000
Remeasured liability (revised payments @ 9	160,000 x 3.2397	518,352
Adjustment to ROU asset	518,352 - 390,000	128,352

	R
Original ROU asset	480,000
Proportionate derecognition (25%)	(120,000)
Adjustment for liability remeasurement	128,352
Revised ROU asset	488,352

Journal Entry:

```
Dr  Lease Liability (derecognized portion)          130,000
    Cr  Right-of-Use Asset (proportionate)                  120,000
    Cr  Gain on lease modification (P/L)                     10,000

Dr  Right-of-Use Asset (remeasurement)              128,352
    Cr  Lease Liability (remeasurement)                     128,352
```

OR combined:

```
Dr  Lease Liability                                   1,648
Dr  Right-of-Use Asset                                8,352
    Cr  Gain on lease modification                           10,000
```

(520,000 - 518,352 = 1,648 net decrease in liability)

(488,352 - 480,000 = 8,352 net increase in ROU asset)

Modification Type 2: Increase in Scope or Extension (NOT at Stand-alone Price)

The Principle

When scope increases or lease term extends, but the consideration is NOT commensurate with stand-alone prices, it cannot be a separate lease. Instead, remeasure the existing lease.

Working Example: Lease Extension

Facts:
- Original lease: Equipment for 5 years, R50,000 p.a.
- After 3 years: Lessee extends for additional 3 years at R45,000 p.a.
- Original discount rate: 8%
- Discount rate at modification: 7%
- Carrying amounts at modification:
  - ROU asset: R92,000
  - Lease liability: R89,286 (PV of 2 remaining payments @ 8%)

Analysis:

The extension adds scope (more time), but R45,000 is below stand-alone price (which is R50,000 based on original contract). Therefore, NOT a separate lease.

Step 1: Remeasure Lease Liability

Revised payments: 2 years at R50,000 + 3 years at R45,000

Year	Payment	PV Factor @ 7%	Present Value
1	50,000	0.9346	46,729
2	50,000	0.8734	43,672
3	45,000	0.8163	36,734
4	45,000	0.7629	34,331
5	45,000	0.7130	32,085
Total			R193,551

Step 2: Calculate Adjustment

	R
New lease liability	193,551
Old lease liability	(89,286)
Increase in liability	104,265

Step 3: Adjust ROU Asset

This is NOT a scope decrease, so the ROU asset is adjusted by the same amount:

New ROU asset = R92,000 + R104,265 = R196,265

Journal Entry:

```
Dr  Right-of-Use Asset                              104,265
    Cr  Lease Liability                                     104,265
```

Modification Type 3: Change in Consideration Only (No Scope Change)

Example: Rent Review

Facts:
- 10-year lease, currently in Year 4
- Payments were R100,000 p.a., now increased to R110,000 p.a. following rent review
- Revised discount rate: 6%
- Carrying amounts before modification:
  - ROU asset: R420,000
  - Lease liability: R405,000

Treatment:

Remeasure the lease liability using revised payments and revised rate:

Remaining term: 7 years
New lease liability = R110,000 x PV factor (6%, 7 years)
= R110,000 x 5.5824
= R614,064

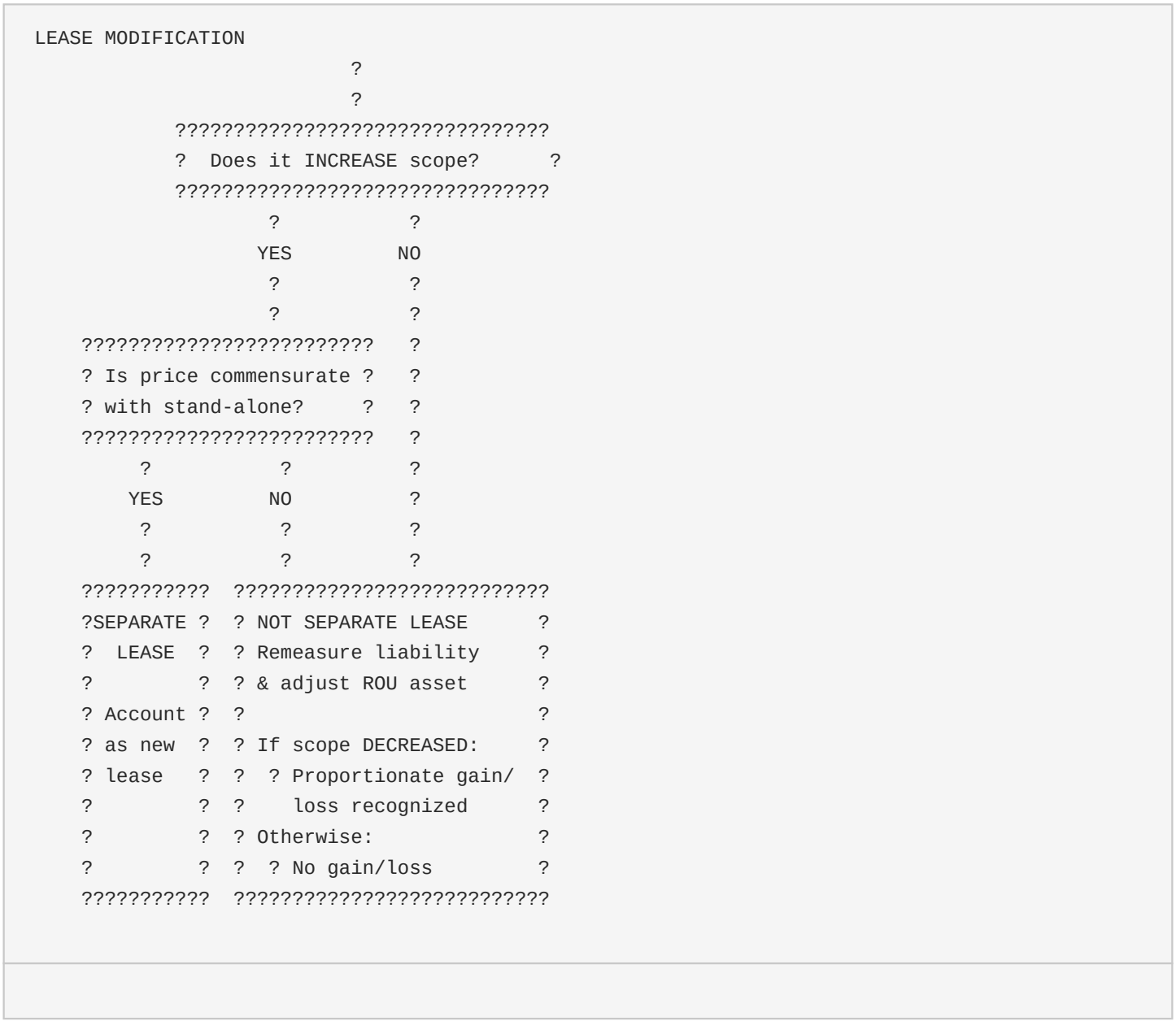
Adjustment = R614,064 - R405,000 = R209,064

Since this is not a scope decrease:

```
Dr  Right-of-Use Asset                              209,064
    Cr  Lease Liability                                     209,064
```

New ROU asset = R420,000 + R209,064 = R629,064

Summary: Modification Decision Tree



COVID-19-Related Rent Concessions

Practical Expedient

In response to COVID-19, the IASB issued an amendment providing a practical expedient for rent concessions that meet certain conditions.

Conditions for Using the Expedient:
1. Change in lease payments results in revised consideration that is substantially the same or less than pre-change consideration
2. Reduction in payments affects only payments due on or before 30 June 2022 (extended)
3. No substantive change to other terms and conditions

If Expedient Applied:
- No reassessment of whether the contract contains a lease
- Account for the concession as if it were not a lease modification
- Typically: Credit P/L (other income), not as reduction to ROU asset

> *The COVID-19 expedient is election-based and applies consistently to similar contracts. Watch for exam questions specifically stating whether the expedient is being applied.*

Common Student Pitfalls

Pitfall	Correct Approach
Forgetting to use a REVISED discount rate	The modification date rate is used for all non-sep
Not separating the gain/loss on partial terminatio	Decrease in scope requires proportionate derecogni
Adjusting ROU asset through P/L for non-scope decr	Only scope decreases create a gain/loss; other rem
Treating all extensions as separate leases	Must be at stand-alone price AND increase scope to
Confusing lease modifications with remeasurements	Modifications require agreement; remeasurements ha

Exam Technique

Modification Questions Typically Test

1. Classification: Is it a separate lease or not?
2. Calculation: Remeasure the lease liability using revised payments and rate
3. Journal entries: Particularly for partial terminations with gain/loss

Mark Allocation Guide

Requirement	Typical Marks
Identifying whether separate lease	2-3 marks
Calculating new lease liability	3-4 marks
Calculating ROU adjustment	2-3 marks

Proportionate gain/loss on termination	3-4 marks
Journal entries	2-3 marks

Key Phrases for Discussion Marks

- "The modification [does/does not] qualify as a separate lease because..."
- "The lease liability is remeasured using the revised discount rate at the modification date of X%..."
- "As this is a decrease in scope, the ROU asset is reduced proportionately and a gain/loss is recognized..."

Comprehensive Example

Question:

XYZ Ltd leases a building from 1 January 20X1 for 10 years at R500,000 per annum payable in arrears. The incremental borrowing rate at inception was 10%.

On 1 January 20X5, the following occurs:
- XYZ returns the ground floor (40% of the building)
- Annual payments are reduced to R380,000 for the remaining 6 years
- The incremental borrowing rate is now 8%

At 31 December 20X4:
- Lease liability: R1,895,394
- Right-of-use asset (net of depreciation): R1,705,855

Required:
1. Determine if this is a separate lease
2. Calculate the revised lease liability
3. Calculate the gain or loss on partial termination
4. Prepare the journal entry at 1 January 20X5

Model Answer

```
Dr  Lease Liability (40% derecognized)              758,158
    Cr  Right-of-Use Asset (40% derecognized)                 682,342
    Cr  Gain on lease modification (P/L)                       75,816

Dr  Right-of-Use Asset (remeasurement)              619,466
    Cr  Lease Liability (remeasurement)                       619,466
```

? Previous: Part 2 - Lessee Accounting Model

Next: Part 4 - Lessor Accounting ?

IFRS 16 Leases - Part 4: Lessor Accounting

Introduction: A Different World for Lessors

While IFRS 16 revolutionized lessee accounting with a single model, lessor accounting remains largely unchanged from IAS 17. Lessors still classify leases as either:
- Finance leases, or
- Operating leases

This dual model reflects the economic difference between leases that transfer substantially all risks and rewards of ownership (finance) versus those that don't (operating).

> *Think of it this way: IFRS 16 took the lessee's "operating lease" classification away. But the lessor still uses both classifications because the lessor needs to determine whether to derecognize the asset.*

Lease Classification: The Foundation

The Core Principle

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards.

Risk and Rewards - What Are They?

Risks	Rewards
Losses from idle capacity	Gain from appreciation in value
Technological obsolescence	Profitable operation over asset's life
Variations in return due to economic conditions	Gain from expected residual value

Classification Indicators

IFRS 16 provides indicators that individually or in combination would normally lead to finance lease classification:

Indicator	Finance Lease Indicator
1. Transfer of ownership	Lease transfers ownership to lessee at end of leas
2. Bargain purchase option	Lessee has option to purchase at price expected to
3. Major part of economic life	Lease term is for the major part of the asset's ec
4. Present value test	Present value of lease payments amounts to at leas
5. Specialized asset	Asset is of specialized nature that only lessee ca

Additional Indicators

Indicator	Finance Lease Indicator
6. Cancellation losses	If lessee cancels, losses are borne by lessee
7. Residual value fluctuations	Gains/losses from residual value fluctuations accr
8. Bargain renewal option	Lessee can continue lease for secondary period at

> *Common pitfall: Students often apply these indicators mechanically without understanding the principle. Remember: the indicators are EXAMPLES of when risks and rewards transfer. The PRINCIPLE is what matters.*

"Substantially All" and "Major Part" - What Do They Mean?

IFRS 16 does NOT define these terms numerically. However:
- Historical practice (from IAS 17) used 75% for "major part" of economic life
- Historical practice used 90% for "substantially all" of fair value

> *These percentages are guidance, not rules. A lease at 73% of economic life could still be a finance lease if other factors indicate risk/reward transfer. Always apply judgment.*

Finance Lease - Lessor Accounting

Initial Recognition

At commencement, the lessor:

1. Derecognizes the underlying asset
2. Recognizes a receivable (the "net investment in the lease")
3. Recognizes any selling profit or loss (if manufacturer/dealer lessor)

Net Investment in the Lease

The net investment is the gross investment discounted at the interest rate implicit in the lease.

```
Gross Investment = Lease Payments + Unguaranteed Residual Value
                   (expected to be received)

Net Investment = Present Value of Gross Investment at Implicit Rate
```

Interest Rate Implicit in the Lease

This is the rate that causes the present value of:
- Lease payments, PLUS
- Unguaranteed residual value

To equal the sum of:
- Fair value of the underlying asset, PLUS
- Initial direct costs of the lessor

In simple terms: the implicit rate equates the lessor's investment to the present value of expected cash flows.

Working Example: Finance Lease Recognition (Non-Dealer Lessor)

Facts:
- Lessor (not a manufacturer/dealer) leases equipment
- Fair value of equipment: R500,000
- Lease term: 5 years
- Annual payment: R130,000 (payable at year-end)
- Unguaranteed residual value at end of lease: R20,000
- Interest rate implicit in lease: 10%
- Carrying amount of equipment: R500,000 (equals fair value)
- Initial direct costs: R0

Step 1: Calculate Gross Investment

Component	Amount
Lease payments (5 x R130,000)	650,000

Unguaranteed residual	20,000
Gross Investment	670,000

Step 2: Calculate Net Investment

Component	PV @ 10%	Amount
Lease payments (annuity)	R130,000 x 3.7908	492,804
Unguaranteed residual (single sum)	R20,000 x 0.6209	12,418
Net Investment		505,222

Note: The difference from R500,000 fair value is due to rounding in PV factors. In practice, the implicit rate is calculated to equate these exactly.

Step 3: Journal Entry at Commencement

```
Dr  Lease Receivable (Net Investment)          505,222
    Cr  Equipment (PPE)                                    500,000
    Cr  Gain on lease (if any)                               5,222*
```

This gain could arise from the transaction; typically net investment = FV in a non-dealer lease

Subsequent Measurement

The lessor recognizes:
1. Finance income - Using effective interest method on the net investment
2. Receipt of lease payments - Reducing the lease receivable

Amortization Schedule

Continuing the example:

Year	Opening NI	Finance Income @ 10%	Payment Received	Closing NI
1	505,222	50,522	(130,000)	425,744
2	425,744	42,574	(130,000)	338,318
3	338,318	33,832	(130,000)	242,150
4	242,150	24,215	(130,000)	136,365
5	136,365	13,637	(130,000)	20,002*

*Residual value remains as the balance (approximately R20,000 - rounding difference)

Year 1 Journal Entry:

```
Finance income:
Dr  Lease Receivable                          50,522
    Cr  Finance Income (P/L)                              50,522

Receipt of payment:
Dr  Bank                                     130,000
    Cr  Lease Receivable                                 130,000
```

Manufacturer or Dealer Lessors

Special Treatment

When a manufacturer or dealer uses leasing to sell its products, the economics are different. The lessor is effectively:
1. Making a SALE (earning gross profit)
2. Providing FINANCING (earning finance income)

Initial Recognition - Manufacturer/Dealer

At commencement, recognize:

Component	Measurement
Revenue	Lower of: Fair value of asset OR PV of lease payme
Cost of sales	Cost of asset (or carrying amount) LESS PV of ungu
Lease receivable	PV of (lease payments + unguaranteed residual) at

> *Initial direct costs of manufacturer/dealer lessors are EXPENSED immediately. They cannot be included in the net investment because they relate to earning the selling profit.*

Working Example: Manufacturer/Dealer Lessor

Facts:
- Manufacturer leases equipment it produces
- Cost of equipment: R300,000
- Fair value: R500,000
- Lease term: 5 years

- Annual payment: R120,000
- Unguaranteed residual: R30,000
- Implicit rate: 12%
- Market rate for similar transactions: 12%

Calculations:

Revenue:
Lower of fair value (R500,000) or PV of lease payments at market rate

PV of lease payments = R120,000 x 3.6048 = R432,576

Revenue = R432,576 (lower than FV of R500,000)

Cost of Sales:
Cost less PV of unguaranteed residual
= R300,000 - (R30,000 x 0.5674)
= R300,000 - R17,022
= R282,978

Gross Profit:
R432,576 - R282,978 = R149,598

Lease Receivable (Net Investment):
PV of lease payments + PV of unguaranteed residual
= R432,576 + R17,022
= R449,598

Journal Entry:

```
Dr  Lease Receivable                          449,598
    Cr  Revenue                                          432,576
    Cr  Deferred Residual Value                          17,022

Dr  Cost of Sales                             282,978
Dr  Deferred Residual Value                   17,022
    Cr  Inventory                                        300,000
```

Or net presentation - the key is that the unguaranteed residual stays on the balance sheet, not in P/L

Operating Lease - Lessor Accounting

The Principle

In an operating lease, the lessor retains the asset on its balance sheet and recognizes lease income over the lease term.

Recognition

Lease Income:
- Recognize on a straight-line basis over the lease term
- OR another systematic basis if that better represents the pattern of benefits

Underlying Asset:
- Continue to recognize on balance sheet
- Continue to depreciate in accordance with IAS 16 or IAS 38
- Apply IAS 36 impairment requirements

Initial Direct Costs

- Add to carrying amount of the underlying asset
- Recognize as expense over lease term on same basis as lease income

Working Example: Operating Lease

Facts:
- Lessor leases office space for 3 years
- Annual rent: R240,000
- Lease incentive (rent-free first 3 months): Foregone rent of R60,000
- Initial direct costs (legal fees): R15,000
- Building carrying amount: R2,000,000, remaining useful life: 20 years

Annual Accounting:

Lease Income (straight-line):
Total payments = R240,000 + R240,000 + R180,000 (9 months Year 1) = R660,000

Wait, let me recalculate:
- Year 1: 9 months at R20,000/month = R180,000
- Year 2: 12 months at R20,000/month = R240,000
- Year 3: 12 months at R20,000/month = R240,000
- Total: R660,000 over 3 years

Straight-line income = R660,000 / 3 = R220,000 per year

Initial Direct Costs:
R15,000 / 3 years = R5,000 expense per year
(Added to building, but amortized separately for illustration)

Depreciation:

R2,000,000 / 20 years = R100,000 per year

Year 1 Journal Entries:

```
Cash received:
Dr  Bank                                    180,000
Dr  Lease Receivable (accrued)               40,000
    Cr  Lease Income                                    220,000

Depreciation:
Dr  Depreciation Expense                    100,000
    Cr  Accumulated Depreciation - Building             100,000

Initial direct cost amortization:
Dr  Lease Expense                             5,000
    Cr  Building (or separate IDC asset)                  5,000
```

Sub-Leases

Classification of Sub-Leases

A sub-lease is a transaction where:

- The intermediate lessor leases an asset from a head lessor
- The intermediate lessor then leases the same asset to a sub-lessee

> *Key rule: The intermediate lessor classifies the sub-lease with reference to the right-of-use asset arising from the head lease, NOT the underlying asset.*

This means:

- Head lease of 20 years on building ? ROU asset with 20-year useful life
- Sub-lease of 18 years ? Likely a FINANCE lease (major part of ROU asset's life)

Accounting by Intermediate Lessor

If Sub-Lease is...	Treatment
Finance Lease	Derecognize ROU asset, recognize sub-lease receiva
Operating Lease	Keep ROU asset, continue recognizing lease liabili

Working Example: Sub-Lease

Facts:
- ABC Ltd leases a building for 10 years (head lease) at R100,000 p.a.
- After 2 years, ABC sub-leases to XYZ Ltd for remaining 8 years at R120,000 p.a.
- ROU asset carrying amount at sub-lease commencement: R640,000
- Lease liability at sub-lease commencement: R576,000 (8 years remaining)
- Discount rate for sub-lease: 6%

Classification:
Sub-lease is for 8 years (100% of remaining ROU asset life) = Finance Lease

Sub-lease Receivable:
R120,000 x PV annuity factor (6%, 8 years)
= R120,000 x 6.2098
= R745,176

Journal Entry at Sub-Lease Commencement:

```
Dr  Sub-Lease Receivable                    745,176
    Cr  Right-of-Use Asset                              640,000
    Cr  Gain on sub-lease (P/L)                         105,176
```

ABC continues to account for the head lease liability:
- Remains on balance sheet at R576,000
- Continue to apply effective interest method and make payments

---

Lease Modifications - Lessor

Finance Lease Modifications

Type of Modification	Treatment
Increase scope as separate lease	Account as new lease
Decrease scope or change consideration	If would have been operating lease originally ? Ac
Other modifications	Recalculate lease payments, adjust receivable usin

Operating Lease Modifications

Account for the modification as a new lease from the effective date:

- Consider any prepaid or accrued lease payments as part of new lease consideration
- Continue depreciation and lease income recognition under new terms

---

Common Student Pitfalls

Pitfall	Correct Approach
Confusing lessor and lessee accounting	Lessors classify (finance vs operating); lessees g
Forgetting unguaranteed residual in net investment	Include it in gross investment and discount it
Including initial direct costs in manufacturer/dea	Manufacturer/dealer lessors EXPENSE initial direct
Classifying sub-lease against underlying asset	Use the ROU asset from head lease as reference
Recognizing operating lease income based on cash r	Use straight-line over lease term (or other system
Forgetting to continue depreciating operating leas	The lessor still owns the asset; depreciate per IA

Exam Technique

Classification Questions

Step 1: State the classification principle (1 mark)
- "A lease is a finance lease if it transfers substantially all the risks and rewards incidental to ownership"

Step 2: Apply relevant indicators (2-4 marks)
- Discuss each indicator that applies
- Conclude on each

Step 3: Overall conclusion (1 mark)
- "Based on the above, the lease is classified as a [finance/operating] lease"

Calculation Questions

Finance Lease:
1. Calculate gross investment
2. Calculate net investment (show individual PV calculations)
3. Prepare amortization schedule if required

4. Show journal entries

Operating Lease:

1. Calculate total lease payments including incentive effects
2. Calculate straight-line income per period
3. Show depreciation calculations
4. Show journal entries

Summary Comparison

Aspect	Finance Lease	Operating Lease
Asset	Derecognized	Remains on lessor's books
Receivable	Net investment in lease	None (only accrued/prepaid)
Income	Finance income (effective interest)	Lease income (straight-line)
Depreciation	N/A (no asset)	Continues on underlying asset
Initial direct costs	Add to net investment*	Add to asset, amortize over term

*Except manufacturer/dealer lessors who expense immediately

? Previous: Part 3 - Lease Modifications

Next: Part 5 - Sale-and-Leaseback Transactions ?

IFRS 16 Leases - Part 5: Sale-and-Leaseback Transactions

What is a Sale-and-Leaseback?

A sale-and-leaseback transaction occurs when an entity (the seller-lessee):
1. Sells an asset to another entity (the buyer-lessor), AND
2. Leases that same asset back from the buyer-lessor

These transactions are common in practice for:
- Releasing capital tied up in property/equipment
- Off-balance sheet financing (historically)
- Tax planning purposes

> *The key accounting question is: Did a "sale" actually occur? This question is answered by applying IFRS 15 Revenue from Contracts with Customers.*

The First Question: Is There a Sale?

Applying IFRS 15 Principles

Before accounting for the leaseback, we must determine whether the transfer of the asset satisfies the requirements to be accounted for as a sale under IFRS 15.

The key question: Does the transfer constitute a performance obligation satisfied?

In substance, we ask: Has control of the asset transferred from the seller-lessee to the buyer-lessor?

Common Indicators That a Sale Has NOT Occurred

Scenario	Why No Sale?
Repurchase option at fixed price	Seller-lessee retains significant risks and reward
Repurchase at above market price making exercise c	Economic compulsion to repurchase means no real tr

Leaseback is a finance lease	If the leaseback transfers substantially all risks
Variable payments tied to asset performance	Seller-lessee retains exposure to asset-specific r

> *If the seller-lessee has a put option (right to require buyer-lessor to repurchase) or the buyer-lessor has a call option (right to require seller-lessee to repurchase) at a price that makes exercise virtually certain, there is NO sale.*

Scenario A: Transfer IS a Sale

When Control Transfers

If the transfer satisfies IFRS 15 requirements for a sale, both parties account as follows:

Seller-Lessee:
1. Measure the ROU asset arising from the leaseback as a proportion of the previous carrying amount
2. Recognize only the gain/loss that relates to the rights transferred to the buyer-lessor

Buyer-Lessor:
1. Account for the purchase using applicable standards (IAS 16, IAS 40, etc.)
2. Account for the lease using normal lessor accounting (IFRS 16)

The Proportional Approach (Seller-Lessee)

The seller-lessee does NOT recognize the full gain on sale because it retains rights through the leaseback. The accounting is:

```
ROU Asset = Previous Carrying Amount x (PV of Lease Payments / Fair Value of Asset)

Gain/Loss = Proportion of gain that relates to rights TRANSFERRED
          = Full Gain x (Fair Value - PV of Lease Payments) / Fair Value
```

Working Example: Sale at Fair Value

Facts:
- Carrying amount of building: R1,000,000
- Fair value of building (sale price): R1,500,000
- Leaseback term: 10 years
- Annual lease payment: R80,000

- Interest rate implicit in lease: 6%
- PV of lease payments: R80,000 x 7.3601 = R588,808

Step 1: Calculate Full Gain

	R
Sale proceeds (fair value)	1,500,000
Carrying amount	(1,000,000)
Full gain	500,000

Step 2: Calculate Proportions

	R	Proportion
Rights retained (leaseback)	588,808	39.25%
Rights transferred	911,192	60.75%
Fair value	1,500,000	100%

Step 3: Calculate ROU Asset

ROU Asset = R1,000,000 x (588,808 / 1,500,000)
= R1,000,000 x 39.25%
= R392,539

Step 4: Calculate Gain to Recognize

Gain recognized = R500,000 x (911,192 / 1,500,000)
= R500,000 x 60.75%
= R303,750

Step 5: Calculate Lease Liability

Lease liability = PV of lease payments = R588,808

Journal Entry (Seller-Lessee):

```
Dr  Cash                                  1,500,000
Dr  Right-of-Use Asset                      392,539
    Cr  Building (carrying amount)                    1,000,000
    Cr  Lease Liability                                 588,808
    Cr  Gain on sale (P/L)                              303,731*
```

*Rounding difference

Alternative Presentation of the Calculation

Component	Calculation	Amount
Cash received		1,500,000
Less: Lease liability	PV of payments	(588,808)
Net cash inflow		911,192
Carrying amount derecognized		(1,000,000)
Add: ROU asset recognized	1,000,000 x 39.25%	392,539
Net asset change		(607,461)
Gain recognized	911,192 - 607,461	303,731

Off-Market Terms

What if Sale Price ? Fair Value?

In practice, the sale price and lease payments may be set off-market (not at fair value). This could be:
- Above-market sale price with above-market lease payments (financing arrangement)
- Below-market sale price with below-market lease payments

Adjustment Required

IFRS 16 requires adjustments to reflect substance:

Scenario	Treatment
Sale price > Fair value	The excess is a financing from buyer-lessor to sel
Sale price < Fair value	The shortfall is an advance lease payment (adjust
Lease payments > Market	Represents additional payment for purchase (adjust
Lease payments < Market	Represents discount granted by buyer-lessor (adjus

Working Example: Above-Market Sale Price

Facts:
- Fair value of asset: R1,000,000
- Sale price: R1,200,000 (above market by R200,000)
- Carrying amount: R800,000

- PV of lease payments at market rate: R350,000
- Leaseback term: 5 years

Analysis:
The excess sale price of R200,000 is effectively a financing received from the buyer-lessor.

Calculations:

For gain calculation purposes, use FAIR VALUE, not sale price:

	R
Fair value	1,000,000
Carrying amount	(800,000)
Full gain	200,000

Rights transferred proportion = (FV - PV of payments) / FV
= (1,000,000 - 350,000) / 1,000,000 = 65%

Gain recognized = R200,000 x 65% = R130,000

ROU asset = R800,000 x 35% = R280,000

Journal Entry:

```
Dr  Cash                                        1,200,000
Dr  Right-of-Use Asset                            280,000
    Cr  Asset (carrying amount)                                 800,000
    Cr  Lease Liability                                         350,000
    Cr  Financial Liability (financing from lessor)             200,000
    Cr  Gain on sale                                            130,000
```

The R200,000 financial liability is repaid over the lease term (often through the above-market lease payments).

Scenario B: Transfer is NOT a Sale

When Control Does Not Transfer

If the transfer does NOT satisfy IFRS 15:
- The seller-lessee has NOT sold the asset
- The arrangement is accounted for as a financing transaction

Seller-Lessee Accounting:

- Continue to recognize the asset
- Recognize a financial liability equal to the transfer proceeds
- Apply IFRS 9 (financial instruments) to the liability

Buyer-Lessor Accounting:
- Do NOT recognize the asset
- Recognize a financial asset equal to the transfer proceeds
- Apply IFRS 9 to the asset

Working Example: No Sale

Facts:
- Entity sells equipment for R500,000
- Simultaneously enters into a leaseback with option to repurchase for R550,000
- The exercise of the repurchase option is virtually certain
- Equipment carrying amount: R400,000
- Interest rate implicit: 8%

Analysis:
The repurchase option (at price making exercise virtually certain) means control has NOT transferred. No sale occurs.

Seller-Lessee Journal Entry:

```
Dr  Cash                                    500,000
    Cr  Financial Liability                             500,000
```

The asset remains on the seller-lessee's books at R400,000 and continues to be depreciated.

Over the financing period:

```
Dr  Finance Cost                             XX,XXX
    Cr  Financial Liability                              XX,XXX
```

Repurchase payments reduce the liability.

Buyer-Lessor Perspective

When There IS a Sale

If the transfer is a sale:

1. Recognize the purchased asset at cost (purchase consideration)

2. Account for the lease using normal lessor accounting:
3. Classify as finance or operating lease
4. Apply appropriate recognition model

When There is NO Sale

If the transfer is not a sale:

1. Do NOT recognize the asset
2. Recognize a financial receivable at the amount of cash paid
3. Apply IFRS 9 to the receivable

Complex Scenario: Finance Leaseback

Special Consideration

What if the leaseback would be classified as a finance lease for the lessor?

A finance lease means the lessor is transferring substantially all risks and rewards BACK to the lessee. This could indicate that control hasn't truly transferred in the first place.

IFRS 16 Guidance:
- If the leaseback is a finance lease, the seller-lessee cannot recognize any gain/loss
- The transaction is effectively a financing arrangement
- Account similar to "no sale" scenario

Common Student Pitfalls

Pitfall	Correct Approach
Recognizing full gain on sale	Only recognize proportion relating to rights TRANS
Using sale price instead of fair value for off-mar	Always use fair value; adjust for any above/below-
Forgetting to assess whether a sale occurred	First step is ALWAYS: Apply IFRS 15 to assess if c
Confusing financing liability with lease liability	Financing liability = excess sale price; Lease lia
Measuring ROU asset at proportion of fair value	Use proportion of CARRYING AMOUNT, not fair value

---

Exam Technique

Structured Approach

Step 1: Is there a sale? (IFRS 15 assessment)
- Identify repurchase options, terms, etc.
- Conclude on whether control transfers

Step 2: If sale - Calculate at fair value
- Determine fair value (adjust if terms are off-market)
- Calculate full theoretical gain/loss

Step 3: Calculate proportions
- PV of lease payments / Fair value = Rights retained
- Remainder = Rights transferred

Step 4: Apply proportions
- ROU asset = Carrying amount x Rights retained %
- Gain recognized = Full gain x Rights transferred %

Step 5: Prepare journal entries
- Show clearly: Cash, ROU Asset, Asset derecognized, Lease liability, Gain

Mark Allocation Tips

Requirement	Typical Marks
IFRS 15 sale assessment	2-3 marks
Proportion calculations	3-4 marks
ROU asset calculation	2 marks
Gain calculation	2 marks
Journal entries	2-3 marks
Off-market adjustments	2-3 marks

Comprehensive Example

Question:

On 1 January 20X1, Seller Ltd sells its headquarters building to Buyer Ltd and simultaneously leases it back. Details:

	Amount
Carrying amount of building	R4,000,000
Fair value of building	R6,000,000
Sale price	R7,000,000
Leaseback term	8 years
Annual lease payment	R600,000
Market rent for similar property	R500,000
Discount rate	7%

The transaction qualifies as a sale under IFRS 15.

Required:

1. Calculate the gain to be recognized by Seller Ltd
2. Calculate the initial ROU asset
3. Prepare the journal entry at transaction date

Model Answer

```
Dr  Cash                                        7,000,000
Dr  Right-of-Use Asset                          1,990,400
    Cr  Building (carrying amount)                          4,000,000
    Cr  Lease Liability                                     2,985,650
    Cr  Financial Liability (above-market price)            1,000,000
    Cr  Gain on disposal (P/L)                              1,004,750*
```

? Previous: Part 4 - Lessor Accounting

Next: Part 6 - Disclosure Requirements & Exam Strategy ?

IFRS 16 Leases - Part 6: Disclosure Requirements & Exam Strategy

The Purpose of Lease Disclosures

Before diving into checklists, understand the objective:

> *IFRS 16.51: The objective is to disclose information that, together with information in the statement of financial position, statement of profit or loss, and statement of cash flows, gives a basis for users to assess the effect that leases have on the financial position, financial performance, and cash flows of the entity.*

In simpler terms: Users must be able to understand your leasing activity and its impact on your business.

This is why disclosures are NOT just a tick-box exercise-they require judgment about what's material and useful.

Part A: Lessee Disclosures

1. Amounts Recognized in Financial Statements

Statement of Financial Position

Disclose the following (either in the statement or notes):

Disclosure	IFRS 16 Reference
Right-of-use assets by class of underlying asset	Para 53(a)
Additions to ROU assets during the period	Para 53(h)
Carrying amount at end of period by asset class	Para 53(j)
Lease liabilities (separately from other liabiliti	Para 47

If ROU assets are NOT presented separately in the statement of financial position, the lessee must:
- Disclose which line items include ROU assets, AND
- Disclose the carrying amount by class

Example Presentation:

Right-of-Use Assets	Land & Buildings	Motor Vehicles	Equipment	Total
Balance 1 January	R4,500,000	R800,000	R350,000	R5,650,000
Additions	R1,200,000	R450,000	R100,000	R1,750,000
Depreciation	(R900,000)	(R300,000)	(R120,000)	(R1,320,000)
Balance 31 December	R4,800,000	R950,000	R330,000	R6,080,000

Statement of Profit or Loss

Disclosure	IFRS 16 Reference
Depreciation charge for ROU assets by class	Para 53(a)
Interest expense on lease liabilities	Para 53(b)
Expense for short-term leases (if not recognized a	Para 53(c)
Expense for low-value asset leases	Para 53(d)
Expense for variable lease payments NOT in liabili	Para 53(e)

Interest expense on lease liabilities is a finance cost, NOT part of depreciation. This affects subtotals like EBIT and EBITDA significantly.

2. Cash Flow Information

Disclosure	IFRS 16 Reference
Total cash outflow for leases	Para 53(g)
Classification: Interest in financing activities (	IAS 7
Classification: Principal in financing activities	IFRS 16.50(a)
Short-term and low-value: Operating activities	IFRS 16.50(b)

Impact on Cash Flow Statement:

Component	Classification	Impact

Interest on lease liability	Financing (typically)	Increases financing outflows
Principal repayment	Financing	Increases financing outflows
Short-term lease payments	Operating	Part of operating cash flows
Variable payments (not in liability)	Operating	Part of operating cash flows

3. Maturity Analysis

> *IFRS 16.58: A lessee shall disclose a maturity analysis of lease liabilities applying IFRS 7, separately from maturity analyses of other financial liabilities.*

Typical Format:

Maturity Period	Undiscounted Payments (R)
Within 1 year	1,200,000
1-2 years	1,200,000
2-3 years	1,200,000
3-4 years	1,200,000
4-5 years	1,200,000
More than 5 years	3,600,000
Total undiscounted payments	9,600,000
Less: Imputed interest	(1,850,000)
Present value (lease liability)	7,750,000

4. Additional Quantitative Disclosures

Disclosure	Purpose
Income from sub-leasing ROU assets	Para 53(f)
Gains/losses from sale-and-leaseback	Para 53(i)

5. Qualitative Disclosures

IFRS 16.59 requires disclosure of qualitative information to help users understand the entity's leasing activities:

Area	Examples

Nature of leasing activities	Types of assets leased, business purpose
Future cash outflows not reflected in measurement	Extension options, termination options, variable p
Restrictions or covenants	Lease agreements imposing restrictions
Sale-and-leaseback arrangements	Terms, reasons for transactions

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Part B: Lessor Disclosures

1. Finance Leases

Disclosure	IFRS 16 Reference
Selling profit or loss	Para 90(a)(i)
Finance income on net investment	Para 90(a)(ii)
Income on variable payments not included in net in	Para 90(a)(iii)
Qualitative and quantitative explanation of change	Para 93

Maturity Analysis (Net Investment in Lease):

Maturity Period	Undiscounted Payments (R)
Within 1 year	450,000
1-2 years	450,000
2-3 years	450,000
3-4 years	450,000
4-5 years	450,000
More than 5 years	-
Total undiscounted payments	2,250,000
Less: Unearned finance income	(275,000)
Net investment in lease	1,975,000

2. Operating Leases

Disclosure	IFRS 16 Reference

Lease income (separate disclosure of variable paym	Para 90(b)
Apply IAS 16 disclosures for underlying assets	Para 95

Maturity Analysis (Future Lease Receipts):

Disclose undiscounted future minimum lease receipts for each of the first five years, and a total for amounts thereafter.

3. Risk Management Disclosures

> *IFRS 16.92: A lessor shall disclose how it manages the risks associated with rights it retains in underlying assets.*

This includes:
- Strategies for asset residual value risk
- Use of residual value guarantees
- Buy-back arrangements

Part C: Special Disclosure Scenarios

Short-Term and Low-Value Leases (Lessee)

If the lessee applies the recognition exemptions:

Required Disclosure	Why Important
That the exemption has been applied	Transparency
The expense recognized	Comparability with lessees who don't apply exempti

> *Even if you apply the exemptions, you MUST disclose the expense. This allows users to understand the total leasing cost.*

Variable Lease Payments

Disclosure Requirement
Dependence on indices or rates
Dependence on sales/usage

Other variable payment dependencies
Reasons for variable payment structures

Extension and Termination Options

Disclose:
- How many leases contain such options
- The additional potential lease payments not included in the liability
- Management's strategy regarding option exercise

Residual Value Guarantees

For lessees:
- Expected payments under guarantees
- Amounts included in lease liability vs. contingent exposure

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Part D: Exam Strategy for IFRS 16

Understanding the Exam Landscape

IFRS 16 is a high-frequency topic at CTA, PGDA, and ITC levels because:

1. It combines conceptual understanding with calculations
2. It affects multiple financial statements
3. It intersects with other standards (IFRS 15, IAS 36, IAS 16)
4. Judgment is required (lease term, discount rate, modifications)

Typical Question Formats

Format	What's Tested	Typical Marks
Calculation-heavy	Lease liability/ROU asset measurement, sub	15-25 marks
Discussion	Classification, recognition principles, judgme	8-15 marks
Mixed	Calculations + explanations + journal entries	20-30 marks
Disclosure preparation	Prepare note disclosure	8-12 marks
Lessor questions	Classification, finance lease vs operating	10-15 marks

Sale-leaseback	Assess if sale occurred, calculate gain	12-18 marks

The Golden Framework for IFRS 16 Questions

Always follow this structure:

Step 1: Classification (If Required)

- For Lessor: Finance lease or operating lease?
- For Lessee: Standard treatment or exemption (short-term/low-value)?

Step 2: Initial Recognition

- What's included in the lease liability?
- What's the discount rate?
- What's included in the ROU asset?

Step 3: Subsequent Measurement

- Lease liability: Effective interest method
- ROU asset: Depreciation (plus impairment if applicable)
- Modifications: Separate lease or remeasurement?

Step 4: Presentation

- Statement of financial position placement
- Statement of profit or loss line items
- Cash flow statement classification

Step 5: Disclosure

- Key disclosure requirements for the scenario

Common Student Pitfalls (The "Bear Traps")

Pitfall	Correct Approach	Marks Lost
Using wrong discount rate	Implicit rate if determinable, otherwise lessee	2-4 marks
Including non-lease components in liability	Separate or use practical expedient; state yo	1-3 marks
Depreciating ROU asset over asset life	Depreciate over SHORTER of lease term an	2-3 marks
Ignoring lease incentives	Reduce ROU asset by incentives received	1-2 marks
Treating ALL variable payments as liability	Only in-substance fixed payments go in liabi	2-3 marks

Forgetting initial direct costs	Include in ROU asset for lessee	1-2 marks
Not reassessing lease term at modification	Modifications require full reassessment	2-4 marks
Accounting for lessor finance lease as opera	Apply classification tests carefully	4-6 marks

Exam Time Allocation Strategy

For a typical 20-mark IFRS 16 question:

Task	Suggested Time	Focus
Read and understand	3-4 minutes	Identify all relevant data
Plan your answer	2 minutes	Which aspects are tested?
Calculations	8-10 minutes	Show workings clearly
Journal entries	3-4 minutes	Labels, dates, amounts
Discussion/Theory	3-4 minutes	Link to principles

> *Never skip the reading phase. IFRS 16 questions often contain hidden information (e.g., "market rate for similar assets" hints at lessor classification, or "purchase option at below market" affects lease term).*

Maximizing Discussion Marks

When asked to discuss or explain, structure your answer:

1. State the principle (what does IFRS 16 say?)
2. Apply to the scenario (how does this apply here?)
3. Conclude (what's the accounting treatment?)

Example Structure:

> *"IFRS 16.18 requires the lease term to include periods covered by an extension option if the lessee is reasonably certain to exercise that option.*
> *In this scenario, Company X has a 5-year lease with a 3-year extension option. Given the specialized nature of the leasehold improvements (R2 million) and the below-market rentals in the extension period, it is reasonably certain that Company X will exercise the option.*
> *Therefore, the lease term should be 8 years, and the lease liability should include the extension period payments."*

Working Format Best Practice

Present calculations in a format markers can follow:

Lease Liability Calculation:

Component	R
Annual lease payment	120,000
Present value factor (6%, 5 years)	x 4.2124
PV of lease payments	505,488
Add: PV of guaranteed residual value	-
Add: PV of purchase option (if certain)	-
Initial lease liability	505,488

ROU Asset Calculation:

Component	R
Lease liability at commencement	505,488
Add: Initial direct costs	12,000
Add: Payments made before commencement	-
Add: Estimated dismantling costs	-
Less: Lease incentives received	(25,000)
Initial ROU asset	492,488

Lessor Classification: The Decision Tree

When facing a lessor question, use this structured approach:

```
Is there transfer of ownership at end of lease?
??? YES ? Finance Lease
??? NO ? Does lessee have purchase option at significantly below market?
          ??? YES ? Finance Lease
          ??? NO ? Is lease term for major part of economic life?
                    ??? YES ? Finance Lease
                    ??? NO ? Is PV of payments ? fair value of asset?
                              ??? YES ? Finance Lease
                              ??? NO ? Is asset specialized for lessee?
                                        ??? YES ? Finance Lease
                                        ??? NO ? Operating Lease
```

SA-Specific Considerations

Industry	Common Lease Scenarios
Retail	Store leases with turnover-based variable payments
Mining	Equipment leases, land rehabilitation obligations
Property	Investment property lessors, sub-lease arrangement
Manufacturing	Specialized equipment, sale-and-leaseback for cash
Transport	Fleet vehicle leases, aircraft leases

JSE Considerations:
- Listed companies face scrutiny on debt covenant impacts
- Analysts compare "EBITDA" carefully (add back depreciation, but not lease payments under old IAS 17)
- Disclosure quality affects analyst valuations

Part E: Comprehensive Exam-Style Question

Question

Retail Ltd enters into the following lease arrangement on 1 January 20X1:

Detail	Information
Underlying asset	Retail store in shopping mall
Lease term	5 years, with option to extend for 3 years
Annual lease payment	R600,000 payable at year end
Extension period payment	R500,000 per year
Retail Ltd's incremental borrowing rate	9%
Rate implicit in the lease	Not determinable
Fair value of store	R4,200,000
Economic life of store	40 years
Lease incentive received	R180,000 (fit-out contribution)
Initial direct costs	R45,000 (legal fees)

Additional information:
- Retail Ltd has invested R2.8 million in leasehold improvements
- The location is considered strategically important

- Retail Ltd has not previously exercised extension options on similar leases
- Mall landlords typically charge higher rentals for new tenants

Required:

(a) Determine the appropriate lease term, providing reasons for your conclusion. (5 marks)

(b) Calculate the initial lease liability and right-of-use asset. (8 marks)

(c) Prepare the lease liability table for the first 2 years. (4 marks)

(d) Prepare all journal entries for the year ended 31 December 20X1. (5 marks)

(e) List the disclosure requirements relevant to this lease. (3 marks)

Total: 25 marks

Model Answer

```
Dr  Right-of-Use Asset                          3,021,420
Dr  Cash (initial direct costs)                        -    (already in ROU)
    Cr  Lease Liability                                      3,156,420
    Cr  Cash (lease incentive received)                        180,000
    Cr  Cash (initial direct costs paid)                        45,000

Simplified:
Dr  Right-of-Use Asset                          3,021,420
Dr  Cash (incentive)                              180,000
    Cr  Lease Liability                                      3,156,420
    Cr  Cash (legal fees)                                       45,000
```

```
Dr  Finance cost                                  284,078
    Cr  Lease Liability                                        284,078
```

```
Dr  Lease Liability                               600,000
    Cr  Cash                                                   600,000
```

```
Dr  Depreciation expense                          377,678
    Cr  Accumulated depreciation - ROU asset               377,678
```

Summary: IFRS 16 Success Checklist

Element	Lessee	Lessor

Recognition	ROU asset + Lease liability	Net investment (finance) or Asset + income (operat
Measurement	PV of payments, IBR or implicit rate	PV of receivables + residual
Depreciation	Shorter of lease term or useful life	N/A (finance) or IAS 16 (operating)
Interest	Effective interest on liability	Effective interest on receivable
Modifications	Remeasure or separate lease	Remeasure or continue
Disclosures	Extensive - maturity, expenses, ROU	Net investment, income, risk

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Key Takeaways

1. IFRS 16 transforms lessee accounting - Nearly all leases go on balance sheet
2. Disclosure is about usefulness - Not just ticking boxes
3. Judgment areas attract marks - Lease term, discount rate, modifications
4. Show your workings - Clear calculations earn marks even if the final answer is wrong
5. Connect to other standards - IFRS 15 (sale-leaseback), IAS 36 (impairment), IFRS 9 (lessor derecognition)

? Previous: Part 5 - Sale-and-Leaseback Transactions

? Continue to: IFRS 15 Revenue from Contracts with Customers