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IFRS 16 *Leases* Marks A New Era Of Accounting – Paving The Way For Intangible Asset Recognition On The Financial Statements

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LEASES ROADMAP – A Right-To-Use an asset or a contract for services that is provided using the asset?

Leases Roadmap

Roadblock 1: Is there an identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 1A**.

Roadblock 1A: Does the supplier have substantive asset substitution rights? If YES, the journey ends. If NO, proceed to **Roadblock 2**.

Roadblock 2: Does the customer have the right to control the use of the identified asset? If YES, the contract contains a lease.

Roadblock 2A: Does the customer have the right to obtain "substantially all" of the economic benefits from the use of the identified asset? If NO, the journey ends. If YES, proceed to **Roadblock 2B**.

Roadblock 2B: Does the customer have the right to direct the use of the identified asset? If NO, the journey ends. If YES, the contract contains a lease.

Roadblock 2B(i): Does the customer have the right to direct how and for what purpose the asset is used throughout the period of use? If YES, the contract contains a lease. If NO, consider **Roadblock 2B(ii)**.

Roadblock 2B(ii): Are the relevant decisions about how and for what purpose the asset is used predetermined? If YES, (i) does the customer have the right to operate the identified asset throughout the period of use without the supplier having the right to change those operating instructions, or (ii) did the customer design the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use? If YES to either (i) or (ii), the customer can still direct the use of the asset and hence, the contract contains a lease.

The last of the BIG three accounting standards

IFRS 16 Leases is the last of the BIG three accounting standards issued by the International Accounting Standards Board ("IASB" or the "Board") that was effective in 2019. The other two were IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*, which became effective a year earlier in 2018. Five years on and the accountancy fraternity does seem to have adapted well to a number of new and revolutionary accounting concepts.

Leases is a topic that I find intriguing from a conceptual viewpoint. It is the first accounting standard to recognise intangible contractual rights and intangible contractual obligations from executory contracts as assets and liabilities on the balance sheet. As of today, except for onerous contracts, contractual rights or obligations to receive or deliver goods and services in the future from executory contracts are not recognised in the financial statements.

I had written numerous articles on leases prior to its effective date and those articles along with other materials related to leases can be found on the Leases (isca.org.) webpage. Do avail yourself to these materials especially to the Leases Roadmap that I first introduced in the article titled *IFRS 16: Leases – Ready for the demand of today*, published in the March 2016 ISCA Journal.

More recently, I have written an article on sale and leaseback arrangements Sale and Leaseback Arrangements and spoke on that topic at a **CLA Global TS *Financial Reporting for Preparers* ("FRfP") webinar** and at the October 2023 ISCA Breakfast Talk.

This article is both a light refresher on leases and a heavier critical assessment of accounting's role as the language of business.

Two decades development of IFRS 16

IFRS Project History [IFRS - Leases](https://www.ifrs.org)

A bird's-eye view of the two decades of IFRS 16 development

The development of IFRS 16 Leases spanned twenty years from1996 to its issuance in 2016. It probably holds the record for an accounting standard by the IASB with the longest development period, surpassing the twelve years it took to develop IFRS 15 *Revenue from Contracts with Customer*.

When reading a book, I sometimes read the first chapter and then jump to the last chapter before reading what's in between to get a bird's-eye perspective without necessarily enduring the rigamarole. I will attempt to pen down the story of leases from a similar vantage point.

The beginning – July 1996 Special Report – Accounting for Leases: A New Approach

The IASB's leases journey started with Warren McGregor's Special Report on A New Approach to Accounting for Leases. The Special Report received contributions from a working group consisting of Board members and senior staff members of the standard-setting bodies of Australia, Canada, New Zealand, the United Kingdom, and the United States of America, and staff of the International Accounting Standards Committee (IASC).

How were lease accounting standards prior to IFRS 16 unsatisfactory?

The Special Report said that the most frequently noted concern relates to the fact that the standards do not require rights and obligations arising under operating leases to be recognised as assets and liabilities in the lessee's financial statements. The standards have promoted the structuring of financial arrangements so as to meet the conditions for classifications as an operating lease. The ability to achieve off-balance-sheet treatment under current lease accounting standards detracts from the comparability and usefulness of financial statements.

What was the root cause of the issue?

To answer this, one must look back to the time prior to the existence of any lease accounting standards (prior to IAS 17 Leases), where rights and obligations arising from a lease were not recognised as assets and liabilities on the financial statements of lessees. The Special Report explained that back then, accounting practices were largely driven by consideration relating to **legal ownership of the physical assets** rather than the **legal ownership of a "right to use"**.

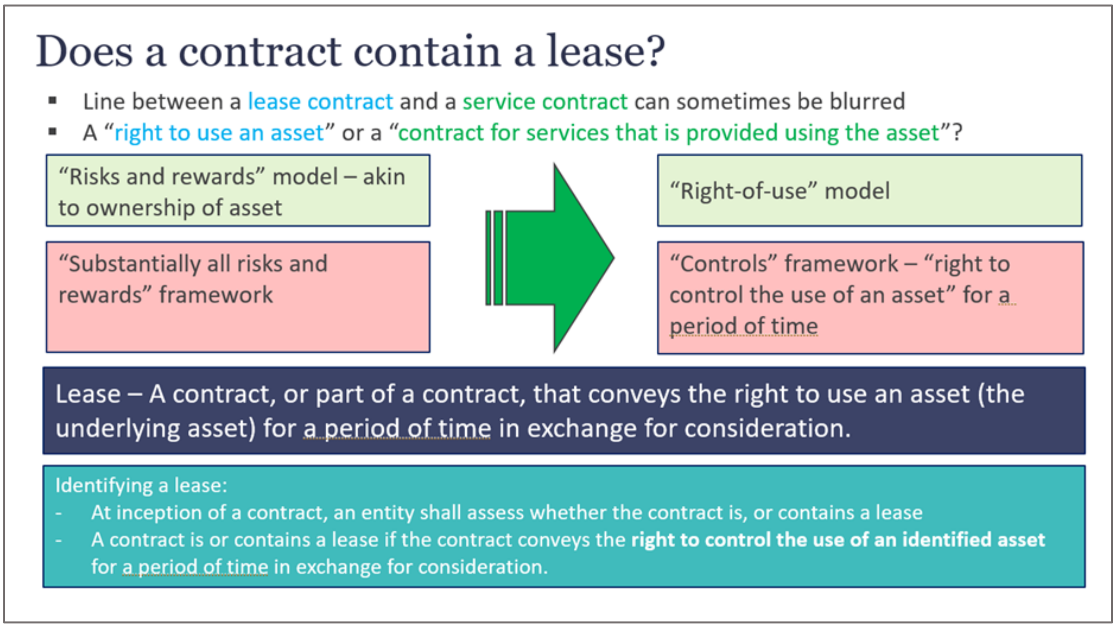
And similarly, liabilities were amounts legally owed to others. Hence the "**ownership view**" was conceived and gave rise to the accounting practice of recognising only rental expenses from lease contracts.

In addition, the Special Report explained that most leases were regarded as examples of executory contracts, or contracts "equally proportionately unperformed". Generally, assets and liabilities arising from executory contracts are not recognised in the balance sheet.

What is the proposed New Approach?

The New Approach calls for all material rights and obligations arising under lease contracts which meet the conceptual framework definitions of assets and liabilities to be recognised as assets and liabilities on the financial statements of lessees.

From ‘Legal Ownership View’ to ‘Risks and Rewards Model’ to ‘Right-Of-Use Model’



Conceptual hurdles are difficult to overcome

Deeply entrenched conceptual hurdles are very difficult but not impossible to overcome, as can be seen with the successful development of IFRS 16. For the lessee, we have moved on from **Legal Ownership View** to IAS 17’s **Risks and Rewards Model** incidental to ownership, which requires an economic substance determination of whether substantially all the risks and rewards incidental to ownership has passed on to a lessee. And finally, to IFRS 16’s **Right-Of-Use Model**, as first proposed by the Special Report in 1996.

Why are the concepts in IFRS 16 revolutionary to the accounting world?

- It is the first accounting standard to recognise an asset based on a right to control the use of an identified asset (see **Roadblock 2**);
- It replaced the long-entrenched “risks and rewards of ownership” requirement for asset recognition with the “controls” framework, consistent with the conceptual framework definition of an asset;

- It introduces the concept of "substantially all of the economic benefits from the use of an identified asset" as a first condition (see **Roadblock 2A**) to determining whether there is a right to control the use of an identified asset (see **Roadblock 2**);
- It expounds on "the right to control the use of an identified asset" (see **Roadblock 2**) with "the right to direct the use of the identified asset" (see **Roadblock 2B**) and "the right to direct how and for what purpose the asset is used" (see **Roadblock 2B(i)**); and
- It defies conventional norm by recognising assets and liabilities from executory contracts.

Numbers do not lie – but can they?

I have shared at length about recognition of leases assets and liabilities on the balance sheet. The measurement of these assets and liabilities at commencement date would equal the present value of future lease payments. This do not usually pose an issue because these future lease payments would be stipulated in the lease contract.

However, the same cannot be said for most internally generated intangibles which although meets the definition of an asset in the conceptual framework, are not recognised on the balance sheet. You may wonder how this is so in today's digital and technology economy where much value has moved from physical assets to intangibles.

The balance sheet dilemma – to allow recognition of internally generated intangibles?

Ms Indranee Rajah, Minister in the Prime Minister's Office, and Second Minister for Finance and National Development recently launched the **Intangibles Disclosure Framework (IDF)** at the IP Week 2023 Celebratory Dinner on 4 September 2023. This brings me back to the 10th Annual Asian-Oceanian Standard-Setters Group (AOSSG) meeting in November 2018 whereby she delivered the keynote address.

At that 2018 AOSSG meeting, the chairman of ISCA Financial Reporting Committee ("FRC") discussed the balance sheet dilemma with the AOSSG and questioned whether reconsideration of the current financial reporting standards is required to maintain its value proposition. He highlighted that "*with the growth of digital companies and their increasing market capitalisation, investors are relying more on Non-Generally Accepted Accounting Principles (Non-GAAP) measures to value such companies. Unlike traditional businesses, much of the value of digital companies lie in volatile intangibles which, under existing accounting standards, would fail to be capitalised as assets on the financial statements*".

This conversation continued into the panel discussion at the ASC-ISCA Financial Reporting Technical Forum on 23 November 2018. The theme at that panel discussion was *Performance Reporting and the Digital Era*, and featured panellist Hans Hoogervorst, the then chairman of the IASB. Questions asked included:

- Are financial statements still able to appropriately capture and communicate the value of digital companies?
- In the era where the value of digital companies lies in non-physical assets, unlike traditional brick-and-mortar companies, are financial statements still painting the right picture with the current financial reporting standards.

The panellists at that panel acknowledged that "*financial statements currently do not provide the complete picture as the value of non-physical assets are not recognised on the balance sheet and investors do rely on non-GAAP performance measures to value such digital companies*".

Closing Remarks

The world has changed at an accelerated rate since the advent of the digital era. So too has economies and businesses. Accounting if it is to retain its coveted place as the language of business, needs to expand its accounting rules and vocabulary to recognise the "new intangible" assets in the digital era and to better communicate the performance of such businesses. This needs to happen quickly because we cannot afford another two decades wait.

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