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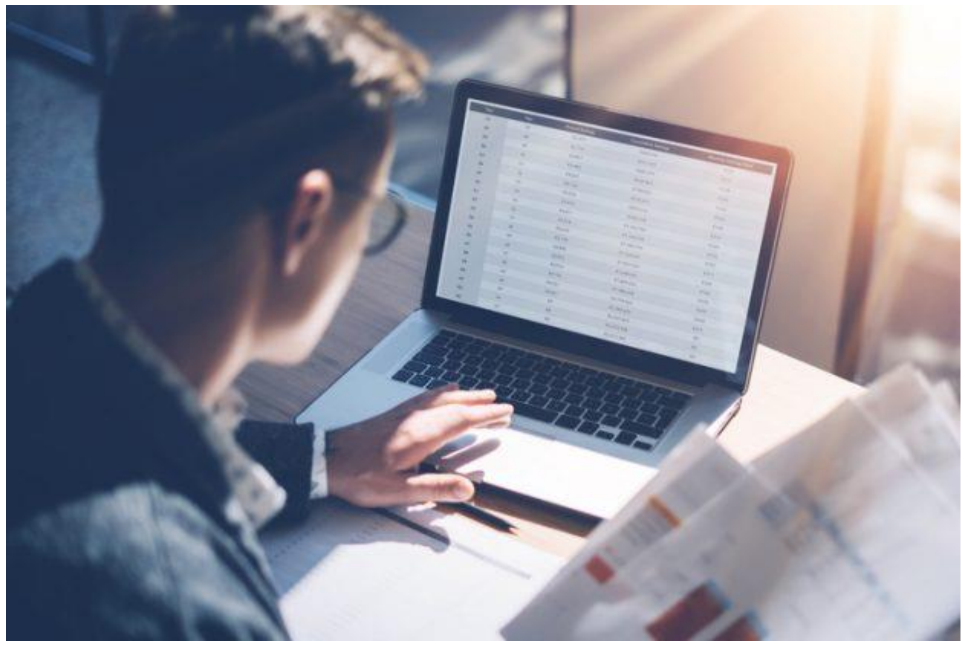


In this issue:

Philippine Financial Reporting Standard 16 Leases (PFRS 16) sets out the principles for the recognition, measurement, presentation and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the entity.

R.S. BERNALDO & ASSOCIATES

TAKING YOU FURTHER

Philippine Financial Reporting Standards 16 Leases (PFRS 16)

Overview:

The new standard is issued on January 13, 2016. It replaces all previous PFRS provisions on lease accounting (PAS 17, SIC 15, SIC 27 and IFRIC 4). PFRS 16 is effective for annual periods **beginning on or after 1 January 2019.** Earlier application is permitted for entities that apply PFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of PFRS 16.

What changes can we expect?

	PAS 17	PFRS 16
Lessee Accounting	Rental expense is recognized in ***Profit or Loss***	Recognize a ***Right-Of-Use Asset*** and a ***Lease liability*** for all leases with a term of more than 12 months, unless the underlying asset is of low value.
Expense at Year end	In the form of ***rent expense***	In the form of ***depreciation expense*** related to the ROU Asset and ***Interest expense*** related to the lease liability
Lessor Accounting	Classifies the lease as **finance lease** if substantially all of the risks and rewards incidental to ownership of the leased asset have been transferred to the lessee, otherwise	Essentially unchanged

With the new standard on Leases, the lessee will be required to recognize the majority of leases in its balance sheet. Lessor accounting will remain essentially unchanged. Lastly, disclosure requirements will increase significantly.

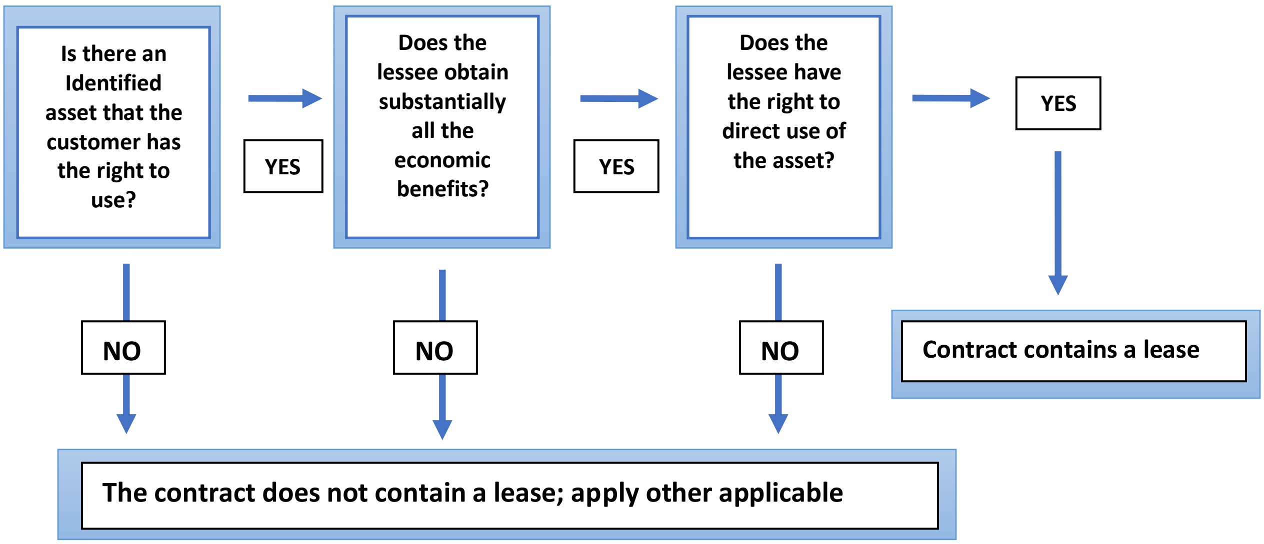
I. Identifying a Lease

➢ Assessment of whether a contract contains a lease or not

All of the following criteria must be met for a contract to contain a lease.

a) There is an identified asset that the customer has the right to use.
b) The lessee obtains substantially all the economic benefits.
c) The lessee has the right to direct the use of the asset.

➢ Determining Whether an Arrangement Contains a Lease Identified Asset



- The Lease Identified Asset must be explicitly or implicitly identified in the contract.
- There must be no substitution rights, meaning there is no practical ability to substitute the asset.
- The Leased Asset must be physically distinct.

➢ Separating Components of a Contract into Lease and Non-Lease

For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract.

❖ Lessee

Allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

The **relative stand-alone price of lease and non-lease components** shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If not readily available, the lessee shall estimate the stand-alone price, maximizing the use of observable information.

❖ Lessor

Allocate the consideration in the contract applying paragraphs 73–90 of PFRS 15.

II. Lease Term

An entity shall determine the lease term by considering the following:

a. non-cancellable period of a lease;
b. periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
c. periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

III. Lessee Accounting

➢ Recognition

At the commencement date, a lessee is required to recognize assets and liabilities for all leases with a term of **more than 12 months**, **unless the underlying asset is of low value.**

➢ Initial Measurement

❖ Right of Use Asset

At the commencement date, a lessee shall measure the right-of-use asset at cost.

The **cost of the right-of-use asset** shall comprise:

- initial measurement of Lease Liability;
- any lease payments made at or before the commencement date, less any lease incentives received;
- any initial direct costs incurred by the lessee; and
- estimated dismantling/restoration cost.

❖ Lease liability

- **Present value of lease payments that are not paid at that date** (using interest rate implicit in the lease, or if not readily determinable, lessee's incremental borrowing rate)

  Lease Payments that are not paid at the commencement date includes the following:

  - fixed payments;
  - exercise price of a purchase option **only if the lessee is reasonably certain to exercise**;
  - amounts expected to be payable by the lessee under **residual value guarantees**;
  - **variable lease payments** that depend on an index or a rate; and
  - payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Subsequent Measurement

Right-of-Use Asset

After the commencement date, a lessee shall measure the right-of-use asset applying a **cost model**, unless it applies either of the other measurement models.

Measurement models

a) Cost model

Measure the right-of-use asset **at cost** less any accumulated depreciation and any accumulated impairment losses and adjusted for any remeasurement of the lease liability.

b) Fair Value Model

If a lessee applies the fair value model in PAS 40 *Investment Property* to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in PAS 40.

c) Revaluation model

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in PAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

Lease liability

After the commencement date, a lessee shall measure the lease liability by:

a) increasing the carrying amount to reflect interest on the lease liability;
b) reducing the carrying amount to reflect the lease payments made; and
c) remeasuring the carrying amount to reflect any reassessment or lease modifications or to reflect revised in-substance fixed lease payments.

Presentation

Right-of-use asset

The **Right-of-use asset** can be presented in the Statement of Financial Position or disclose in the notes separately from other assets or under the same line item where it would be presented as if the asset is owned. Disclose in which line items in the statement of financial position include those right-of-use assets or presented as investment property if it meets the definition of an investment property

Lease Liability

The lease liability can be presented as a separate line item or disclose on which line item in the liabilities section of the Statement of Financial Position it is included.

➢ *Disclosure Requirements*

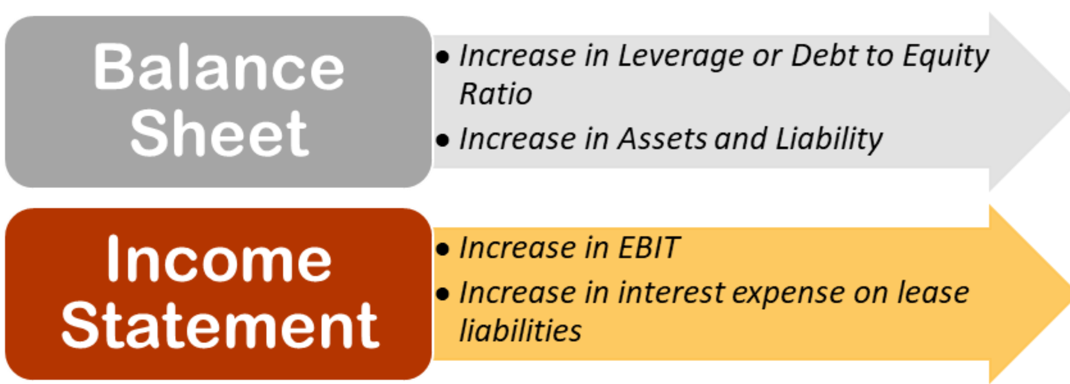
A lessee shall disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements.

The lessee shall **disclose** the following:

- ✓ depreciation charge for right-of-use assets by class of underlying asset;
- ✓ interest expense on lease liabilities;
- ✓ the expense relating to short-term leases accounted for applying paragraph 6. This expense need not include the expense relating to leases with a lease term of one month or less;
- ✓ the expense relating to leases of low-value assets accounted for applying paragraph 6. This expense shall not include the expense relating to short-term leases of low-value assets
- ✓ the expense relating to variable lease payments not included in the measurement of lease liabilities;
- ✓ income from subleasing right-of-use assets;
- ✓ total cash outflow for leases;
- ✓ additions to right-of-use assets;
- ✓ gains or losses arising from sale and leaseback transactions; and
- ✓ the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

➢ *Impact on Financial Metrics*

Most commonly used financial ratios and performance metrics will be impacted, such as debt to equity ratio, current ratio, asset turnover, interest cover, EBIT, operating profit, net income.



➢ *Tax Implications*

The rules remain unchanged for tax purposes.

- For **income tax** purposes, the lessee may deduct the amount of rent paid or accrued from gross income, including all expenses under the lease agreement which the lessee is required to pay to or for the account of the lessor. The difference between the rent expense and the sum of depreciation expense and interest expense is treated as future deductible expense and a deferred tax asset is recognized.

- For **Value-Added Tax (VAT)** purposes, the monthly payments to the lessor are reported monthly since this is subject to VAT upon payment, and not at the inception of the lease.

- For **withholding tax** purposes, the transaction remains a lease, which is subject to a 5% withholding tax.

➢ *Transition Accounting and Effective Date*

The **effective date of PFRS 16 Leases is 1 January 2019**. Early application is permitted but it can't be applied before an entity that also adopts IFRS 15 Revenue from Contracts with Customers.

There are two methods to adopt the new leases standard. A lessee may choose between full retrospective approach or a modified retrospective approach. The selected approach has to be applied to the entire lease portfolio.

❖ Full Retrospective Approach

The transition accounting under the full retrospective approach requires entities to retrospectively apply the new standard to each prior reporting period presented as required by PAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Under this transition approach, entities need to adjust its equity **at the beginning of the earliest comparative period presented.**

❖ Modified Retrospective Approach

Under this approach, a lessee does not restate comparative information. The date of initial application is the first day of the annual reporting period in which a lessee first applies the requirements of the new lease standard. At the date of initial application of the new lease standard, lessees recognize the cumulative effect of initial application as an **adjustment to the opening balance of equity as of 1 January 2019**. Comparative figures for the year ended December 31, 2018 are **not restated** to reflect the adoption of PFRS 16 but instead continue to reflect the lessee's accounting policies under PAS 17 *Leases.*

IV. Lessor Accounting

PFRS 16 substantially carries forward the lessor accounting requirements in PAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently.

V. Steps to consider in Transition to PFRS 16

At year-end or before the start of the audit, the following are the steps needed to be taken into consideration to assess the impact of PFRS 16.

1. Review all lease contracts entered into by the Company as of December 31, 2019 with lease term of more than twelve (12) months.
2. Assess whether the contract qualifies as a lease.
3. Compute for the right-of-use asset and lease liability to be recognized and provide amortization for the lease liability.
4. Calculate the deferred tax asset to be recognized at year-end.
5. Consider the pro-forma journal entries for the application of standard as well as for the restatement of opening balances.

VI. Sample Problem

We provided a sample problem in relation to PFRS 16 Leases with the corresponding pro-forma entries and restatement entries. See attached file *(**Annex A**)* for your reference.

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