Accounting news
Deloitte Czech Republic

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Statement of Changes in Equity

The amendment to the Accounting Act effective from 1 January 2016 brought about, inter alia, a change in the definition of financial statement components. While through the end of 2015, Section 18 (1) of the Accounting Act stipulated that the financial statements may also include a statement of cash flows or a statement of changes in equity, since 1 January 2016, the guidance provided on this area in Section 18 (2) has been as follows: “The financial statements of business companies also include a statement of cash flows and a statement of changes in equity. Small and micro reporting entities are not obliged to prepare a statement of cash flows and a statement of changes in equity.” The implication is that medium sized and large reporting entities are newly required to prepare and present both statements.

This article will deal with the statement of changes in equity. We addressed the preparation of the statement of cash flows in significant detail in our Accounting News published in May and June 2014.

Importancy of the Statement of Changes in Equity

The statement of changes in equity contains significant information for users of financial statements relating to the reasons underlying changes in equity for the reporting period. In essence, these reasons may be divided into two groups as follows:

a) Transactions with owners, eg:
   - Changes in share capital;
   - Allocation of profit (allocations to funds, profit share payment);
   - Purchase of own shares; and
   - Contributions or withdrawals outside the share capital balance.

b) Other transactions such as:
   - Revaluation of assets (equity accounting, available-for-sale securities);
   - Reversal of revalued assets;
   - Changes in methods;
   - Corrections of prior years’ errors; and
   - Impacts of corporate transformations (mergers).

Structure of the Statement of Changes in Equity

The format and structure of the statement of changes in equity are not defined in the Czech accounting regulations for businesses. No change was made as a result of the adoption of the amended Accounting Act and Regulation No. 500/2002, which have been in effect since 1 January 2016. So, the only guidance can be found in Section 3 of the Regulation indicating that the statement of changes in equity is a breakdown of the balance sheet line item A "Equity" and provides information about the categorisation of its items that present the overall changes in equity for the period. Section 44 of the Regulation only provides additional details to the effect that the statement of changes in equity provides information about increases or decreases in individual equity components between two balance sheet dates. Reporting entities shall calculate profit shares paid and funds which were drawn.

Due to the absence of detailed guidance and given that the format and structure of statements of changes in equity markedly differ in practice, the National Accounting Council issued Interpretation I-32 – Structure and Content of the Statement of Changes in Equity in September 2015.
Set out below is the brief summary of key points of the Interpretation.

- The statement takes the tabular form.

- **Columns** represent individual parts of equity (the same as in the balance sheet):
  - Zero lines from the balance sheet are not presented, immaterial balance sheet lines under the same total line can be aggregated.
  - The following items can be aggregated into one single item “Accumulated profit or loss”:
    - Retained earnings;
    - Other profit or loss of prior years; and
    - Profit or loss for the period (including a profit share prepayment).
  - The last column presents the overall impact of transactions in equity.

- **Lines** represent transactions changing the equity amount or structure:
  - Transactions are divided into capital transactions with owners and other transactions.
  - Transactions can be aggregated in terms of materiality and similar nature.
  - Tax effect – in aggregate for all transactions or jointly with the transaction (disclose the tax effect in the notes to the financial statements if it is material). The Interpretation prefers the gross method of reflecting tax effects, i.e., the treatment where the statement separately shows, for example, the revaluation of available-for-sale securities as a result of the change in their fair value and the tax effect of the revaluation.
  - The statement shows transactions for the current period and for as many comparative periods as reported in the other statements included in the financial statements.
  - The opening balances are also presented in individual columns in respect of the oldest comparative period.

- **Errors and changes in methods**:
  - Comparative balances always include amounts that were presented in the original (prior year) set of financial statements.
  - Corrections of errors and changes in methods are presented as separate transactions.
  - If the corrections of errors or changes in methods change the opening balances of the oldest presented comparative period, the following needs to be presented:
    - Original opening balances (before the correction);
    - The correction; and
    - The new balance after the correction.

- **Transformations of business companies and cooperatives**:
  - If the closing balances and opening balances differ, the change is presented as a transaction and the new opening balance is presented.
  - Transformations are presented separately in the statements, at the turn of two reporting periods.
- **Consolidated financial statements:**
  - The statement should include a description of transactions that changed the amount of minority interests in equity.
  - Given that the Czech accounting regulations do not designate these interests as part of equity, it is at the reporting entity’s discretion to decide whether it will explain these changes separately in the notes to the financial statements or whether it will present them, for the sake of clarity or efficiency, as a separate column behind the “total” column.

The National Accounting Council’s Interpretation also contains an illustrative example of the statement of changes in equity, but it does not serve as a model template.

For the full wording of the Interpretation please refer to [www.nur.cz](http://www.nur.cz) or [here](http://www.nur.cz).

**Conclusion**

It is typical for the statement of changes in equity that its lines and columns change depending on the specific transactions realised by the entity. The format of the statement will thus differ among entities or among individual financial statements of the same entity.

A model statement of changes in equity, jointly with the model balance sheet, profit and loss account and statement of cash flows for the year ending 31 December 2016, can be found at [www.deloitte.cz](http://www.deloitte.cz) or [here](http://www.deloitte.cz).
Practical impacts of the new IFRS 16 ‘Leases’

In January 2016, the International Accounting Standards Board (IASB) published a new standard, IFRS 16 Leases. The new Standard provides a comprehensive model for the identification of lease arrangements and their treatment in the financial statements of both lessees and lessors. It supersedes IAS 17 Leases and its associated interpretative guidance.

In the March issue of the Accounting News, we focused on the history of the leases project and the most significant requirements of the new standard, namely its scope, definition of leases, treatment of leases in the financial statements of both the lessee and lessor, effective date of the standard and its transitory provisions. This issue of the Accounting News deals with practical impacts of the new standard. Given that IFRS 16 has not introduced significant changes in the accounting requirements for lessors, we will predominantly focus on the impacts of the new standard on lessees.

We note that the project of developing the new standard on leases was implemented as a joint project with the Financial Accounting Standards Board (FASB). The FASB issued its new leases standard, ASU 2016-02 on 25 February 2016. There are some notable differences between both standards. These differences are mentioned in the article in the US GAAP section of this issue of the Accounting news.

Definition of the lease
At first sight, the new definition of lease seems to be consistent with the current definition:

• IAS 17: “A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.”

• IFRS 16: “A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.”

The IFRS 16 Application guidance, however, provides detailed instructions and illustrative examples on applying the definition, indicating that the definition under IFRS 16 differs in some aspects from the current definition under IAS 17. Primarily, it will be more difficult to assess in practice what makes a lease asset an “identified asset” and differentiate a lease from a service contract on the basis of whether the customer has the right to control the use of an identified asset. It is therefore possible that IFRS 16 will exclude from its scope a number of service contracts that were considered to be leases under IAS 17. On the other hand, it is unlikely that contracts that do not meet the definition of leases under IAS 17 would be considered leases pursuant to IFRS 16.

In contrast to IAS 17, IFRS 16 also contains detailed instructions for assessing combinations of contracts and separating individual components of contracts. This may be interesting for lessees who will enter a lease agreement including both lease and non-lease components.

Upon the first application of IFRS 16, companies may use a practical expedient when it is not required to reassess whether existing contracts that the company has already recognised contain a lease under IFRS 16.

Lessor accounting
IFRS 16 does not introduce significant changes in lessor accounting. Lessors will continue to classify leases as either finance leases or operating leases in line with IFRS 16 and account for those two types of leases as applying IAS 17. Nevertheless, there are several minor differences primarily related to:

• Applying the new definition of lease by lessors;
• Sale and leaseback transactions;
• Subleases; and
• Modification of leases.
IFRS 16 also requires a lessor to disclose additional information about how it manages the risks related to its residual interest in assets subject to leases.

**Lessee accounting**

**Lessee accounting requirements according to IAS 17**

IAS 17 focuses on identifying when a lease is economically similar to purchasing the asset being leased. When a lessee determines, using the criteria defined in the standard that the lease is economically similar to purchasing the underlying asset, the lease is classified as a finance lease and reported on a company’s balance sheet. All other leases are classified as operating leases and not reported on the company’s statement of financial position (the so-called “off balance sheet leases”). Off balance sheet leases are accounted for similarly to service contracts, with the company reporting a rental expense in the statement of profit or loss (typically on a straight-line basis, i.e., the same amount in each period of the lease).

**Lessee accounting requirements according to IFRS 16**

IFRS 16 eliminates the requirement for lessees to classify leases as either operating leases or finance leases. Instead, all leases are treated in a similar way to finance leases applying IAS 17.

**Former off balance sheet leases (operating leases)**

IFRS 16 substantially changes the accounting for off balance sheet leases applying IAS 17. Upon the application of IFRS 16, lessees are required to:

a) Recognise lease assets (right of use assets) and lease liabilities in the statement of financial position;

b) Recognise depreciation of lease assets and interest on lease liabilities in the statement of profit or loss over the lease term; and

c) Present the amount of cash paid for the principal portion of the lease liability within financing activities, and the amount paid for interest portion within either operating or financing activities in the cash flow statement.

This model is based on the concept that a lease contract is economically similar to purchasing the right to use an asset with the acquisition cost paid in instalments.

**Former on balance sheet leases (finance leases)**

IFRS 16 does not change substantially the accounting for finance leases in IAS 17. The main difference relates to the treatment of residual value guarantees provided by a lessee to a lessor. IFRS 16 requires that the company recognise only amounts expected to be payable under residual value guarantees rather than the maximum amount guaranteed as required by IAS 17.

**Recognition exemptions**

Instead of applying the recognition requirements of IFRS 16 described above, a lessee may elect to account for lease payments as an expense on a straight-line basis over the lease term or another systematic basis for the following two types of leases:

- **Leases with a lease term of 12 months or less** and containing no purchase options – this election is made by class of underlying asset; and

- **Leases where the underlying asset has a low value** when new (such as personal computers or small items of office furniture) – this election can be made on a lease-by-lease basis. The ‘low value’ exception only applies to leased assets that are not highly dependent on, or
highly interrelated with, other assets. The standard does not specify any limit within which the value of an asset would be considered low.

If these leases were accounted for as operating leases under IAS 17, the accounting principle would remain unchanged.

- Disclosure of information on leases
  Disclosure requirements for lessees pursuant to IFRS 16 are more stringent than those under IAS 17. It is therefore likely that gaining and processing the necessary data will take a longer period of time.

Impact on a lessee’s statement of financial position
The most significant impact of the new requirements will be an increase in lease assets and financial liabilities for companies with a large volume of operating leases (ie off balance sheet leases).

The change is likely to have the most substantial effect on companies operating in:
- Aviation (eg lease of airplanes);
- Retail (lease of selling and warehousing premises); and
- Tourism, leisure and transportation (lease of premises or transportation vehicles).

A decrease in equity will also be seen over the lease term because the residual value of leased assets (as a result of depreciation on a straight-line basis) will decrease faster than the residual value of lease liabilities (the value of which will drop as lease payments are made but it will concurrently increase due to interest). The overall impact on equity will depend on the composition of the lease portfolio.

Impact on a lessee’s statement of profit or loss
For companies with material off balance sheet leases, IFRS 16 changes the nature of expenses related to those leases. IFRS 16 replaces the straight-line operating lease expense (recognised in the operating expenses) for those leases applying IAS 17 with:
- A depreciation charge for the lease asset (included within operating expenses); and
- An interest expense on the lease liability (included within finance expenses).

This change aligns the lease expense treatment for all leases, as indicated in the table below.
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### Impact of IFRS 16 on the lessee’s cash flow statement

<table>
<thead>
<tr>
<th></th>
<th>IAS 17</th>
<th>IFRS 16</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Finance leases</td>
<td>Operating leases</td>
</tr>
<tr>
<td>Revenue</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Operating expenses (without depreciation and amortisation)</td>
<td>---</td>
<td>Single expense</td>
</tr>
<tr>
<td>EBITDA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
<td>Depreciation</td>
<td>---</td>
</tr>
<tr>
<td>Operating profit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance costs</td>
<td>Interest</td>
<td>---</td>
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<tr>
<td>Profit before tax</td>
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</tbody>
</table>

There will also be a change in the expenses recognised over the lease term. Although the depreciation charge is typically even, the interest expense reduces over the life of the lease as lease payments are made.

**Impact of IFRS 16 on the lessee’s cash flow statement**

In terms of accounting for operating lease under IAS 17, related cash flows are recognised in the cash flow statement under operating activities. By applying IFRS 16, a company is required to classify cash flows related to lease into two parts:

- Payment of a portion of principal — recognised as part of financing activities; and
- Interest — recognised as part of operating or financing activity (based on the lessee’s accounting principles).

Payments of short-term and low-value leases will be recognised as part of operating activity.
Change in financial indicators
IFRS 16 will give additional insight into the company’s assets and liabilities and improve comparability between companies that lease assets and companies that borrow financial resources to buy assets.

For companies with material off balance sheet leases, there will be a change in key financial metrics derived from the company’s reported assets, liabilities and profit, such as:

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Calculation</th>
<th>Anticipated effect of IFRS 16</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leverage</td>
<td>Liabilities/equity</td>
<td>Increase</td>
<td>Increase in liabilities and decrease in equity, if any</td>
</tr>
<tr>
<td>Asset turnover</td>
<td>Sales/assets</td>
<td>Decrease</td>
<td>Increase in assets</td>
</tr>
<tr>
<td>Current ratio</td>
<td>Current assets / Short-term liabilities</td>
<td>Decrease</td>
<td>Increase in liabilities</td>
</tr>
<tr>
<td>EBIT</td>
<td>Profit before interest and tax</td>
<td>Increase</td>
<td>Excluding interest – pursuant to IAS 17, the entire paid rental for operating lease is part of operating profit</td>
</tr>
<tr>
<td>EBITBA</td>
<td>Profit before interest, tax, depreciation and amortisation</td>
<td>Increase</td>
<td>Excluding interest and depreciation of an asset – pursuant to IAS 17, the entire paid rental for operating lease is part of operating profit</td>
</tr>
<tr>
<td>Operating cashflow</td>
<td></td>
<td>Increase</td>
<td>A portion of cash flows is transferred to financing activities</td>
</tr>
<tr>
<td>ROCE</td>
<td>EBIT/payables + equity</td>
<td>?</td>
<td>Depends on the composition of the lease portfolio (increase in EBIT and payables)</td>
</tr>
</tbody>
</table>

A change in values of some indicators included in the table above may affect the remuneration system of employees and management as well as the dividend policy in a number of companies.

Effective date and transition
The Standard is applicable for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply IFRS 15 Revenue from Contracts with Customers at or before the date of initial application of this Standard.
Some companies may find attractive the possibility of applying IFRS 15 and IFRS 16 along with IFRS 9 Financial Instruments already from 1 January 2018 (ie the effective date of IFRS 9 and IFS 15). For example, for a lessor that will be required to reassess its concluded multi-component contracts in view of IFRS 9 and IFRS 15 as of 1 January 2018 and subsequently with regard to IFRS 16 as of 1 January 2019, it will be more appropriate to adopt all of these standards at the same time.

A lessee can apply this Standard either by a full retrospective approach or a modified retrospective approach. If the latter approach is selected, an entity is not required to restate the comparative information and the cumulative effect of initially applying this Standard must be presented as an adjustment to the opening balance of retained earnings (or other component of equity as appropriate).

Implementing the new Lease Standard
The IASB set the effective date on 1 January 2019 with the consideration of the time and cost that will be involved in implementing the new Standard. This time allows entities to consider the effects of IFRS 16 for example in respect of:

- Changes needed to its systems and processes; for example to track leases individually or at portfolio level and to perform calculations;
- Judgements required particularly in respect of the definition of a lease and in the assessment of the lease term;
- Any potential tax impacts if the treatment of a lease for tax purposes is based on its treatment in financial statements;
- The impact of the Standard on key metrics, debt covenants and management compensation; and
- Additional information that entities may need to gather to make the required disclosures.

The amount of the implementation costs will depend on the size of a company’s lease portfolio, the terms and conditions of its leases and the systems already in place to account for leases in compliance with IAS 17.

How can we be of assistance to you with respect to the new standard IFRS 16?
The new standard IFRS 16 introduces major changes in classifying and reporting leases namely in relation to lessees. In this regard, Deloitte offers the following:

- Further dReport articles covering the topic;
- Publications in English available on www.iasplus.com
- Consultation with Deloitte experts regarding the specific impacts of IFRS 16 on your reporting entity;
- Assistance in implementing the requirements set out by the new standard;
- Spring webcast summarising the key requirements and changes introduced by the new standard; and
- Autumn seminar on IFRS 16.

To learn more about our advisory services, please contact Lenka Neuvirtová (neuvirtova@deloitteCE.com).

Sources: www.iasplus.com
IFRS EU Endorsement Process

The European Financial Reporting Advisory Group (EFRAG) updated its report showing the status of endorsement of each IFRS, including standards, interpretations, and amendments, most recently on 9 March 2016.

As of 21 March 2016, the following IASB pronouncements are awaiting European Commission endorsement for use in the EU:

**Standards**
- IFRS 9 *Financial Instruments* (issued in July 2014)
- IFRS 15 *Revenue from Contracts with Customers* (issued in May 2014)
- IFRS 16 *Leases* (issued in January 2016)

**Amendments**
- Amendments to IFRS 10 and IAS 28 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (issued in September 2014)
- Amendments to IFRS 10, IFRS 12 and IAS 28 *Investment Entities: Applying the Consolidation Exception* (issued in December 2014)
- Amendments to IAS 7 *Disclosure Initiative* (issued in January 2016)

Click here for the [Endorsement Status Report](#)
Invitation to Spring Seminars

New Revenue Standard – IFRS 15

Dear Friends,

We would like to invite you to Deloitte’s spring seminar on International Financial Reporting Standards (IFRS).

The seminar will focus on the new revenue standard IFRS 15 Revenue from Contracts with Customers.

The new standard is effective for reporting periods beginning on 1 January 2018 and has not yet been endorsed for use in the EU, the estimated time of endorsement is in the 2nd quarter of 2016. Although the effective date of the standard seems to be very far away, the implementation of IFRS 15 should not be underestimated. It is likely that many companies will find the assessment of impacts and the preparation for new revenue recognition and presentation so difficult that they will need the entire interim period to do so. Therefore, each company should consider the impacts of IFRS 15 as soon as possible and plan the necessary steps in a timely manner.

The seminar is predominantly intended for accountants, economists and financial managers of projects relating to IFRS and for all who want to know more about IFRS.

The seminar will be held in Prague in the Czech language and will be delivered by our professionals.

Date
Prague: 12 April 2016

More information is available at: http://events.deloitte.cz/en

IFRS 9 for Financial Institutions

We would like to invite you to the Deloitte’s spring workshop on International Financial Reporting Standards (IFRS). This workshop is predominantly intended for accountants, economists, risk managers and financial analysts of financial institutions.

The new standard on the presentation and measurement of financial assets and liabilities – IFRS 9 Financial Instruments will be discussed in detailed at the workshop.

The new standard is effective for reporting periods beginning on 1 January 2018 and earlier application is permitted. The application of this standard in the European Union has not yet been endorsed; the estimated time of endorsement is in the 2nd half-year of 2016. Although the effective date of the standard seems to be very far away, the implementation of IFRS 9 should not be underestimated. Practical experience indicates that for financial institutions, the evaluation of impacts and the preparation for new recognition and measurement of financial instruments itself is a challenge.

We would like to point out that the workshop is also suitable for the participants of the workshop we organised on this particular topic in May last year. This time, we will look into the respective issues in greater detail and will illustrate the application of the standard’s requirements on several practical examples.

The workshop will be held in Prague in the Czech language and will be delivered by our professionals.

Date
Prague: 27 April 2016

More information is available at: http://events.deloitte.cz/en
FASB’s newly issued leasing standard ASC Topic 842 follows the issuance of IFRS 16

In the previous issue of dReport we brought to you an article on newly issued IFRS 16, *Leases* which was issued by the IASB in January 2016. As expected, in February, the FASB published an equivalent standard in US GAAP, ASU 2016-02, *Leases* which introduces a new section in the ASC, Topic 842, *Leases* and supersedes the Topic 840, *Leases*.

While the main objectives of both the IASB and the FASB are similar – to increase the transparency and comparability among entities by recognizing most leases in the balance sheet – the topic was so complex and even after 10 years of extensive work on the lease project the two bodies could not find, in certain areas, a full consensus and as such differences will still remain between IFRS and US GAAP.

Key provisions and information on IFRS 16 were provided to you already last month; in this article we would like to summarize the key aspects of US GAAP standard ASU 2016-02, *Leases* and point out most of the key differences as compared to IFRS 16.

The following changes are probably of the most significant changes in the accounting guidance in years as they will impact virtually any reporting entity – any entity that enters into a lease – and thus warrants focused attention and diligent preparation before adoption. Practical impacts of these changes on IFRS reporting entities are discussed earlier in this issue.

The expected results of the changes in lease accounting are mainly in the more transparent and clear representation of a lessee’s rights and obligations arising from leases; it is also expected to leave fewer opportunities for companies to structure leasing arrangements to obtain a desirable outcome on the balance sheet.

The new standard also aligns lessor accounting and sale and leaseback transactions guidance more closely to the new revenue guidance issued in 2014, it also brings the readers further information about lessors’ leasing activities and lessors’ exposure to credit and asset risk as a result of leasing. Last, the new standard clarifies the definition of a lease to address issues from practical application in current GAAP and aligns the concept of control over the leasing more closely with the control principle used in revenue recognition and consolidations.

The key change compared to the current standard is the requirement to recognize the leases currently classified as operating leases through recognition of the asset (a right-of-use (ROU) asset – right to use the asset for the lease term) and liability from the lease (liability to make lease payments).

As the new US GAAP guidance, as opposed to IFRS, retains a distinction between operating and finance lease and the classification criteria between the operating and finance leases have not changed extensively, the main impact on the financial statements will be mostly on the balance sheet, the statements of comprehensive income and of cash flows will for most entities not change so drastically.

Main Provisions of the new standard and key differences with IFRS

Scope of the new standard

The scope of the new standard includes leases of all property, plant and equipment (PPE) and excludes leases of intangible assets, leases to explore for or use nonrenewable resources, leases of biological assets, leases of inventory and leases of assets under construction.
The new IFRS guidance defines a similar scope, however, it includes all assets (not limited to PPE) with similar exceptions defined by a different standard. IFRS also gives the companies an option to choose to apply IFRS 16 also for intangible assets while this is not an option under US GAAP.

**Short-term leases**
The standard talks about short-term leases which do not need to follow the new lease accounting and for which the lessee would recognize the payments on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease today) without recording a ROU asset and liability on the balance sheet. A lease qualifies as a short-term lease if the lease term is of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise. The election of such an exception needs to be made by class of the underlying assets.

IFRS is virtually consistent with US GAAP here. In addition, IFRS 16 also allows an exemption of low-value assets from the recognition of ROU assets and liabilities. IFRS 16 does not specify the threshold for "low-value" assets but in the discussions the IASB held on this topic, reference was made to USD 5,000. Both the FASB and the IASB believe that entities will be able to adopt a reasonable capitalization policy under which the entity will not recognize ROU assets and liabilities for leases below a certain threshold on the balance sheet. Lessees would again recognize the payments on a lease on a straight-line basis over the lease term.

**Definition of a lease**
In order to define if the contract contains a lease and clearly differentiate such contracts from e.g. maintenance service type contracts, ASC B42 defines a lease as a “contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.”

A leased asset need to be specifically identifiable. A physically distinct portion of a larger asset could represent a specified asset (e.g., one floor of a building). A capacity portion of a larger asset will generally not represent a specified asset (e.g., percentage of a storage tank).

A entity controls an identified asset when the entity has both of the following:
- *The right to obtain substantially all of the economic benefits from its use.*
- *The right to direct its use.*

In Topic 842 you will find several examples and detailed guidance for application of the lease definition.

Topic 842 requires that components of the contract be split into the lease portion and the non-lease portion. Payments attributable to the non-lease portion do not enter the value of the lease liability or the respective asset and are not accounted for as leases. Lessees may, in accordance with their accounting policy, choose not to separate the non-lease part component from the total contract value and account for the whole contract as a lease. The election must be made on the class of the underlying asset level.

**Lessees accounting**
For both operating and finance leases, as of the lease commencement date a lessee recognizes an asset for its right to use the underlying asset (i.e. the right-of-use (ROU) asset) and a liability for its lease obligation in the statement of financial position. These are initially measured at the present value of the lease payments.

To amortize the ROU asset, there will be different accounting for finance and operating leases.
Under the finance lease approach, the ROU asset is generally amortized on a straight-line basis. This amortization together with interest on the lease liability calculated using the effective interest method results in the highest total costs of leasing at the beginning of the period decreasing together with a decreasing liability. The interest and amortization costs are presented separately in the statement of comprehensive income.

For operating leases the approach requires that the cost be presented as a single line item in the statement of comprehensive income and allocated over the lease term on a straight-line basis.

The criteria for determining whether to classify the lease as finance or operating and consequently account for accordingly are similar as the current requirements in IAS 17 (see below).

The new IFRS standard recognizes only one approach which is similar to the way the finance leases will be treated under the new ASC, Topic 842.

In addition, IFRS 16 allows an alternative measurement basis for the ROU asset, for example, the fair value model under IAS 40 Investment property or the revalued amount in accordance with IAS 16 Property, plant, and equipment, while no such alternatives are allowed in US GAAP.

Lease Classification
An entity is required to determine the classification of a lease as of the lease commencement date.

The ASU’s classification criteria apply to both lessees (US GAAP only) and lessors (US GAAP and IFRSs).

The evaluation focuses on whether control of the underlying asset is effectively transferred to the lessee (e.g., substantially all of the risks and rewards related to ownership of the underlying asset are transferred to the lessee). Therefore, a lease would be classified as a finance lease (from the standpoint of a lessee) or a sales-type lease (from the standpoint of a lessor) if any of the following criteria are met:

- “The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.”
- “The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.”
- “The lease term is for the major part of the remaining economic life of the underlying asset.” (The ASU provides an exception to this criteria for leases that commence at or near the end” of the underlying asset’s economic life which would be, based on ASU, for example a lease starting in the final 25 percent of an asset’s economic life.)
- “The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset.”
- “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.”

Leases that do not meet any of these criteria (i.e., a lease in which the lessee does not effectively obtain control of the underlying asset) would be classified as operating leases by the lessee and as either operating leases or direct financing leases by the lessor.
A lessee is not required to reassess its classification of a lease unless:
1) the lease is subsequently modified and the modification is not accounted for as a separate contract or
2) there is a change in the lease term (e.g., there is a change in the assessment of whether the lessee is reasonably certain to exercise a renewal option) or a change in the assessment of the exercise of a purchase option.

A lessor would only reassess its lease classification if the lease is subsequently modified and the modification is not accounted for as a separate contract.

As the ASU’s classification criteria changed compared to current US GAAP and newly are similar to those in IAS 17, a lease that would have been assessed as an operating lease may now need to be recognized as a finance lease.

Another change related to classification criteria relates to real estate. Based on the ASU an entity would assess land and other elements in a real estate lease as separate lease components unless the accounting result of doing so would be insignificant. Currently US GAAP guidance requires a lessee to account for land and buildings separately only when:
1) the lease meets either the transfer-of-ownership or bargain-purchase-price classification criteria or
2) the fair value of the land is 25 percent or more of the total fair value of the leased property at lease inception.

As a result there will be more situation when the real estate leases will need to be split and assessed as separate lease elements.

Lessor accounting
US GAAP keeps the current lessor accounting approach without significant changes for both operating and capital (direct financing and sales-type) leases. Although the lease classification criteria will slightly change, still a vast majority of operating leases will remain operating and the lessor will continue to recognize the revenue on a straight-line basis over the lease term.

The guidance has been adjusted to align with the new revenue standard. A dealer’s profit would be recognized up front if the arrangement is a sales-type lease (i.e., the transaction qualifies as a sale under ASC 606) and is deferred and recognized as interest income over the lease term, in case of direct financing lease.

In IFRS the dealer’s profit for finance lease is recognized up front.

Lease payments
To quantify the value of the ROU asset entities need to compute the present value of the lease payments. The lease payments need to include the following costs:
• fixed payments including the payments that are in substance fixed
• variable payments which are based on an index or rate (e.g. CPI) calculated using the index or rate available at the inception
• amounts that are probable to be owed by lessee under residual value guarantees
• payments connected to renewal or termination options if the lessee can reasonably expect to exercise such options.

Lease payments do not explicitly include variable payments that are computed based on usage or performance (e.g. sales volumes).
The difference between US GAAP and IFRS guidance is in the conditions at which the reassessment is allowed for variable payments based on the index or rate. Under US GAAP, such payments are reassessed when the lease obligation changes for other reasons, such as a change of lease term. Under IFRS 16 the reassessment is performed whenever there is a change in the contractual cash flow (e.g. any adjustment for a change in the index or CPI).

Discount rate
Lessees use the rate charged by the lessor if the rate is readily determinable. If the rate is not readily determinable, lessees will use their incremental borrowing rate as of the date of lease commencement.

Lessors use the rate they charge the lessee.

Private-company lessees can elect to use a risk-free rate while IFRS 16 does not allow any such exception.

Effective date and Transition
The new guidance is effective for public business entities for annual periods beginning after 15 December 2018 and interim periods therein. For all other entities the ASU becomes effective for annual periods beginning after 15 December 2019 and interim periods thereafter.

Transition to the new standard requires the entities to recognize leases at the beginning of the earliest period presented using a modified retrospective approach with a number of practical expedients that entities may choose to follow.

How can we be of assistance to you with respect to the new standard
The preparation for the transition and the transition itself will require appropriate time and resources. We will devote further space to more specific areas related to the new lease standard also in following months.

Further publications whether in the following issues of dReports or on iasplus.com/us, Deloitte specialists on US GAAP, IFRS or advisory team can help you during this process at any stage.
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