IFRS 16 Leases: IFRS vs Luxembourg GAAP

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Preface

The International Financial Reporting Standards (IFRS) play a critical worldwide role. Across 144 jurisdictions, IFRS are required for most if not all domestic, publicly accountable entities — such as listed companies and financial institutions — in their capital markets. In 2018 and 2019, the new standards of IFRS 9, IFRS 15 and IFRS 16 were issued.

Purpose

This publication aims to help you understand the significant differences between IFRS 16 Leases and Lux GAAP, which apply to entities subject to the Law of 19 December 2002 as amended. It also provides some best practices.

IFRS 16 applies to annual reporting periods beginning on or after 1 January 2019. It fulfills the International Accounting Standards Board's (IASB) long-standing goal of bringing all significant leases on-balance sheet for lessees.

Although this brochure does not cover every difference between the standards, it does provide a concise summary of the ones we encounter the most due to differences in emphasis, specific application guidance or practice.

This publication's focus is mainly on recognition, measurement and presentation — however, it also covers areas that are disclosure-based. And, it does not address the requirements of the IFRS for *Small and Medium-sized Entities*.

If you are a preparer, this publication can help you identify areas to emphasize in financial statements. And, if you are a user, it can help you spot areas to focus on when communicating with preparers.

This publication only highlights the key differences between the two frameworks. However, we recognize that the significance of each difference varies by entity. Some differences that appear major may not be relevant to your business. And, by contrast, a seemingly minor difference may cause you significantly more work. Therefore, for an analysis of the differences that specifically apply to your company, please contact us.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

We hope you find this publication useful. If you have any questions or need advice, please do not hesitate to contact us.

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Overview of accounting for leases under IFRS 16

Objective

This Standard sets out the principles for 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. [IFRS 16.1]

An entity shall consider the terms and conditions of contracts and all relevant facts and circumstances when applying this Standard and should apply this Standard consistently to contracts with similar characteristics and in similar circumstances. [IFRS 16.2]

Effective date and scope

The new standard is effective for annual periods beginning on or after 1 January 2019.

The new standard applies to all leases, including sub-leases, with few exclusions.

Definition

A contract is a lease, or contains one, if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. [IFRS 16.9]

Identifying a lease

To view a flowchart that assesses the key elements that define a lease, please refer to Appendix 1.

Lease and non-lease components

If a contract is, or contains, a lease, then an entity accounts for each separate lease component separately from non-lease components following a two-step approach. As a practical expedient, a lessee may elect, by class of underlying asset, to account for each lease component and any associated non-lease component as a single lease component. [IFRS 16.12, 15]

A lessor allocates consideration in a contract to the separate lease and non-lease components by applying IFRS 15 *Revenue from Contracts with Customers*. A lessee allocates 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. [IFRS 16.13, 17]

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Activities or costs that do not transfer goods or service to the lessee are not separate components in a contract. Payments related to these costs are considered as part of the total consideration that is allocated to the separately identified components. [IFRS 16.B33]

Initial application

Lessor

A lessor classifies leases as either operating or finance leases, based on the substance of the transaction rather than the form of the contract. The lease classification test is essentially unchanged from IAS 17. [IFRS 16.61, 63]

A lessor classifies a lease as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease that is not a finance lease is an operating lease. [IFRS 16.62]

Under a finance lease, the lessor recognizes a lease receivable equal to the net investment in a finance lease — which comprises the present value of the lease payments and any unguaranteed residual value accruing to the lessor. The underlying asset is derecognized and any difference between its carrying amount and the finance lease receivable is recognized in profit or loss. A manufacturer or dealer lessor recognizes the selling margin in a finance lease by applying its normal accounting policy for outright sales. [IFRS 16.A, 67-72, 74]

Under an operating lease, the lessor recognizes the lease payments as income over the lease term, on either a straight-line basis or another systematic basis. The lessor continues to present the underlying asset in its statement of financial position. [IFRS 16.81, 88]

Lessee

A lessee applies a single, on-balance sheet lease accounting model to all its leases unless the lessee elects the recognition exemptions (see Recognition exemptions). A lessee recognizes a right-of-use (ROU) asset, which represents its right to use the underlying asset, and a lease liability, which represents its obligation to make lease payments (Appendix 2). [IFRS 16.IN10, 5, 22]

At the commencement date, a lessee measures the lease liability at the present value of the future lease payments (Appendix 3). The right-of-use asset is measured at cost, which includes:

- the lease liability
- initial direct costs
- prepaid lease payments and lease incentives received
- estimated costs to dismantle, remove or restore the asset (Appendix 4). [IFRS 16.23-24, 26]

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Lease payments

Lease payments are payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term. Both the lessee and the lessor include the following in the lease payments:

- fixed payments, including in-substance fixed payments, less any lease incentives
- variable lease payments that depend on an index or a rate
- the exercise price of a purchase option that the lessee is reasonably certain to exercise
- amounts related to residual value guarantees
- payments of penalties for terminating the lease if the lease term reflects early termination. [IFRS 16.A, 27, 70]

Lease term

The lease term is the non-cancellable period of the lease together with optional renewable periods that the lessee is reasonably certain to extend and periods after an optional termination date the lessee is reasonably certain not to terminate early. [IFRS 16.18]

Discount rate

At the commencement date, a lessee uses the interest rate implicit in the lease if this can be readily determined. If this cannot be readily determined, then the lessee uses its incremental borrowing rate. At inception, a lessor determines the interest rate implicit in the lease and uses it to help to assess the classification of the lease and to measure the net investment in a finance lease. [IFRS 16.26, 63(d), 68]

Initial direct costs

Initial direct costs are the incremental costs of obtaining a lease that would otherwise not have been incurred, except for costs incurred by manufacturer or dealer lessors in connection with finance leases. [IFRS 16.A]

A lessee includes any initial direct costs incurred in the cost of the right-of-use asset at the commencement date. [IFRS 16.24(c)]

In the case of a finance lease, a lessor includes initial direct costs in the measurement of the net investment in the lease. In the case of an operating lease, the initial direct costs are added to the carrying amount of the underlying asset and are recognized as an expense on the same basis as the lease income. [IFRS 16. 69, 83]

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Recognition exemptions

A lessee can elect to not apply the lessee accounting model to leases with a lease term of 12 months or less — i.e. short-term leases. This election is made by the class of the underlying asset. A lease that contains a purchase option is not a short-term lease. A lessee can elect not to apply the lessee accounting model to leases for which the underlying asset is of low value when it is new. This election is made on a lease-by-lease basis. [IFRS 16.5-8, B3]

Subsequent measurement

Lessor

Under an operating lease, the lessor depreciates the underlying asset over the asset's useful life. [IFRS 16.84]

Under a finance lease, the lessor accrues interest income on the finance lease receivable. The receipts under the lease are allocated between reducing the net investment and recognising finance income, to produce a constant rate of return on the net investment. Finance lease receivables are subject to derecognition and measurement requirements of IFRS 9. A lessor regularly reviews estimated unguaranteed residual values used in computing the finance lease receivable. [IFRS 16.75-77]

Lessee

After initial recognition, a lessee measures the lease liability at amortized cost using the effective interest method. The lease liability is also re-measured to reflect changes in the lease payments. [IFRS 16.36, 39-43]

A lessee measures the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses — except when it applies the alternative measurement models for revalued assets and investment property. A lessee adjusts the carrying amount of the right-of-use asset for re-measurement of the lease liability (Appendix 5). [IFRS 16.29-35, 39]

Specific topics

There is specific guidance on accounting for lease modifications by lessees and lessors. [IFRS 16.A, 44-46, 79-80, 87, IE7]

In a sale-and-leaseback transaction, the seller-lessee first determines if the buyer-lessor obtains control of the asset based on IFRS 15 *Revenue from Contracts with Customers*. If not, then the transaction is accounted for as a financing arrangement. [IFRS 16.98-103]

In a sub-lease, the intermediate lessor accounts for the head lease and the sub-lease as two separate contracts. An intermediate lessor classifies a sub-lease by reference to the right-of-use asset arising from the head lease. [IFRS 16.3, A, B58]

Overview of accounting for leases under IFRS 16

Disclosures

Lessor

For operating leases, a lessor discloses:

- the lease income relating to variable lease payments that do not depend on an index or rate
- other lease income
- detailed maturity analysis of the lease payments receivables.

If applicable, disclosures are made in accordance with IAS 16, IAS 36, IAS 38, IAS 40 and IAS 41. [IFRS 16.90, 95-97]

For finance leases, a lessor discloses:

- the selling profit or loss
- finance income on the net investment in the lease
- lease income relating to the variable lease payments not included in the net investment in the lease
- significant changes in the carrying amount of the net investment in the lease
- maturity analysis of the lease payments receivable. [IFRS 16.90, 93-94]

A lessor also discloses quantitative and qualitative information, such as the nature of its leasing activities and how it manages risks associated with rights that it retains in underlying assets. [IFRS 16.92]

Lessee

The lessee discloses:

- carrying amount of right-of-use asset by class of asset as at year-end and corresponding line items in the statement of financial position
- additions to right-of-use asset
- lease liabilities and corresponding line items in the statement of financial position
- maturity analysis of the lease liabilities. [IFRS 16.47, 53, 58]

The lessee also discloses:

- depreciation charge for right-of-use asset by class of underlying asset
- interest expense on lease liabilities
- expense related to variable lease payments not included in the lease liabilities
- lease expense where the recognition exemption is applied, i.e. short-term and low-value leases
- income from sub-leasing the asset
- gains and losses arising from sale-and-leaseback transactions. [IFRS 16.53-54]

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In addition, the lessee discloses the total cash outflow for leases, qualitative information describing how liquidity risk related to lease liabilities is managed and explains the use of the recognition exemption for short-term and low-value leases. [IFRS 16.53, 58-60]

Specific disclosures are required if the IAS 16 revaluation model or IAS 40 fair value model is used for the right-of-use asset. [IFRS 16.56-57]

Transition

On transition, a lessee can apply either a full retrospective approach or a modified retrospective approach with one or more practical expedients. A lessor is not required to make any adjustments on transition, except for sub-leases and sale-and-leaseback transactions. [IFRS 16.C3-C20]

On transition, entities can also choose whether to apply the new definition of a lease to all their contracts or apply a practical expedient to 'grandfather' their previous assessment of which existing contracts are, or contain, leases. [IFRS 16.C3-C4]

When applying a modified retrospective approach to leases previously classified as operating leases under IAS 17, a lessee can also choose how to measure the right-of-use asset on transition using one of two methods — either as if IFRS 16 had always been applied or at an amount equal to the lease liability. This choice is applied on a lease-by-lease basis. For a more detailed overview of the lessees' approach to the recognition and measurement using the modified retrospective approach, please refer to Appendix 6. [IFRS 16.C8-C11]

Overview of accounting for leases under LUX GAAP

Scope

Accounting for leases is not expressly defined under the Law of 19 December 2002, as subsequently modified on the register of commerce and companies and the accounting and annual accounts of undertakings (the "Law") which defines Lux GAAP.

However, the option of using the substance over form principle [L.2002 Article 29 (3)] can lead to different accounting approaches that apply to lease contracts under Lux GAAP. For example, this can qualify them as finance leases, where an entity acquires an asset under a leasing contract and the latter includes an option to buy the asset at the end of the contract.

To distinguish between an operating lease and a finance lease, IFRS may be used as a guide.

Definition

Identifying a lease

The Law does not state how to identify a lease and there is no specific guidance under Lux GAAP. Lease identification is usually based on the legal form of the contract and it can be referred to the Luxembourg civil code *[Articles 1708 to 1712].* IFRS 16.9's definition may also serve as a guide.

Lease and non-lease components

Usually, there is no separation of items if a contract is a lease agreement. If a contract includes significant non-lease components, IFRS may be used as a guide. Lux GAAP does not provide any specific guidance regarding this.

Initial application

Lessor

There is no specific guidance under Lux GAAP regarding this. IFRS may be used as a guide and the lessor can choose to either (i) derecognize the asset or (ii) maintain the asset on its balance sheet and accrue rental income over the contract's life, as legally the asset remains with the lessor during the lease contract.

Overview of accounting for leases under LUX GAAP

Lessee

There is no specific guidance under Lux GAAP regarding this. It is not mandatory to recognize any lease contract on the balance sheet under Lux GAAP. However, in the case of a finance lease, the undertaking can decide to account for the leased item as an asset. Initial measurement is usually based on the leased asset's value as stated in the financial lease agreement; although, in our view, IFRS may be used as a guide.

Lease payments

There is no specific guidance under Lux GAAP regarding this. Payment obligations are usually presented based on their legal or contractual form and recorded on an accrual basis when the service is provided. It includes both fixed and variable lease payments. Penalties are presented separately from lease payments. Payment regarding the exercise of a purchase option is accounted for as a financial instrument.
Lux GAAP is silent on lease incentives when they relate to rent-free periods. In our view, they can either (i) be ignored, i.e. they are not accounted for as no payment is due in this period, or (ii) be accounted for as per IFRS requirements, if a reporting entity applies the substance over form principle.

When applying the substance over form principle, IFRS may be used as a benchmark. In that case, leasing contracts that give the lessee the option to buy the leased asset at the end of the leasing period — or the right to use the asset over its useful economic life — might follow the accounting method where the leased asset is recognized as a tangible asset and part of the leasing agreement's future payments as a debt. It is also permitted to expense all rental charges through the profit and loss account for these leases.

Discount rate

There is no specific guidance under Lux GAAP regarding this. However, future payments are usually not discounted under Lux GAAP.

Initial direct costs

There is no specific guidance under Lux GAAP regarding this, but the IFRS definition may apply under Lux GAAP.

Subsequent measurement

Lessor

There is no specific guidance under Lux GAAP regarding this. If the lessor used IFRS as a benchmark andrecognized a leased asset on its balance sheet, it should be treated the same as *any tangible assets the entity owns — whereby its value is reduced systematically by value adjustments over its useful economic life [L.2002 Article 55 (1) b)].* In addition, these assets should be tested for any permanent reduction in value.

Rental income is to be recognized in the profit and loss account on an accruals basis.

Overview of accounting for leases under LUX GAAP

Lessee

There is no specific guidance under Lux GAAP regarding this, but two methods are commonly used.

- For operating leases, the lessee records rental expenses on an accrual basis based on contractual amounts directly in the profit and loss account.
- For finance leases, the lessee can either account it similarly as an operating lease or can recognize an asset on the balance sheet with a corresponding financial lease liability in a manner comparable to IFRS. Regarding the leased asset, the method is similar to IFRS except that the revaluation model is currently not accepted under Lux GAAP.

Fixed assets with limited useful economic lives must be reduced by value adjustments calculated to systematically write off the assets' value over their useful economic lives [L.2002 Article 55 (1) b)]. In addition, they should be tested for any permanent reduction in value.

Disclosures

Lessor

The total amount of any financial commitments, guarantees or contingencies that are not included in the balance sheet, and an indication of the nature and form of any in rem security which have been provided must be set out in the notes to the accounts *[L.2002 Article 38]*.

The notes to the annual accounts must disclose *the total amount of any financial commitments that are not included in the balance sheet, in so far as this information is of assistance in assessing the financial position. Commitments vis-à-vis affiliated undertakings must be disclosed separately [L.2002 Article 65 (1) 7°].*

Lessee

The rental expense is classified under the caption 5b) Other external expenses in the eCDF profit and loss account and the notes to the annual accounts must disclose the total amount of outstanding financial commitments, in so far as this information is of assistance in assessing the financial position of the entity. Commitments vis-à-vis affiliated undertakings must be disclosed separately.

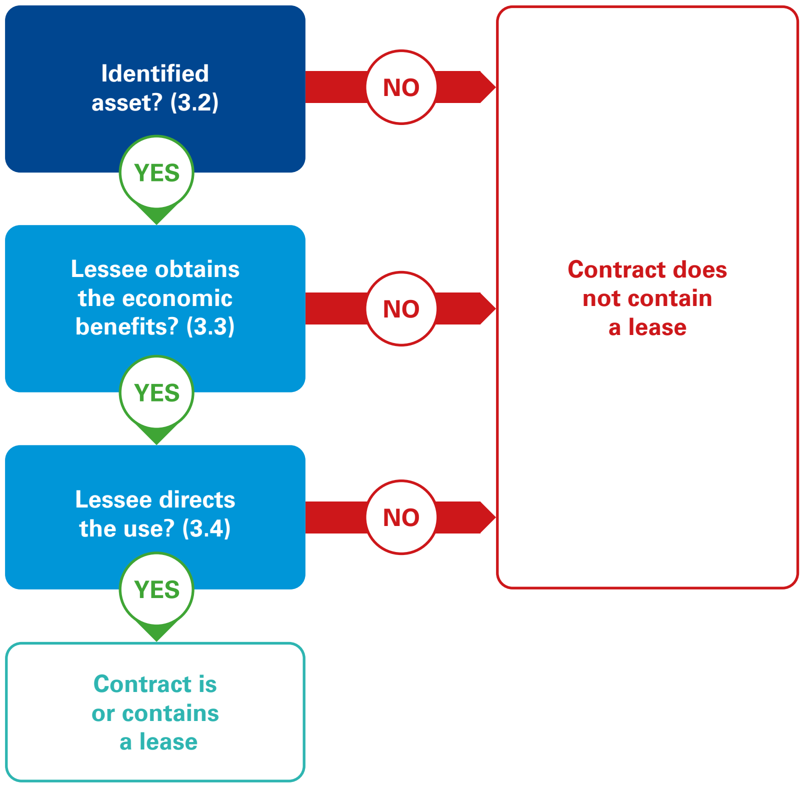
Lessor and lessee

Transactions - including leasing transactions are entered into with related parties must be disclose in the notes. The notes should include *the amount of these transactions, the nature of the related party relationship and all other information about those transactions necessary to the understanding of the financial position of the undertaking [L.2002 Article 65 (1) 7ter°].*

Information may be aggregated according to the nature of transaction if separate information is not necessary for the understanding of the effects of the related party transactions on the financial position of the undertaking. The information of those transactions might be limited by certain options or exemptions that exist in the Law.

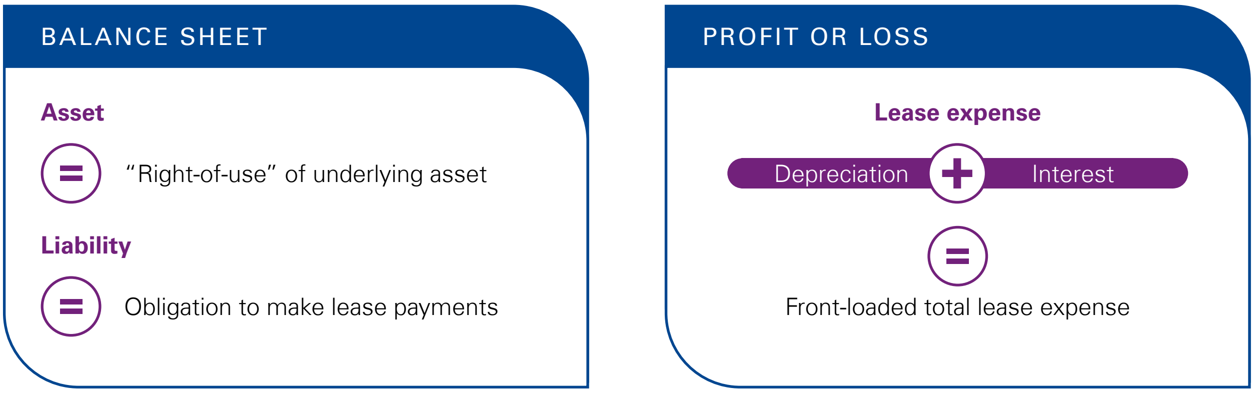
Appendix

Appendix 1: Lease identification



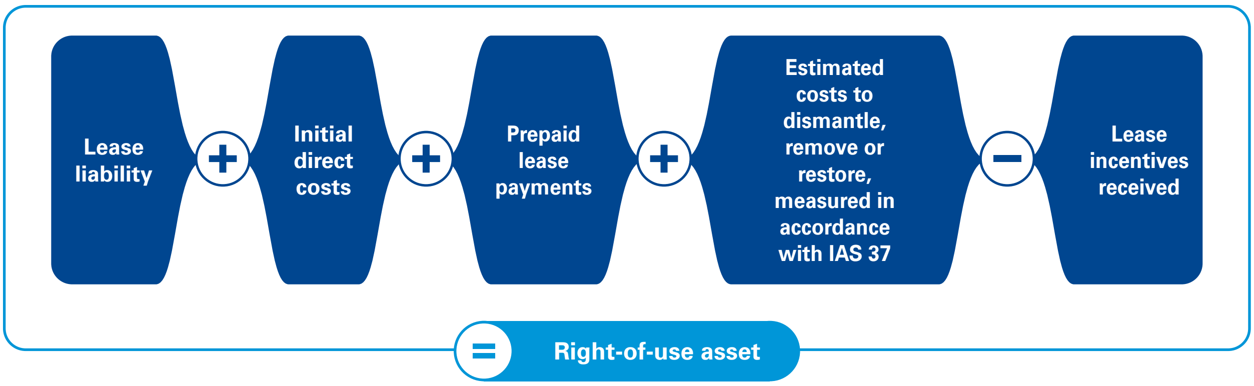
Appendix

Appendix 2: Lessee accounting model



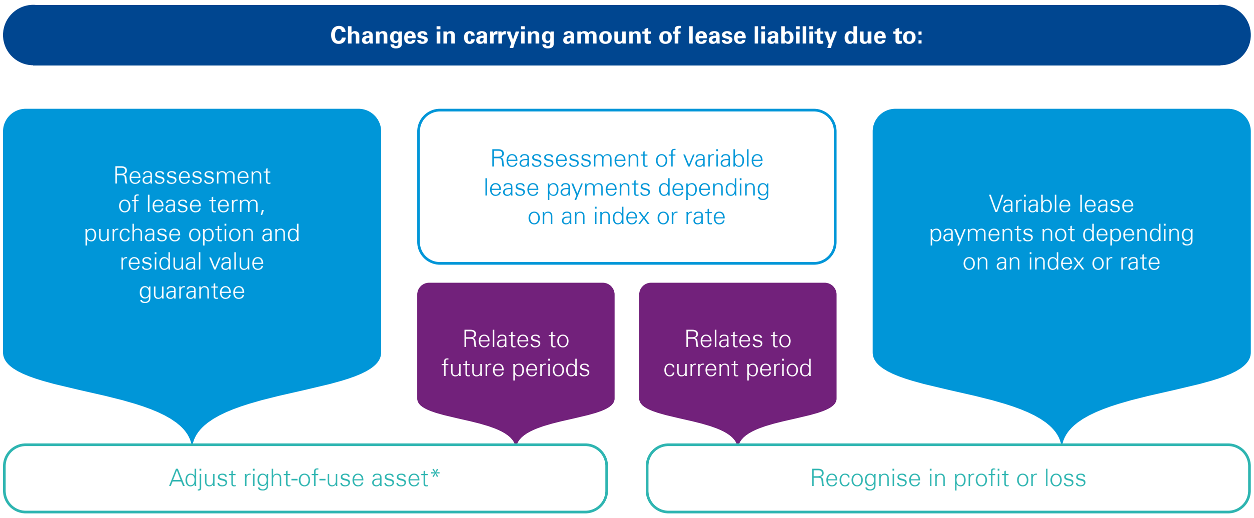
Appendix 3: Initial measurement of the lease liability

Appendix 4: Initial measurement of the right-of-use asset



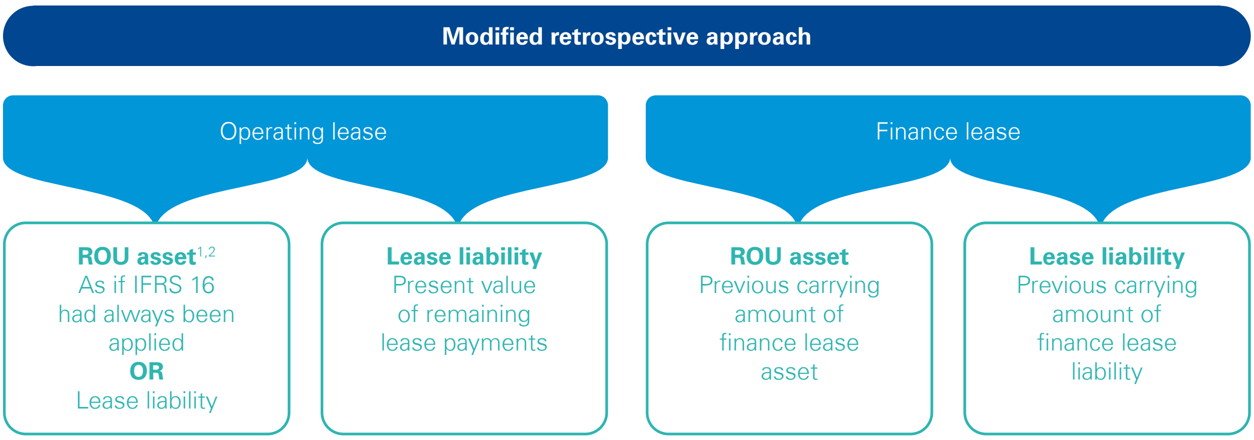
Appendix

Appendix 5: Subsequent measurement of the right-of-use asset



* If the carrying amount of the right-of-use asset is reduced to zero, then any further reductions are recognised in profit or loss.

Appendix 6: transition – lessee's approach to the recognition and measurement using modified retrospective approach



1. Under the modified retrospective approach, a lessee chooses on a lease-by-lease basis how to measure the ROU asset on transition to IFRS 16.
2. A lessee measures an ROU asset that will be accounted for as investment property using the fair value model in IAS 40 from the date of initial application. A lessee is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in IAS 40.

Appendix

How KPMG can help you

Even with a quick look over IFRS 16, it is clear that it is a complex accounting standard. However, many practical considerations can ease a company's IFRS 16 impact assessment and implementation.

KPMG has proven experience in assisting entities with their IFRS 16 impact assessments and transition requirements. Our IFRS experts are ready to help you with the following:

- Review your lease agreements to understand interpretation challenges.
- Accounting impact assessment and gap analysis.
- Analysis of transition options.
- Assessment of reasonableness of the discount rate applied under available implementation options.
- Preparation of new accounting policies and financial statement disclosures in the year of implementation, ensuring compliance with new accounting standard requirements.
- Selection, design and implementation of lease accounting software.
- Ad hoc accounting advice to account for a specific transaction following Lux GAAP/IFRS.
- Conversions from IFRS to Lux GAAP and vice versa.
- Full IFRS 16 implementation.
- IFRS 16 training.

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