PEDABO BULLETIN

A monthly technical publication providing high level insights, information and clarification on accounting, tax and business advisory matters

IFRS 16: A New Lease of Life?

Introduction

The International Accounting Standards Board (IASB) has released a new standard, IFRS 16 on Leases, on the 13th January, 2016. The new standard replaces the old accounting requirements for lease transactions which have been in place for over 30 years. The erstwhile standard, IAS 17, classifies leases into finance and operating lease and requires lessee to bring into the statement of financial position, assets under finance lease only. According to the IASB, the old accounting requirements no longer fit for purpose as it makes it difficult for investors and others to get an accurate and correct picture of a company's lease assets and liabilities, particularly for industries such as the airline, retail and transport sectors.

A survey conducted jointly by IASB and FASB showed that of 30,000 listed entities using both IFRS and US GAAP, 14,000 of them disclose information about off balance sheet leases in their 2014 financial statements. The future payments for the off balance sheet leases in their financials amounted to US$2.9trn.

IFRS 16 defines a lease as *'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'* and the provisions of the standard applies to all types of lease arrangement except for:

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Special Report

UAE, Nigeria Signs Double Tax Treaty

The Nigerian government has recently signed an agreement for the avoidance of double taxation and prevention of fiscal evasion with the United Arab Emirate. This took place in January, 2016 in Dubai where President Mohammed Buhari led the Nigerian Delegation. Residents of both countries can take advantage of the provisions of the treaty to minimise the tax to be paid in the other country.

It is however doubtful It is however doubtful that this treaty will be of any benefit to Nigerian residents as there is no income tax chargeable in UAE.

The agreement cannot be operational in Nigeria until it is ratified by the National Assembly. Section 12 of the Constitution of the Federal Republic of Nigeria requires treaties to be enacted into law by the National Assembly before they can have the force of law. It is expected that the National Assembly will scrutinize the contents of the treaty, its diplomatic and financial benefits to Nigeria before ratifying it. It is important to note that the double tax treaty Nigeria signed with Malaysia in 2012 is yet to be ratified.

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I. leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
II. leases of biological assets within the scope of IAS 41 Agriculture held by a lessee;
III. service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements;
IV. licences of intellectual property granted by a lessor within the scope of IFRS 15 Revenue from Contracts with Customers; and
V. rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights

The standard also supersedes the provisions of IAS 17 Leases; IFRIC 4 Determining whether an Arrangement contains a Lease; SIC-15 Operating Leases—Incentives; and SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of Lease. It comes into effect from 1st January, 2019. Earlier adoption is however allowed for entities applying IFRS 15 on or before IFRS 16 effective date.

In the books of the Lessee

IFRS 16 requires lessee to report ***all lease arrangements*** in the statement of financial position by recognising a 'Right of Use' asset and a corresponding lease liability. The 'Right of Use' is required to be measured initially at cost, determined as the sum of:

I. The present value of outstanding lease payment as at measurement date using the implicit interest rate or incremental borrowing cost, where the former cannot be reliably determined.
II. Lease payments made at or before commencement of the lease, net of any incentive
III. Initial direct costs incurred by the lessee and
IV. Estimated decommissioning cost to be incurred by the lessee

Subsequently, the 'Right of Use' is measured applying either the cost model, investment property model under IAS 40 or revaluation model under IAS 16 with the asset being depreciated in line with the provisions of IAS 16 on property plants and equipment over the earlier of the lease term or the economic useful life of the asset. Under IFRS 16 cost model, lessee shall measure the 'Right of Use' asset at cost less accumulated depreciation and accumulated impairment loss and adjusted for any re-measurement of lease liability as prescribed in the standard. Impairment provisions under IAS 36 also apply to such assets.

Lease liability is required to be re-measured annually by increasing the carrying amount to reflect interest on the lease liability, reducing the carrying amount to reflect the lease payment made and re-measuring the carrying amount to reflect any reassessment, lease modification or revised in-substance lease payment.

A lessee may elect not to apply the recognition requirements to the following leases:

(a) short term leases (less than 12 months); and
(b) leases for which the underlying asset is of low value

If a lessee elects to apply the recognition exemptions mentioned above, the lease payments are recognised as an expense on either a straight-line basis over the lease term or another systematic basis where it is more representative of the pattern of the lessee's benefit.

"A lease is operating where the lessor still retains the risk and reward of ownership."

In the books of the Lessor

The new standard retains, substantially, the previous accounting requirements for lessor. It requires lessor to classify all lease arrangements into finance or operating lease on the basis of the party that bears the risk and rewards incidental to ownership of the asset. A lease is operating where the lessor still retains the risk and reward of ownership.

A lessor is required to measure a finance lease, on initial recognition, as a receivable in the statement of financial position at an amount equal to the net investment in the lease which is the present value of the gross investment in the lease. The difference between the gross and net investments constitutes the unearned finance income.

The gross investment in the lease is defined as the lease payment receivable by a lessor under the finance lease plus the unguaranteed residual value accruing to him under such arrangement. Finance income is recognised subsequently based on an effective interest rate method that provides a constant periodic rate of return on the lessor's net investment at the reporting date. Lease payments received and relating to the period is applied against the gross investment to reduce both the principal and the unearned finance income.

Operating lease payments are to be recognised on a straight line basis as income over the lease term net of any incentive. Lease assets are to be carried as property, plants and equipment and recognised in line with the provisions IAS 16 and 36.

Disclosures

IFRS 16's disclosure requirements, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, 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 lessee

Illustrative Example

A Limited enters into a 10-year lease of a floor of a building, with an option to extend for five years from B Limited, the owner of the property. Lease payments are N2.5m per year during the initial term and N3.5m per year during the optional period, all payable at the beginning of each year.

To obtain the lease, A Limited incurs initial direct costs of N400,000, of which N300,000 relates to a payment to a former tenant occupying that floor of the building and N100,000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to A Limited for entering into the lease, B Limited agrees to reimburse to A Limited, the real estate commission of N100,000 and the latter's leasehold improvements costs of N700,000.

At the commencement date, A Limited concludes that it is reasonably certain to exercise the option to extend the lease by the additional 5 years. The interest rate implicit in the lease is not readily determinable. A Limited's incremental borrowing rate is 8 per cent per annum, which reflects the fixed rate at which it could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 15-year term, and with similar collateral.

The property originally cost N100m to B Limited and has an economic useful life of 80 years. The unused portion of this life span was 70 years as at the commencement of the lease.

Conclusion

It is no doubt that the new IFRS will impact the financials of entities that have operating leases contracts as erstwhile off balance sheet right of use are now to be disclosed in the statement of financial position. Thus, off balance sheet arrangements such as sales and lease back would not be exercisable going forward. Also, such company's total assets would increase as well as their total liabilities. Some financial ratios of companies (for example gearing, interest cover and sales cover ratio) would be affected as well, as a result of these changes in status quo.

In view of above, it is pertinent that Nigerian business entities start evaluating how and to what extent, this new standard will affect existing and future business transaction.

Solution

Accounting by Lessee		
At Commencement		
Right of Use Asset:	**N**	
1 PV of outstanding lease liability:		
(for 9 years as 1st year is payable upfront)	15,617,219.78	
Option for renewal period (last 5 years since lessee is certain of exercising it)	6,990,721.75	
	22,607,941.53	
3 Lease payment at or before commencement (Upfront)	2,500,000.00	
4 Initial Direct Cost	400,000.00	
5 Incentive re Lease (excluding leasehold improvement cost)	- 100,000.00	
6 Estimated Decomissioning Cost	-	
	25,407,941.53	
Accounting Entries		
Dr Right of Use Asset	25,407,941.53	
Dr Bank - Reimbursement	100,000.00	
Cr Lease Liability		22,607,941.53
Cr Bank-First Instalment		2,500,000.00
Cr Bank - Initial Direct cost		400,000.00

Accounting by Lessee		
At Reporting Date	-	
1 Depreciation		
Dr Depreciation Expense:	1,693,862.77	
Cost of Right of Use Asset	25,407,941.53	
Lower of lease term and economic useful life	15.00	
Cr Accum Dep		1,693,862.77
2 Finance Cost		
Dr Finance Charge	1,808,635.32	
Cr Lease Liability		1,808,635.32

Accouting by Lessor		
At Commencement		
1 Carrying Amount of Asset at commencement of Lease	**87,500,000.00**	
Cost	100,000,000.00	
Accum Depreciation	12,500,000.00	
Economic useful life	80	
Expired economic life	10	
2 Lease Rental Income		
Dr Bank	2,500,000.00	
Cr Operating Lease Advance		2,500,000.00
At Reporting Date		
1 Depreciation		
Dr Depreciation Expense:	1,250,000.00	
Carrying amount of Property	87,500,000.00	
Unexpired economic useful life	70.00	
Cr Accum Dep		1,250,000.00

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Turnover Assessment must be without Recharges ...Tax Appeal Tribunal Declares

The Tax Appeal Tribunal, Lagos Zone has recently ruled that application of turnover assessment as provided in section 30 of Companies Income Tax Act (CITA) should be on gross value of turnover of the non-resident company deriving income in Nigeria. The decision was given in the case involving the Federal Inland Revenue Service (FIRS) and VF Worldwide Holdings Limited. The latter company has erstwhile been filing its turnover assessment net of recharges from its Nigerian subsidiary, and subjecting the balance to tax at the 6% rate used by FIRS. The tax authority rejected this basis raising additional assessment on the recharges. The company contested this assessment, filing a notice of appeal with the Tax Appeal Tribunal.

"Furthermore, taxpayers are advised to get proper counsel when undertaking transactions and avoid relying on FIRS representations alone..."

In giving its decision, the Tribunal noted two important principles that have been settled by the Court of Appeal in recent cases. Firstly, the provisions of a circular or letter from FIRS cannot prevail when in conflict with the provisions of CITA. Secondly, before a taxpayer can rely on the doctrine of legitimate expectation to prevent a tax authority from abandoning an earlier position, the taxpayer must have made full disclosure or displayed utmost good faith in the transaction.

Since the appellant did not disclose its profit to the respondent, the latter had to compute the former's tax liability using the deemed profit mode as provided in section 30 of CITA.

The position of the law appears to be settled that expenses (recharges included) will not be allowed under the deemed profit basis. Taxpayers are advised to take this principle into consideration while undergoing self-assessment, tax planning and other similar activities.

Such court actions like this from VF Worldwide are laudable because they enrich our tax system and settle prior controversies. Furthermore, taxpayers are advised to get proper counsel when undertaking transactions and avoid relying on FIRS representations alone because such representations do not change the position of the law on such matters.

Finally, taxpayers are encouraged to ensure that tax directives from FIRS are in line with the law and challenge such when they are in conflict with the laws because such directives cannot overrule the tax laws.

Stamp Duties On Fund Transfers: Matters Arising

The Central Bank of Nigeria (CBN), by a circular dated 15th January 2016, directed all deposit banks and financial institutions to charge stamp duties of N50 on all electronic transfers and deposits into accounts on transactions from N1,000 and above. The duty is to be deducted from the receiving party. In line with the provisions of the schedule to the Stamp Duties Act (SDA), the circular exempts deposits into savings accounts and deposits into self-accounts from its operation. It stated that salary deposits are also exempted.

Background

The CBN circular states that the action is part of efforts to boost the revenue base of government and in compliance with the Stamp Duties Act and the court judgment in Suit No. FHC/L/CS/1710/2013 (Kasmal International Services Limited v. Access Bank Plc. and ors.). Section 89 of the SDA requires payment of duty on receipts acknowledging payment or deposit of money.

Analysis

It is pertinent to note that when the SDA was enacted, technological advancements like electronic transfers were not available and therefore not envisaged. The Federal High Court in Kasmal's case has acquiesced to the extension of the provisions to electronic payment. Some critics of the charge point to the fact that the case is currently on appeal and may be overturned.

Another issue arising on the matter, is the authority of Nigerian Postal Service (NIPOST) to administer stamp duties. The Stamp Duties Act and NIPOST Act 2004 empower the agency to collect stamp duties on instruments to be evidenced by adhesive stamps. Receipts are one of such instruments that can be denoted by adhesive stamps. The question that arises then, is if e-payments should fall in the category of transactions collectible by NIPOST.

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One obvious point, noted in the circular itself, is the increased revenue to government that will likely be raised from the administration of the duty. This, the circular emphasised, is apt in this period of dwindling revenues due to the fall in oil prices. Analysts have projected that the government will raise billions of naira in revenue from this introduction. For instance, data from the Nigerian Inter Bank Settlement System (NIBSS) shows that over 15 million cheques were processed in 2014.

Conclusion

The Nigerian Government continues to look for other sources of revenue and it is unlikely that the introduction of this duty will be the last of its kind. Increasing taxes like Value Added Tax and introduction of new taxes have been mooted as possible new ways of raising revenue. While the dusts settles, at least in the interim, the banks have started compying with the circular with immediate effect.

New Guidelines For Banking Operations In The Free Trade Zones... CBN

In pursuit of its mandate for the development of the banking operation in Nigeria the central bank of Nigeria on the 1st of February, 2016 published new guidelines for banking operation in the Free Trade Zone (FTZ) in Nigeria.

The document provided details of regulatory and supervisory requirement necessary to promote efficient and sustainable banking service in FTZs, spelled out details of permissible and prohibited activities of banks in Nigeria's FTZ and to provide details of incentives available to banks in the FTZs
Some of these incentives, which stem from the provision of the Nigeria Export Processing Zone Authority Act, include;

- Freedom to move funds in and out of the zone on all eligible transactions;
- Exemption from stamp duties on all its documents;
- Exemption from withholding tax deductions on interest payable on deposits, dividends and royalties;
- Exemption from corporate and capital gains taxes.

Banks currently operating in the FTZ before the issuance of these guidelines are required from the commencement of these guidelines to regularize and comply with the provisions for establishing presence in the FTZ within six months of the issuance of the guidelines while parent banks planning to establish units in these centres must apply, receive approval in form of approval-in- principle (AIP)and then a final licence from the authority and comply with all requirements as stated in the guidelines.

The guideline require that all banks planning to have units in a FTZ or already have units are required to have a minimum capital base of $10 million or such amount as CBN may from time to time determine. They must also meet all the prudential guidelines.

Amongst other things, emergence of this guideline provides the operating manual for banks in the FTZ, highlighting the sources and utilization of funds, rules for sourcing and utilization of funds and rendition of returns.

As from the commencement of this guideline, only banks or financial holding companies licensed under BOFIA, or licensed foreign banks shall qualify to apply to the Authority for approval to establish presence to carry on banking business in Nigeria's FZs.

Pedabo Associates Limited is a professional services organization that provides audit, tax, accounting, financial advisory and corporate finance services.

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