GUIDANCE NOTE ON IMPLEMENTATION OF IFRS 16

1.0 INTRODUCTION

The International Financial Reporting Standards (IFRS) was adopted in Tanzania in July 2004 as part of measures to improve reporting practices, transparency and disclosures by reporting entities. Adoption of IFRS implies that all revisions to the existing standards as well as new accounting standards issued by the International Accounting Standards Board (IASB) must be adopted by all reporting entities. In January 2016, the IASB issued the final version of IFRS 16 (Leases) to replace IAS 17 (Leases) requiring all reporting entities that have adopted IFRS to implement the new accounting standard by January 1, 2019.

Bank of Tanzania is interested in high quality application of IFRS 16 (the Standard) that results in a faithful presentation of lease transactions in the financial statements of banks and financial institutions. In this regard, this guidance intends to promote robust and consistent application of the Standard, especially in areas where banks and financial institutions are expected to exercise considerable judgment, elect to use simplifications and other practical expedients permitted under the Standard.

Further, this guidance is not intended to override the Standard but endeavour to promote consistency of application, facilitate greater comparability across the banking sector and address supervisory concerns.

2.0 IMPLEMENTATION OF IFRS 16

The Standard specifies how reporting entities will recognize, measure, present and disclose leases. It provides a single lessee accounting model, requiring lessees to recognize assets and liabilities for all leases unless the lease term is 12 months or less, or the underlying asset has a low value. In addition, the standard requires enhanced disclosures, which will provide greater transparency of a lessee's financial leverage and capital employed. Lessors accounting remains substantially unchanged from its predecessor IAS 17 as will continue to classify leases as operating or finance.

In order to ensure proper and consistent adoption of the Standard requirements in the Tanzanian banking sector, the Bank of Tanzania expects banks and financial institutions to observe the regulatory guidance prescribed below:

2.1 Identification of Lease Arrangements

The Standard defines a lease as any arrangement that gives a customer (lessee) the right to control the use of an identified asset for a period of time in exchange for consideration. Control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantial economic benefit from that use. Further, an asset is typically identified by being explicitly specified in a contract, but an asset can also be identified by being implicitly specified at the time is made available for use by the lessee.

2.2 Intercompany Arrangements

Banks and financial institutions should assess intercompany arrangements to determine if those arrangements are leases or contain embedded leases. When the arrangements are categorized as leases, banks and financial institutions should recognize the Right of Use Asset and Lease Liability as required in the Standard. The intercompany arrangement which are not categorized as leases, should be adequately disclosed.

2.3 Separating Lease and Service Components

Some of the arrangements in the banks and financial institutions contain both the right to use an asset (lease component) and services (service component). If the arrangement contains both lease and service components, the Standard provides guidance on how to separate those components. If a bank or financial institution separates lease and service components, it should only capitalise amounts related to the lease components. However, if it is costly to separate lease and service components, banks and financial institutions should combine and account for them as a single lease.

2.4 Application of Exemptions

The standard allows a lessee to elect not to apply the recognition requirements to short-term leases and leases for which the underlying asset is of low value.

a) Short-Term Leases

The standard defines a short-term lease as a lease that, at the commencement date, has a lease term of 12 months or less. However, a lease shall not be regarded as short term lease, if it contains a renewable option on which a bank or financial institution is reasonable certain to exercise the option, in this case the lease term should be 24 months. Further, any lease that contain a purchase option shall not be regarded as short term lease.

b) Low Value Asset

The standard does not provide an explicit definition of the term “low value” asset, rather it provides some guidance as to how to assess whether an underlying asset is of low value. It is important to note that the low value assessment is performed on the underlying asset, and not on the right of use asset. It is based on the value of that underlying asset when new, regardless of the age of the asset being leased.

Further, low value assessment should be performed on an absolute basis and is separate from materiality. This means all banks and financial institutions, regardless of size, are supposed to reach similar conclusions about whether different underlying assets qualify as low-value. In this regard, to ensure consistency, banks and financial institutions shall not apply the low value exemptions to a lease whose value of the underlying asset(s) when new exceeds Tanzanian Shillings ten million.

2.5 Initial Measurement

The standard requires the right of use asset, and the lease liability to be initially measured at the present value of unavoidable future lease payments. The following payments should be included in the initial measurement of the right-of-use asset and lease liability:

(i) Fixed payments (including in-substance fixed payments);

(ii) Variable lease payments if any (for example, payments linked to a consumer price index or market rates);

(iii) Amounts expected to be payable by the lessee under residual value guarantees;

(iv) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option;

(v) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising a termination option.

Further, the right of use asset may require adjustment for initial direct costs, prepayments, incentives and costs related to restoration at the end of a lease.

2.6 Discount Rate

The standard requires the future lease payments to be discounted using the rate implicit in the lease, or where this is not readily determined, the lessee's incremental rate of borrowing. Therefore, banks and financial institutions are required to use the interest rate implicit in the lease as a discount rate to derive the lease liability. However, if the interest rate implicit in the lease cannot be readily determined, then banks and financial institutions should use the rate that would pay to borrow money equivalent to the value of the underlying asset of the lease. A bank or financial institution that intends to use another rate that would accurately represent their incremental borrowing rate, it shall document and disclose the assumptions used to arrive into such rate.

3.0 TREATMENT OF RIGHT OF USE ASSET IN REGULATORY CAPITAL REQUIREMENT

As required by the Standard, recognition of right of use assets and lease liability on the balance sheet will have impact on the existing framework for calculation of regulatory capital and leverage ratios by the increased amount of assets and liability from lease transactions.

For regulatory capital purposes, banks and financial institutions shall treat right of use asset as tangible assets and apply a risk weight consistent with the risk weight that would be applied to the underlying asset if owned/acquired.

4.0 TRANSITION ARRANGEMENT FROM IAS 17 TO IFRS 16

Banks and Financial institutions shall apply the Standard using modified retrospective approach. For leases previously classified as operating leases, banks and financial institutions shall measure the lease liability at the date of initial application as the present value of the remaining lease payments, while the right of use asset shall be measured at an amount equal to the lease liability. Further, the discount rate used shall be the incremental borrowing rate at that date of initial application.

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