RSM INSIGHT: ADOPTING IFRS 16 *LEASES*

by RSM IFRS Advisory Committee

December 2019

RSM

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ADOPTING IFRS 16 *LEASES*

1. General Points

No finance v operating lease distinction

IFRS 16 does not differentiate between finance leases and operating leases for lessees. Therefore, previously capitalised assets subject to finance leases under International Accounting Standard (IAS) 17 and included in property, plant and equipment (PPE) will have to be reclassified on transition as right-of-use (ROU) assets and included with any ROU assets arising from operating leases.

Presentation choice

ROU assets must be presented separately from other assets per IFRS 16.47(a). ROU assets can either be presented separately on the face of the statement of financial position (SoFP) or within the same line item as PPE, with disclosure in the notes of the amount of ROU assets included in that line item.

Similarly, IFRS 16.47(b) requires all lease liabilities, including previously recognised finance lease liabilities under IAS 17, to be presented separately from other liabilities, either on the face of the SoFP or with disclosure of which line items in the SoFP include those liabilities.

Note that showing the movements in ROU assets is not a requirement of IFRS 16 and therefore this information need not be disclosed.

The educational webcasts and webinars on the implementation of IFRS 16 on IASB's website includes a presentation on 'Lessee Disclosures':

https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ifrs-16/#webcasts

Lease by lease v class of asset

Recognition options and practical expedients

One of the optional recognition exemptions in IFRS 16 can be taken on a lease-by-lease basis and the other is by class of underlying asset.

All the practical expedients on transition under the modified retrospective approach can be taken on a lease-by-lease basis. The practical expedient not to assess whether a contract is or contains a lease at date of initial application applies to all contracts, regardless of the transition approach (IFRS 16.C3).
IFRS 16 can be applied to a portfolio of leases rather than to separate leases as a practical expedient when the criteria in IFRS 16.B1 are met.

Lease-by-lease basis

- Elect not to recognise low value leases (IFRS 16.8)
- Measurement of the ROU asset under the modified retrospective transition approach (IFRS 16.C8(b))
- Apply a single discount rate to a portfolio of leases with reasonably similar characteristics when applying the modified retrospective transition approach (IFRS 16.C10(a))
- Apply IAS 37 to assess whether the lease is onerous immediately before date of initial application as an alternative to performing an impairment review when applying the modified retrospective transition approach (IFRS 16.C10(b)
- Elect not to recognise a ROU asset and lease liability under the modified retrospective transition approach for leases for which the lease term ends within 12 months of the date of initial application (IFRS 16.C10(c))

- Exclude initial direct costs from the measurement of the ROU asset at date of initial application under the modified transition approach (IFRS 16.C10(d))
- Use hindsight, e.g., in determining lease term, when applying the modified transition approach (IFRS 16.C10(e))

By class of underlying asset

- Elect not to recognise short-term leases (lease term of 12 months or less at commencement date) (IFRS 16.8)
- Elect not to separate non-lease components and lease components (IFRS 16.15)

2. Transition

What practical expedients are available on transition?

See the section on General points for a list of the practical expedients on transition.

Does it matter which option is taken when measuring a ROU under the modified transition approach (BC 286)?

IFRS 16.C8(b) provides that a lessee can choose, on a lease-by-lease basis, to measure a ROU asset at either:

(i) its carrying amount as if IFRS 16 had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the SoFP immediately before the date of initial application.

The option in (ii) is obviously attractive, being the simpler of the two options. However, clients should be made aware that the measurement of the ROU asset under this option will result in a higher value than under option (i), with higher depreciation charges to recognise in future over the remaining lease term. Clients may therefore wish to consider option (i) for significant leases; e.g. long property leases.

Under option (i), the value of the ROU asset would differ from the lease liability and the difference is a transition adjustment to opening equity (P&L) reserves at the date of transition, which is the beginning of the reporting period.

Although the standard permits a free choice of the measurement basis for ROU assets on transition, the basis for conclusions paragraph BC286 indicates that the IASB expects preparers to apply option (i) for more significant leases.

BC286 *Although acknowledging that a choice of approach could result in reduced comparability, the IASB concluded that permitting a choice of measurement approaches for the right-of-use asset on transition to IFRS 16 should be largely "self-policing" in terms of application. This is because the effect of the less costly option (measuring the ROU asset equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments) is an increase in operating expense (i.e. higher depreciation) for the remainder of the term of the lease. The IASB concluded that a lessee is expected to select the less costly option only for leases for which the costs of applying a more accurate transition approach outweigh the benefit of achieving a "correct" post-transition income statement. The IASB expects this to apply to leases that are high in volume but low in value but not to leases such as long-term leases of property or large equipment.*

Change in accounting for landlord contributions towards lessee assets may give rise to a transition adjustment

The accounting for these has changed under IFRS 16 – see the section below on Lease incentives. The issue arising is how to treat the balance of any amounts deferred in respect of such reimbursements on transition under the modified retrospective approach.

Where such reimbursements are material, clients should consider whether IFRS 16.C8(b) option (i) may be a more appropriate transition method.

Where can I find more guidance in respect of transitioning to IFRS 16?

The educational webcasts and webinars on the implementation of IFRS 16 on the IASB's website includes a presentation on 'Transition to IFRS 16'.

https://www.ifrs.org/supporting-implementation/supporting-materials-by-ifrs-standard/ifrs-16/#webcasts

3. Lease incentives

Definition changed

The definition of lease incentives in IFRS 16 has changed from the superseded guidance in SIC 15.

SIC 15 referred:

In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. Examples of such incentives are an up-front cash payment to the lessee or the reimbursement or assumption by the lessor of costs of the lessee (such as relocation costs, leasehold improvements and costs associated with a pre-existing lease commitment of the lessee). Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

IFRS 16 defines lease incentives as:

Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

Accounting for contributions by the landlord to lessee requires consideration of lessor v lessee assets

Under both superseded SIC 15 and IFRS 16, reimbursements by landlords for lessee assets are lease incentives.

Under IFRS 16 the accounting is different, with lease incentives received being required to be deducted from the cost of the ROU asset (IFRS 16.24(b)) and those receivables reducing the lease payments included in the measurement of the lease liability (IFRS 16.27(a)).

A point to bear in mind is that the reimbursement should be for the lessee's assets. If the reimbursements are for assets of the landlord, the accounting for them is different because in this situation the lessee is simply acting as agent for the landlord and these should not be recorded as assets of the lessee.

IE 13 being amended

The IASB is proposing to amend Example 13 of the illustrative disclosures to IFRS 16 in the Exposure Draft Annual Improvements to IFRS Standards 2018–2020 published in May 2019.

The facts in example 13 include a payment from the lessor to the lessee for lessee's leasehold improvements of CU7,000. The example then states that the lessee does not account for payments relating to leasehold improvements as a lease incentive but applies other relevant Standards. The explanation given is ‘because costs incurred on leasehold improvements by lessee are not included within the cost of the right-of-use asset’.

The explanation did not clarify that the leasehold improvements in this example were not the lessee’s assets. This resulted in a certain amount of confusion with users. In response, the IASB is proposing to remove the reference to the payment from the lessor for the leasehold improvements in the example.

4. Incremental borrowing rate (IBR)

What factors should be considered when determining a lessee’s IBR?

An IBR is specifically defined ‘to take into account the terms and conditions of the lease’ (BC162) – it is therefore a lease-specific rate.

The IBR should consider the features specific to a lease, which include:

- Length of the lease
- Security
- Amount of borrowing (should assume 100%)
- Currency
- Economic environment
- Lessee

Can a lessee use a single discount rate for all leases?

Generally, no, as IFRS 16.B1 makes it clear that IFRS 16 specifies the accounting for a single lease, and thus the discount rate should be specific to the lease.
However, as a practical expedient, IFRS 16.B1 permits the use of a single discount rate for a portfolio of similar leases where the effect of applying such an approach can be demonstrated as not materially impacting on the financial statements compared to applying the standard to the individual leases. This may be challenging.

Can a lessee use its WACC?

No – A WACC includes the cost of equity as well as the cost of debt and is not specific to the lease. Adjustments will be required to this to determine the IBR for each lease.

Can a lessee use property yields to determine the IBR for property leases?

BC162 states:

The IASB noted that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point when determining its incremental borrowing rate for a lease (for example, the rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases). Nonetheless, a lessee should adjust such observable rates as is needed to determine its incremental borrowing rate as defined in IFRS 16.

As BC162 highlights, clients might consider using property yields as a starting point. However, these are market-based measures of the annual return expected on a property and will not reflect the features specific to the particular lease and the lessee and therefore adjustments will be required to determine the IBR. Whilst such yields are observable, they are generally considered to be useful only as a benchmark (reflecting the upper end) because they are difficult to quantitatively adjust to arrive at an IBR.

What does 'similar term' mean?

Inter alia, an IBR should reflect the rate at which a lessee would have to borrow over a similar term to the lease (see definition in IFRS 16. appendix A). The question that arises is whether the rate should reflect both the term of the lease (bullet loan repayment) and its repayment profile (an amortizing rate).
Why does it matter? - a 5-year loan repayable at the end of the term is likely to attract a higher rate of interest than a 5-year loan being repaid over its term.
IFRS 16 does not explicitly require a lessee to determine its IBR to reflect the interest rate in a loan with a similar repayment profile to the lease payments.
Judgement is therefore required when adjusting observable borrowing rates. See IFRIC decision June 2019 for further analysis.

5. Lease term

Interaction of the lease term with IAS 16

IAS 16.56(d) requires expiry dates of related leases to be considered when determining the UEL of leasehold improvements.

IFRS 16.B37 requires a lessee to consider the economics of carrying out leasehold improvements when determining the enforceable period (i.e. term) of a lease.

In both cases, an entity considers its expected utility of the leasehold improvements and so their UEL is not limited by the term of the lease. See IFRIC decision June 2019 for further analysis.

For example, an entity might often reach a conclusion that it would only receive benefit from a leasehold improvement for as long as the lease term. However, it may be possible to economically and practically dismantle an improvement and redeploy it, such that its UEL may extend beyond the term of the related lease.

6. Deferred tax

Beware – deferred tax may arise

However, deferred tax can arise from IFRS 16 due to:

- IFRS 16 transitional adjustments
- Early-adoption of IFRS 16
- IFRS groups with non-IFRS or overseas subsidiaries
- Leases subject to capital allowances

In IFRS group accounts, deferred tax can arise where subsidiaries are using local GAAP, as the tax base will reflect the accounting for leases in the subsidiary. Deferred tax can also arise where overseas subsidiaries are subject to different tax rules.

Does the initial recognition exemption apply to ROU assets and lease liabilities?

In July 2019, the IASB published proposals to amend the IAS 12 initial recognition exemption so deferred tax assets and liabilities would arise on any temporary differences in relation to the recognition of a lease asset and a lease liability. Although, typically, those deferred tax assets and liabilities will be offset. The Exposure Draft (https://www.ifrs.org/news-and-events/2019/07/iasb-proposes-amendments-to-accounting-for-deferred-tax/) is open for comment until 14 November 2019. This guidance will be updated if IAS 12 is subsequently amended.

7. Impairment of right-of-use assets

IAS 36 is applied to ROU assets

ROU assets that don't generate independent cash flows are treated in the same way as corporate assets – allocated to CGUs or tested based on groups of CGUs. ROU assets no longer being used would be treated in the same way as redundant PPE.

Does the lease liability needed to be included in the CGU carrying amount?

Generally, it is likely that a CGU with leased assets cannot be disposed of without the leases so a recoverable amount based on FVLCD will consider the assumption of the lease liability. In this situation the lease liability also needs to be included in the CGU carrying amount.

Where a comparison of FVLCD with VIU is required, the lease liability must be deducted from the both the VIU recoverable amount and the CGU carrying amount.

Practical issues can arise with application of IAS 36 to CGUs with ROU assets

For example:

- Impact on discount rate - with the increase in debt and the lower cost of debt relative to equity, discount rates based on a WACC would be expected to fall. There may be a lack of market data in the short term that reflects the impact of operating leases coming on balance sheet on which to base discount rates.
- How to deal with leases that end in the forecast period – replacement asset or new lease? This is likely to depend on management's plans.
- How to deal with leases that end after the forecast period – the calculation of the terminal value is usually based on extrapolating the final period of the forecasts, which will assume continuation of the current leases. So doing would fail to reflect the effects of lease termination and replacement occurring beyond the forecast period. One way of addressing this issue, is to include replacement assets/leases in the terminal year and then make an adjustment to reflect that some of these expenditures will only start when the lease ends. Such adjustments may be challenging.
- Indicators of impairment – the inclusion of a ROU asset increases the carrying amount of the CGU but the market cap remains unchanged (at least in the short term) - does that mean there is now an indicator of impairment where there wasn't before?
- Transition choices could impact on whether VIU calculations indicate an impairment especially where there isn't much headroom. This is because each of the methods values the ROU asset and lease liability in a different way and using different discounts rates, so that the amount of the ROU asset added to a CGU will differ depending on the transition approach taken, but the cash flows excluded from the VIU remain the same. These factors impact the level of headroom.
- Need to think about the unit of account for the lease in the same way as under IAS 37 – for example where part of a property has been vacated.

8. Disclosures

Interims – what disclosures are required?

IAS 34.16A(a) requires a description of the nature and effect of any change in accounting policies compared with the most recent annual financial statements.

Finals – reconciliation to prior year lease commitments note and use of practical expedients

If a lessee elects to apply IFRS 16 under the modified retrospective approach, additional disclosures are required in the first reporting period of adoption:

- The weighted average IBR applied to lease liabilities at the date of initial application.
- An explanation of any difference between:
  - operating lease commitments disclosure under IAS 17 in the previous reporting period, discounted using the incremental borrowing rate at date of initial application; and
  - lease liabilities recognized at the date of initial application
- When applicable, the fact that any of the specified practical expedient(s) in IFRS 16.C10 has been used.