RSM INSIGHT: CLARIFYING THE TRANSITION TO IFRS 16 *LEASES*

by RSM IFRS Advisory Committee

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Contents

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IFRS 16 Leases is now effective, since it applies for periods beginning on or after 1 January 2019. One of the most difficult aspects of IFRS 16 is initial adoption, because of the many different transition options and practical expedients available.

Confused about the accounting entries you may be required to record on transition to IFRS 16 Leases? This article explains and illustrates the main transition options available.

1. TREATMENT OF COMPARATIVES

Full Retrospective Approach

This approach requires applying the requirements of IAS 8 in full, which means that comparative amounts are restated as though IFRS 16 had always applied, and the impact of the adoption of IFRS 16 on each line item in the financial statements. Three balance sheets are required on transition, under IAS 1.

If IAS 33 Earnings per share applies to the entity, the impact of the adjustment for the current and comparative period on basic and diluted earnings per share is shown.

This approach ensures comparability of results, and a lower charge to the income statement in periods subsequent to the adoption of the standard. However, it requires the determination of historic Incremental Borrowing Rates (IBR) and is likely to be more costly to implement.

Modified Retrospective Approach

The standard also permits an approach where comparative amounts are not restated, and instead, an adjustment is made to retained earnings, which represents the difference between the balance sheet under the previous standard and the balance sheet under the new standard.

The effect of this method must be disclosed. In particular, the weighted average lessee's IBR applied to lease liabilities recognised in the statement of financial position at the date of initial application; and an explanation of any difference between:

- Operating lease commitments disclosed applying Internal Account Standard (IAS) 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the IBR at the date of initial application; and
- The value of the lease liabilities recognised in the statement of financial position at the date of initial application.

The benefits of this approach are a reduced cost of transition, the ability to make use of a number of practical expedients, and the use of more easily identifiable incremental borrowing rates (at the date of transition, rather than the commencement date of ongoing leases).

HIGHLIGHT 1 – WHY MIGHT THERE BE A DIFFERENCE BETWEEN THE DISCOUNTED AMOUNTS DISCLOSED UNDER IAS 17 AND THE AMOUNTS RECOGNISED UNDER IFRS 16?

Some examples:

- Application of the practical expedient permitted to exclude from transition leases with less than 1 year to run at the date of transition
- Differences in the definition of a lease, leading to different recognition criteria
- Application of practical expedient permitted to exclude from transition leases of low value assets

- Incomplete previous disclosures
- Comparison done applying one interest rate to all leases in the disclosure, but not accounted for as a portfolio under IFRS 16

These examples are not exhaustive.

2. PRACTICAL EXPEDIENTS

Under the modified retrospective method, several practical expedients are available. While these are intended to ease the transition, it is important to understand the effect of the choices made.

Measurement of the right-of-use (ROU) asset

On a lease-by-lease basis, a decision has to be made about how to measure the ROU asset at the date of transition:

- As if IFRS 16 had always applied, but discounted using the IBR at the date of initial application; or
- At the value of the remaining lease liability at the date of transition, adjusted for any timing differences, including accrued or prepaid lease payments, or the remaining straight-line lease liability recognised under IAS 17 at the date of transition.

EXAMPLE 1. Right of use asset measurement – expedient

Consider the following fact pattern:

- Start of lease: 1 January 2018
- End of lease: 31 December 2023
- Lease length: 6 years
- Annual rental charge: $120,000 per annum (paid monthly)
- Incremental borrowing rate 1 January 2018: 7%
- Incremental borrowing rate 1 January 2019: 5%

For a year end 31 December 2019, and a date of initial application of 1 January 2019, the different options result in the following entries at the date of initial adoption:

	Modified retrospective: ROU at start of lease	Modified retrospective: ROU asset = Lease liability
ROU Asset	491,760	531,338
Lease liability	(507,617)	(531,338)
Reserves	15,857	-

And the following amounts are entries in the statement of financial performance for each of the following years, representing the sum of depreciation and interest expense:

	Modified retrospective: ROU at start of lease	Modified retrospective: ROU asset = Lease liability
FY19	130,082	130,109
FY20	123,903	125,301
FY21	117,292	120,253
FY22	110,218	114,952
FY23	102,648	109,386
TOTAL	**584,143**	**600,000**

The practical expedient will usually be simpler to apply. However, in many instances, including the example above, it will result in a higher depreciation charge, and therefore a lower profit, in the years subsequent to adoption.

Leases with termination dates within 12 months of the Date of Initial Application

There is the option to treat these as short-term operating leases, effectively maintaining the previous accounting treatment, or to include them in the transition and therefore recognise on the balance sheet.

HIGHLIGHT 2 – IS THERE A BENEFIT OF ONE OVER THE OTHER?

Creating a ROU asset and Lease Liability which will be depreciated in full over the year of adoption is likely to create additional work to model.

The value of operating costs recognised will be higher if the expedient is taken up, and the profit recognised will usually be lower.

The presentation of the expense will differ, as it will be shown as depreciation and interest if the lease is incorporated into the transition model; but will be shown as an operating expense if it is not. This may affect metrics such as EBITDA.

EXAMPLE 2. Leases with termination dates within 12 months of the Date of Initial Application

Consider the following fact pattern:

- Start of lease: 1 October 2016
- End of lease: 30 September 2019
- Lease length: 3 years
- Annual rental charge: $120,000 per annum (paid monthly)
- Fixed rental increase: 3%
- Straight Line Lease Liability under IAS 17, at 1 January 2019: (5,359)
- Incremental borrowing rate 1 January 2019: 5%

For a year end 31 December 2019, and a date of initial application of 1 January 2019, the different options result in the following entries at the date of initial adoption:

At 1 January 2019	Applying IFRS 16 to the lease: Modified retrospective: ROU asset = Lease liability	Do not apply IFRS 16
ROU Asset	91,013	-
Lease liability	(96,372)	-
SL Lease Liability: derecognise	5,359	-

And the following amounts are entries in the statement of financial performance for each of the following years:

FY19	Applying IFRS 16 to the lease: Modified retrospective: ROU asset = Lease liability	Do not apply IFRS 16
OPERATING COSTS:		
Short-term lease expense	-	92,986
Depreciation	91,013	-
FINANCE COSTS		
Interest	1,974	-
TOTAL	92,986	92,986

Leases of assets of low value

Leases of low value assets can continue to be expensed as an operating lease: a ROU asset and lease liability do not need to be recognised. The threshold has not been defined within IFRS 16, per BC100 the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US$5,000 or less.

HIGHLIGHT 3 – WHAT IS A LOW VALUE ASSET?

Consider a lease of a car parking space, for 2 years, paying $200 per month. The total payments are only $4,800. However, because of the location of the car parking space - say, in the Central Business District of a particular city - the underlying asset value is likely to be closer to, say, $50,000.

Therefore, despite the low value of payments, the underlying asset is not of low value, so this lease cannot be exempted.

Onerous leases

There are two options in relation to leases which were identified as onerous under IAS 37 in the comparative year:

- An entity may perform an impairment review on newly recognised ROU assets; or
- An entity may rely on an assessment of whether a lease is onerous as at the date immediately before the transition.

In the second case, the onerous lease provision is deducted from the newly recognised ROU asset, thereby decreasing the depreciation charged each year going forward.

EXAMPLE 3. Onerous Leases

Consider the following fact pattern:

- Entity X leases an office in a level of a building for $120,000 per year, which it no longer **utilizes.** At the date of transition, the lease has 4 years left to run.
- It has sub-let the premises for $100,000 per year, in advance, until the end of the lease term.
- Since the sub-lease is for a lower amount than the head lease, an onerous lease provision had been recognised under IAS 37, with a value of $74,465.
- This represents $20,000 per annum for four years, discounted at 5%.

With the practical expedient	Without the practical expedient
Deduct $74,465 from the right of use asset recognised on transition, so recognise a right of use asset of $242,360.	Recognise a right of use asset equal to the lease liability – of $316,826 – and subject it to an impairment review immediately on recognition.