RSM INSIGHT: December Year-end Accounting Reminders IFRS

by RSM IFRS Advisory Committee

January 2020

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

Contents

RSM INSIGHT: December Year-end Accounting Reminders - IFRS
1. Introduction 3
2. Key Topics and Reminders (effective January 1, 2019) 3
IFRS 16 3
IFRIC 23 – Uncertainty over Income Taxes 6
IFRS 9 – Prepayment Features with Negative Compensation 7
IAS 19 – Employee Benefits 7
IAS 28 – Investments in Joint Ventures & Associates 7
Annual Improvements 2015-2017 7
3. New Standards and Amendments (effective January 1, 2020) 8

December year-end accounting reminders – IFRS

1. Introduction

This newsletter will discuss reporting requirements as of December 31, 2019. The first section will discuss key topics and reminders that financial statement preparers and reviewers should consider in preparing their statements and provide an illustrative example of common issues encountered from the past 3 quarters.

The next section will discuss standards and interpretations that are not effective as at December 31, 2019 but should be disclosed consistent with paragraph 30 of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.*

2. Key Topics and Reminders (effective January 1, 2019)

IFRS 16

IFRS 16 *Leases* comes into effect for periods commencing on or after 1 January 2019. Lessees with contracts that are currently treated as operating leases in their financial statements (i.e. the business pays rent) will be affected by the changes.

What are the main changes?

IAS 17 *Leases*, the predecessor to IFRS 16, requires entities to classify their contracts as either operating or finance leases, based on the extent to which risks and rewards incidental to ownership of the leased asset lie with the lessor or the lessee. However, IFRS 16 removes the 'operating" and "finance" lease classifications and replaces them with the concept of right-of-use assets and the associated lease liabilities. Put simply, this change results in the recognition of a lease liability on the balance sheet for operating leases (which reflects the present value of future rental payments) and a corresponding asset, which is referred to in the standard as a right-of-use ("ROU") asset.

Key Learnings to Date

Two options for measuring a ROU asset under the modified approach

Under the modified transition approach, IFRS 16.C8(b) states that a lessee can choose on a lease-by-lease basis, to measure a right-of-use 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 statement of financial position immediately before the date of initial application.

The option in (ii) is initially more attractive, being the simpler of the two alternatives. However, preparers should be made aware that the measurement of the ROU asset under this option will result in a higher value than under option (i), resulting in higher depreciation charges in the future over the remaining lease term. Therefore, clients may wish to consider option (i) for significant leases (e.g. long-term property leases).

Under option (i), the value of the ROU asset would differ from the lease liability, and the difference is recorded as a transition adjustment to opening equity (i.e. retained earnings) at the date of transition, which is at the beginning of the reporting period.

Factors affecting the Incremental Borrowing Rate

For lessees, most leases are discounted using the Incremental Borrowing Rate ("IBR"). The incremental borrowing rate is defined as the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. Determining the incremental borrowing rate will often involve significant judgment and may have a significant impact in the calculation of the right-of-use asset and lease liability. Companies should work with their accounting advisors and auditors to ensure they have determined an appropriate incremental borrowing rate.

Starting with the Weighted Average Cost of Capital (WACC), adjustments should be made to recognize that the WACC includes the cost of equity, but the IBR does not. Other factors to consider include the following:

- The length of the lease: the longer the lease, the higher the rate
- The underlying value of the asset being leased: the better the security, the lower the rate;
- The entity's existing debt: the higher the current cost of borrowing, the higher the incremental cost of borrowing;
- The quality of the asset being leased: the higher quality of asset, the lower the rate.

Based on the factors above, the IBR may differ for different leases held by the same entity. For example, a property lease may have a lower IBR than a vehicle lease, since it will usually have a longer term, and the underlying asset represents better security.

Provision for restoration of assets on transition

Many lease contracts contain restoration or make-good provisions. For example, leases for commercial premises often include a "make-good" clause, which requires the lessee to remove their fit-out at the end of the lease and return the premises to their original condition. The expected cost of doing this is recognised as a provision under IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

The recognition of a make good provision associated with leases is not a new requirement from IFRS 16, since it is an existing requirement of IAS 37. However, its treatment changes under IFRS 16, because the initial recognition of right of use assets includes 'an estimate of costs to be incurred in [making good] the underlying asset.' We have also seen instances where a provision was not recognised previously, but the review of lease contracts undertaken to implement IFRS 16 has identified that a make-good clause exists, and therefore a provision is necessary.

In the year of transition, the treatment of these costs and associated provisions depend on the transition method applied, on whether or not such a provision had already been recognised.

Lease Incentives

Lessees will often receive incentives from lessors to enter into lease agreements. 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." The definition is therefore silent on the treatment of lease incentives where lessors reimburse lessees for their fit-out costs.

A key consideration in this is whether fit-out costs are incurred to build assets which are for the lessor's benefit, or for the lessee's benefit. Please see below for further discussion.

- If the assets constructed are to remain the benefit of the lessee, and are of no benefit to the lessor, then the contribution should be treated like any other cash incentive received or receivable
- If the asset constructed will ultimately be the lessor's, then this is outside the scope of IFRS 16. The lessee does not end up with an asset in addition to the right-of-use asset, and instead, is in effect making upfront payments for costs of the lessor, with the lessor reimbursing them

Careful consideration of the terms of the lease agreements is imperative in ensuring these issues are identified early and accurately addressed in applying IFRS 16.

Non-Lease Components

Lease agreements often contain clauses, which refer to other goods or services to be purchased from the lessor, such as maintenance costs, utilities, insurance costs, and property taxes. The accounting treatment of these additional items depends on whether they are for goods or services which provide a benefit to the lessee.

Lease and associated non-lease components may be accounted for together (i.e. one lease component). This election is made by class of the underlying asset (i.e. building, vehicles etc.)

If this election is not made, lease components and non-lease components are always separated, and non-lease components are accounted for under other standards. The consideration in the entire contract will be allocated based on the stand-alone selling prices of the lease and non-lease components.

Lease Type	Lease Component	Non-lease Components	Not Components
Car Leases	• Right to use a vehicle	• Car servicing • Car maintenance	• Stamp duty • Registration
Property Leases	• Right to use a building	• Cleaning services • Maintenance services • Common area maintenance • Security • Energy usage • Water usage	• Property taxes • Property insurance • General insurance
Equipment Leases	• Right to use machinery	• Maintenance services • Servicing	
Accounting Treatment	Account separately	Account separately, unless practical expedient elected	Include in the consideration allocated to the components

Example - Applying the practical expedient to combined lease and non-lease components

A lessee enters into a 10-year lease for an office building. The lease payments are $50,000 per year, and the contract includes a utility charge of $0.005 / kWh consumed. The contract includes payments for common area maintenance costs of $10,000 per year, and property tax payments based on 0.2% of the assessed value each year. The assessed value is $10,000,000 for year 1, which is known at the lease commencement date.

The lessee concludes the following:

- There is one lease component (the right to use the office building) consisting of $50,000 per year
- There are two non-lease components (the common area maintenance) consisting of $10,000 per year and the utility charges of $0.005 / kWh consumed
- The property taxes do not represent a lease or non-lease component since there is no good or service transferred to the lessee
- The lessee elects to use the practical expedient to combine lease and non-lease components

At the commencement date, the lessee measures the lease liability at the present value of the fixed lease payments (10 annual payments of $50,000 and $10,000 for the office building and common area maintenance respectively.) Also included in the initial measurement of the lease liability is an in-substance payment for property taxes in year 1, calculated as 10,000,000 x 0.2% = 20,000.

The lessee will exclude the utility charges of $0.005/ kWh consumed because they are variable payments that depend on usage. Furthermore, the lessee will exclude future property tax payments, because they are variable payments that depend on the future value of the office building. The lessee will recognise the payments for the utility charges and the future property tax payments as a variable lease payment – in profit or loss when they are incurred.

IFRIC 23 – Uncertainty over Income Taxes

IFRIC 23 clarifies how to apply the recognition and measurement requirements of IAS 12 when there is uncertainty over the income tax treatment. The standard comes into effect for periods commencing on or after 1 January 2019. In order to accurately apply the standard, there are three key concepts:

1. What an uncertain tax treatment is;
2. How the uncertain tax treatment shall be measured; and
3. When should amounts be derecognised or remeasured?

Uncertain tax treatment

An uncertain tax treatment is where there is uncertainty over whether the relevant taxation authority will accept the tax treatment under tax law. Examples of an uncertain tax position are:

- An allocation or shift of income between jurisdictions
- Acceleration of a deduction that would be available in a later period
- The decision to exclude taxable income from a return

Measurement

In determining the measurement of an uncertain tax position, companies should assume that the relevant tax authority will examine all the amounts that it has the right to examine with full knowledge of all the related information. If it is probable that the tax authority will accept the treatment in the tax return, the amount in the financial statements is the same as in the tax return; if it is not probable, the amount in the financial statements is not the same as in the tax return.

Management can use the most likely amount (i.e. the single most likely amount in a range of possible outcomes) or an expected value method (i.e. sum of the probability-weighted amounts in a range of possible outcomes). The most likely amount would be most appropriate where the possible outcomes are concentrated on one value. In contrast, the expected value method is most appropriate where there is a range of possible outcomes that are neither binary nor concentrated on one value.

Derecognition / Remeasurement

Companies are required to reassess a judgment or estimate if facts and circumstances that the original judgment or estimate was based on change. Examples of a change can include:

- Examinations or actions by a tax authority
- Changes in rules established by a taxation authority
- The expiry of a taxation authority's right to examine or re-examine a tax treatment

Companies are required to apply IAS 8 and account for it as a change in estimate and apply IAS 10 *Events after the Reporting Period* to determine whether a change is an adjusting or non-adjusting event.

IFRS 9 – Prepayment Features with Negative Compensation

Negative compensation arises where contractual terms permit the borrower to prepay the instrument before maturity, at an amount that could be less than the unpaid principal and interest. This effectively results in a payment to the borrower, instead of compensation from the borrower, even though the borrower chose to prepay the debt instruments. The changes to the standard enable companies to measure a pre-payable financial asset with negative compensation at amortized cost or FVTOCI rather than FVTPL.

In order to classify an instrument with prepayment features with negative compensation at amortised cost, the following three criteria must be met:

- Entity acquires or originates the asset at a premium or discount to the contractual par amount.
- Prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for early termination of the contract
- On initial recognition, the fair value of the prepayment feature is insignificant

IAS 19 – Employee Benefits

When a plan amendment, curtailment, or settlement occurs, entities are required to base the current service cost and net interest amounts on the updated assumptions at the date of the planned amendment.

The standard has also been clarified; in calculating the gain / loss after an amendment, any asset ceiling is ignored, and the effect on the planned amendment on the asset ceiling is recognised in other comprehensive income.

The amendment to IAS 19 should not be applied retrospectively, and only applied to amendments occurring in periods commencing on or after 1 January 2019.

IAS 28 – Investments in Joint Ventures & Associates

Entities must apply IFRS 9 to financial instruments in associates or joint ventures to which the equity method is not applied. Entities must apply the amendment retrospectively in accordance with IAS 8 for annual reporting periods beginning on or after January 1, 2019. Early adoption is permitted, but entities must disclose this fact.

Annual Improvements 2015-2017

These amendments will impact the following standards:

IFRS 3 *Business Combinations* and IFRS 11 *Joint Arrangements*, regarding the remeasurement of an investor's previously held interest in a joint operation when it obtains control of a business.

IAS 12 *Income Taxes,* surrounding the accounting for income tax consequences of dividend payments.

IAS 23 *Borrowing Costs*, clarifying which borrowing costs are eligible for capitalization

3. New Standards and Amendments (effective January 1, 2020)

In accordance with IAS 8 paragraph 30, entities are required to disclose new IFRS standards that have been issued and not yet effective. The list below outlines new standards and amendments effective January 1, 2020. Early application of the amendments and new standards is permitted with note disclosure.

<table>
<tr><td>IFRS 3 – Definition of a Business</td><td>On October 22, 2018, the International Accounting Standards Board (IASB) issued an amendment to IFRS 3 Business Combinations, to improve the definition of a business. The amendments will clarify whether an acquisition is a business or a group of assets.

The amendment clarifies that an output of a business is to provide goods or services, whereas the previous definition referred to the generation of dividends, cost reductions or other economic resources.

Furthermore, the standard introduces an optional concentration test, where substantially all of the fair value of gross assets acquired is concentrated in a single asset; the assets acquired would not represent a business.

Distinguishing between a business and a group of assets is important as business combinations can result in goodwill. The amendment to the standard will likely result in more acquisitions treated as asset acquisitions rather than business combinations.</td></tr>
<tr><td>Definition of Material – Amendments to IAS 1 and IAS 8</td><td>The amendments clarify the definition of material and its application by:
Aligning the wording of the definition of material across IFRS Standards and other publications and making improvements to wording
Including some of the supporting requirements in IAS 1 Presentation of Financial Statements in the definition to give them more prominence
Clarifying the explanation accompanying the definition of material</td></tr>
<tr><td>The Conceptual Framework for Financial Reporting</td><td>The IASB issued a revised conceptual framework. Key changes include:
New concepts on measurement, including factors to be considered when selecting a measurement basis
New concepts on presentation and disclosure, including when to classify income and expenses in other comprehensive income
Derecognition guidance on when assets and liabilities are removed from financial statements
Updated definitions of assets and liabilities, and recognition criteria for including assets and liabilities in the financial statements
Clarification on prudence, stewardship, measurement uncertainty, and substance over form</td></tr>
</table>

The aim of this publication is to provide general accounting guidance only and it is not a substitute for professional advice. No responsibility for any errors or omissions nor loss occasioned to any person or organization acting or refraining from acting as a result of any material in this publication can be accepted by the authors or RSM International. You should not act on the basis of the material in this publication without taking professional advice.

RSM International Limited is a company registered in England and Wales (company number 4040598) whose registered office is at 50 Cannon Street, London EC4N 6JJ, United Kingdom. RSM is the brand used by a network of independent accounting and consulting firms, each of which practices in its own right. The network is not itself a separate legal entity of any description in any jurisdiction. The network is administered by RSM International Limited. The brand and trademark RSM and other intellectual property rights used by members of the network are owned by RSM International Association, an association governed by article 60 et seq of the Civil Code of Switzerland whose seat is in Zug.

© RSM International Association, 2020