Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas

Common application issues in implementing the new leases standard

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Introduction

The new leases standard, IFRS 16 *Leases*, fundamentally changes the way in which entities account for leases. In addition to the headline change of 'bringing most leases on balance sheet', the standard results in significant changes to financial reporting and has many broader business implications. The transition requirements in IFRS 16 are relatively complex with entities needing to make a number of transition-related decisions and judgements which can have significant financial consequences.

IFRS 16 became effective on 1 January 2019. It applies mandatorily to 31 December 2019 full year and half-year financial statements (and already applied to 30 June 2019 half-year financial statements). While we are seeing an increased level of interest and effort by entities to understand the impact of IFRS 16, many are still significantly underprepared for the implementation of this major change.

With this in mind, this article briefly looks at some of the common application issues.

Lease definition

IFRS 16 introduces a revised definition of a 'lease' and provides additional guidance on applying this new definition. While the revised definition is not expected to cause major changes to lease conclusions in practice, it can result in different conclusions in some cases, particularly in arrangements where there were difficult judgements in the past or those which are not legally structured as a lease but involve substantial use of a single asset (e.g. power purchase arrangements).

Data collection

Gathering the contracts for analysis can require considerable effort and may require collaboration with other functional areas such as finance, legal, property and IT. Some of the contracts can be very lengthy and hence the analysis may require considerable time.

It can also be a challenge to get comfort over the completeness of leasing information, particularly for multinational entities with numerous subsidiaries potentially located in a number of geographical regions with different systems and processes. In different jurisdictions, leases can take different forms and thus it is critical to ensure consistency in the nature of data collected where this is performed on a geographic basis.

Discount rate

In determining the amount of lease liability under IFRS 16, entities will need to discount future lease payments using either (a) the interest rate implicit in the lease (if it can be readily determined) or (b) the lessee's incremental borrowing rate. In many cases, the interest rate implicit in the lease will not be readily determinable and therefore entities will need to come up with an appropriate incremental borrowing rate.

Determination of the incremental borrowing rate can be a significant issue for lessees. Some entities do not have any existing external borrowings (e.g. cash rich entities or Australian subsidiaries of large overseas entities). Similarly, many not-for-profit entities do not have borrowings. For these entities, coming up with the incremental borrowing rate can be a practical challenge. It would not generally be appropriate for a lessee to use its Weighted Average Cost of Capital (WACC) as the WACC includes equity as well as borrowings and it is not specific to the term, security and amount of the lease.

In practice, one possible way for entities to determine the incremental borrowing rate might be to approach their local bank for an indicative rate that the bank would charge to borrow over a similar term, with similar security, the funds to obtain an asset of similar value to the Right-of-Use (ROU) asset in a similar economic environment taking into account the credit risk of the entity. Management can then use this rate as a starting point in coming up with an appropriate discount rate. Another possible approach is for entities to come up with a reasonable estimate of the incremental borrowing rate using information such as the Reserve Bank of Australia's published lending rates as the starting point with adjustments for entity-specific factors as necessary. Given the complexity of the area, some entities may need to seek external professional advice in determining an appropriate incremental borrowing rate.

Lease term

Determining the correct lease term under IFRS 16 is a significant issue. Firstly, the longer the lease term, the larger the lessee's ROU asset and lease liability will be. Secondly, the length of the lease term determines whether a lease qualifies for the short-term lease exemption. Finally, IFRS 16 contains additional application guidance on how to deal with periods covered by options to extend or terminate a lease. While this detailed guidance can be helpful, it also means there is more to consider when determining the lease term. There can be considerable judgement in determining whether it is 'reasonably certain' that an entity would exercise its extension option or not exercise its termination option.

This is an area where the practice is still evolving. For instance, at its June 2019 meeting, the IFRS Interpretations Committee discussed:

- how to determine the lease term of a cancellable lease (where a lease does not specify a particular contractual term but continues indefinitely until either party to the contract gives notice to terminate) or a renewable lease (where a lease specifies an initial period and renews indefinitely at the end of the initial period unless terminated by either party); and
- whether the useful life of any related non-removable leasehold improvements is limited to the lease term.

Transition choices

The transition requirements in IFRS 16 are quite involved as there are a large number of choices available and these choices could have a significant financial impact on the financial statements. Accordingly, it is important for entities to understand the transition choices available, gather necessary data and model the possible options to ensure that the elections made by the entity best reflect its circumstances and needs. For instance, the decisions on transitional provisions could affect the entity's ability to pay dividends, compliance with banking covenants and the attractiveness of employee bonus arrangements.

The following table summarises the main transition choices available to entities:

General choices	
Lease definition	All or nothing policy choice to: • apply the new lease definition to all contracts; or • grandfather previous lease determinations and only apply the new definition to new or modified leases after the Date of Initial Application (DOIA)
Transition methods	All or nothing policy choice to use either: • the full retrospective method; or • modified retrospective method Under the full retrospective method, IFRS 16 is applied as if it had always been effective since the start of the lease. No additional transition reliefs are available. Under the modified retrospective method, the cumulative effect of applying IFRS 16 is recognised in equity as an adjustment to the opening balance of retained earnings for the current period. Prior periods are not restated.

Choices only available under the modified retrospective transition method	
Leases previously classified as finance leases	ROU asset and lease liability are measured at the same amounts as IAS 17 *Leases* at DOIA.
Leases previously classified as operating leases	Lease liability is measured at the present value of the remaining lease payments, discounted using the incremental borrowing rate at DOIA. The ROU asset can be measured at: • the asset's carrying value as if the Standard had been applied since the commencement date of the lease but discounted using the lessee's incremental borrowing rate at DOIA [Option 1]; or • an amount equal to the lease liability, adjusted by prepayments or accrued lease payments [Option 2]. While Option 1 involves more complex calculations, it will result in a lower carrying amount of the ROU asset than under Option 2. Option 2 results in a higher carrying value of the ROU asset, and therefore higher subsequent depreciation expense and lower profit over the remaining lease term. Choice between Option 1 and Option 2 is available on a lease-by-lease basis so entities could choose Option 1 for larger leases (e.g. property leases) and Option 2 for relatively smaller leases (e.g. photocopiers).
Leases with low value assets or leases ending within 12 months of DOIA	Entities can either recognise: • ROU asset and lease liability in accordance with IFRS 16; or • continue to account for as a period expense as it has under IAS 17
Discount rate	A single discount rate can be used for a portfolio if the portfolio has leases of similar characteristics.
Impairment	ROU asset must be assessed for impairment. Entities can either: • apply IAS 36 *Impairment of Assets* at DOIA; or • adjust the ROU asset by the amount of any previously recognised onerous lease provision
Initial direct costs	Entities can choose to exclude initial direct costs from the measurement of ROU assets at DOIA.
Use of hindsight	Entities are permitted to apply hindsight when applying the standard (e.g. in determining the lease term where there are options to extend or terminate the lease)

Peppercorn leases

In the Australian not-for-profit (NFP) context, it is worth noting that AASB 1058 *Income of Not-for-Profit Entities* and AASB 16 *Leases* previously required NFP entities to measure ROU assets on initial recognition at fair value in respect of leases that have significantly below-market terms and conditions principally to enable the entity to further its objectives. However, in December 2018, the AASB issued AASB 2018-8 *Right-of-Use Assets of Not-for-Profit Entities* permitting NFP lessees to recognise those ROU assets for below-market or peppercorn leases either at cost or fair value. This amendment solves the previous concerns many NFPs had around fair valuing their peppercorn leases.

Conclusion

The transition to IFRS 16 involves a lot more than simply recognising an asset and a liability on the balance sheet. In addition to the broader business implications associated with the introduction of IFRS 16, entities need to make a number of transition decisions which will have significant financial consequences. If you are not yet prepared for IFRS 16 implementation, time is running out as this standard applies mandatorily to entities with 31 December 2019 financial year end or half-year reporting obligations.