

# Adviser alert – *Insights into IFRS 16 – Transition choices*

February 2019

## Overview

The Grant Thornton International IFRS team has published *Insights into IFRS 16 – Transition choices*.

The *Insights into IFRS 16* series provides insights on applying IFRS 16 *Leases* in key areas. Each edition will focus on an area of IFRS 16 to assist you in preparing for the required changes on adoption of the standard.

The bulletin *Insights into IFRS 16 – Transition choices* provides guidance on the transition to IFRS 16.

## The issue

Like other recent accounting standards, IFRS 16 includes significant transition reliefs to make first-time application simpler. Appendix C to IFRS 16 contains all the details of the transition provisions that are available.

The key takeaway is that there are a significant number of choices available and decisions about these can have a significant impact on the reported balance sheet and income statement. It is therefore important to make sure that you obtain all the data necessary to apply the standard and that you model the possible options to ensure you select the one that will best meet your needs.

The bulletin sets out the transition choices that are available and discusses some of their practical implications. The final page includes a flow chart summarizing the decisions to be made.

## Resource

The bulletin *Insights into IFRS 16 – Transition choices* follows this *Adviser alert*.

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# Insights into IFRS 16

## Transition choices

Many recent accounting standards include significant transition reliefs to make first time application simpler – IFRS 16 is no exception. Appendix C to IFRS 16 contains all the details of the transition provisions that are available.

This article sets out the choices that are available and discusses some of their practical implications. The final page then includes a flow chart summarising the decisions to be made.

The key takeaway is that there are a significant number of choices available and decisions about these can have a significant impact on the reported balance sheet and income statement. It is therefore important to ensure that you obtain all the data necessary to apply the Standard, and that you model the possible options to ensure you select the one that will best meet your needs. For example, the application of the various transitional provisions could have an impact on:

- your ability to make dividend payments
- tax payments
- your banking covenants
- the attractiveness of employee bonus arrangements
- the availability of investor reliefs
- the metrics your investors use to assess your position and performance.

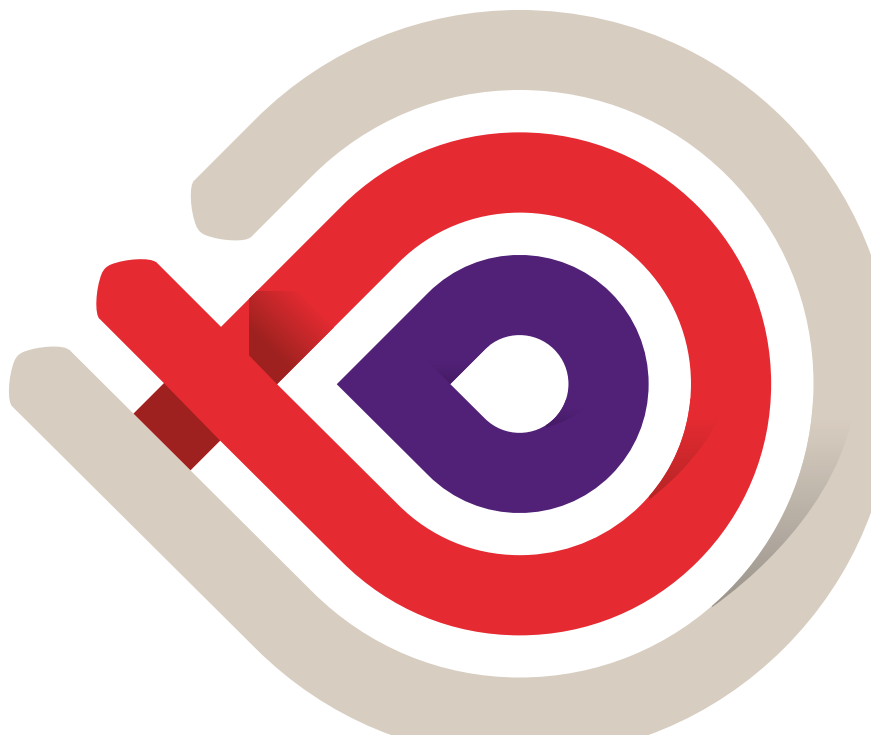
## Identify leases

The first decision to be made on transition is which lease definition to use when identifying leases. For contracts in place at the date of initial application you can either:

- apply the IAS 17/IFRIC 4 definition of a lease, or
- apply the IFRS 16 definition of a lease.

Initial application is the beginning of the annual reporting period in which an entity first applies IFRS 16. For entities with a year-end of 31 December, the date of initial application will be 1 January 2019, unless the Standard is adopted early.

Although the definition of a lease under IFRS 16 is similar to IAS 17 and IFRIC 4, IFRS 16.9 introduces the requirement that a lease contract must convey the 'right to control the use of an identified asset for a period of time in exchange for consideration'.



While there will likely be a significant overlap between leases identified under IAS 17 and IFRS 16, we expect some differences to arise, with the key difference between the two standards being the ability to “control” an identified asset. IFRS 16 includes substantially more guidance on identifying a lease which can be found in the application guidance (Appendix B of IFRS 16).

#### The practical implications

- Have you identified all your lease contracts?
- Does the altered definition have any implications in practice?
- What is the impact of the revised definition, will this result in more or less leases?

## The application methods to choose

IFRS 16 provides two methods for first time application of the Standard:

- full retrospective application
- modified retrospective application.

#### Full Retrospective

If the full retrospective approach is taken, the liability and asset are measured as if IFRS 16 had been applied since the start of the lease. There are no further transition reliefs available if this route is taken and full retrospective application in accordance with IAS 8 ‘Accounting Policies, Estimates and Errors’ is required. Comparatives also need to be restated.

#### Modified Retrospective

The cumulative effect of adopting 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. This will result in the current and prior periods not being comparable, therefore consideration should be given to how this is explained to the users in the financial statements.

Under the modified retrospective approach, for leases previously classified as operating leases, the lease liability is measured at the present value of the remaining lease payments and discounted using the incremental borrowing rate at the date of initial application. The right-of-use asset can be measured at:

- an amount equal to the lease liability, adjusted by prepayments or accrued lease payments relating to that lease at the date of initial application; or
- the asset’s carrying value as if the Standard had been applied since the commencement date of the lease. Although the carrying value is determined from the commencement of the lease, it is discounted using the lessee’s incremental borrowing rate at the date of initial application.

For those leases previously classified as finance leases, the right-of-use asset and the lease liability are measured at the same amounts as IAS 17 at the date of initial application.

**Handy hint: using the first of these approaches to measuring the right-of-use asset will be the more straightforward option. However, in many situations, it will result in a higher asset value on transition. This means higher depreciation charges recognised on the right-of-use asset and, more importantly, lower net income in the periods following adoption.**

#### The practical implications

- How will you estimate the incremental borrowing rate for leases in place at the date of initial application?
- Will you apply the portfolio approach described in IFRS 16.B1 and IFRS 16.C10(a) to determine incremental borrowing rates for groups of assets? If so, what portfolios of assets will you determine incremental borrowing rates for? For example, separating assets into portfolios for:
  - property and cars, or
  - property in London, other property in the UK and cars, or
  - some other portfolios?
- What evidence will your auditors require that your identification of portfolios would not give a materially different result to applying the Standard on a lease-by-lease basis?
- Can you source the data needed to calculate the original asset carrying value? Will this be beneficial to either the income statement or the balance sheet position?

## Advantages and disadvantages of applying the modified retrospective approach

The main advantage of using a modified approach as opposed to a full retrospective approach is the cost savings that can be made. Costs are saved as a result of not having to restate comparatives and the additional transitional reliefs that are available to be applied (these are discussed further below).

The biggest disadvantage is the loss of comparability of information.

## Other transitional reliefs when applying the modified retrospective approach

If the modified retrospective transition method is chosen, there are further policy decisions which need to be made for those leases previously accounted for as operating leases under IAS 17. Each of these choices can be made on an individual lease-by-lease basis.

### Low value assets

On transition, if the lease is for a low value asset, then there is no requirement to recognise any transition adjustments and can account for the lease expense on a straight-line basis or another systematic basis if more representative.

### Leases of investment property

Prior to the adoption of IFRS 16, IAS 40 'Investment property' permitted you to recognise an asset in respect of investment property held under an IAS 17 operating lease if that asset was accounted for using the fair value method. Upon adoption of IFRS 16, no transition adjustments are required for these assets. IAS 40 and IFRS 16 are applied from the date of initial application onwards.

For operating leases of investment property not previously recognised as an asset, the new right-of-use asset is accounted for at fair value if the fair value model in IAS 40 is going to be applied. Subsequent to the date of initial application the right-of-use asset and the lease liability are accounted for by applying IAS 40 and IFRS 16.

### Discount rate

This transitional relief allows a single discount rate to be applied to a portfolio of leases. Each portfolio needs to have reasonably similar characteristics, for example similar remaining lease terms for similar classes of assets in similar economic environments.

### Impairment

Right-of-use assets must be assessed for impairment on transition. To do this, you can either:

- apply IAS 36 at the date of initial application, or
- adjust the right-of-use asset by the amount previously recognised as an onerous lease provision.

### Leases ending within 12 months of initial application

For an existing lease which ends within 12 months of initial application of IFRS 16, you can choose to either recognise the right-of-use asset and liability in accordance with the normal requirements of IFRS 16 or account for the lease as a short-term lease. If accounted for as a short-term lease, the lease would continue to be accounted for as it has been under IAS 17 with payments recognised as an expense over the lease term on a straight-line basis or another systematic basis if more representative.

### Initial direct costs

On transition, you can choose to either include or exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

### Use of hindsight

A lessee is permitted, but not required, to apply hindsight when applying the Standard. For example, in determining the lease term where there are options to extend or terminate the lease.

### Practical decisions to make

- How will you account for operating leases of investment property not previously recognised as an asset under the IAS 40 fair value model?
- Will you apply the small value asset exemption to leases in place at the date of initial application?
- Which approach will you use to determine the impairment of right-of-use assets at the date of initial application?
- For leases with less than 12 months to run at the date of initial application will you apply IFRS 16 and account for the right-of-use asset and lease liability or treat them as short-term leases?
- Can you identify any initial direct costs at the date of initial application? Will you choose to exclude these from the measurement of the right-of-use asset?
- Are you able to determine the decisions you would have made in the past concerning judgemental areas such as whether or not to exercise extension or termination options? If not, the hindsight practical expedient is likely to be valuable.

## Other transitional provisions

There are further transitional provisions which are not set out in detail here. These relate to:

- lessor accounting where the lessor is an intermediate lessor
- sale and leaseback transactions before the date of initial application
- amounts previously recognised in business combinations.

### Example

Applying the transition options to a simplified example demonstrates how the balance sheet and statement of profit or loss will vary depending on the choices made.

#### Facts

- CU10,000 payable annually in arrears from lease commencement date
- 10-year lease, starting 1 January 2016, previously accounted for as an operating lease
- Right-of-use asset is depreciated on a straight-line basis
- 7% discount rate at lease commencement (interest rate implicit in the lease)
- 10% incremental borrowing rate at date of initial application – 1 January 2019
- Company's year-end is 31 December.

#### Analysis – Full retrospective approach

The right-of-use asset and the lease liability are recorded in the financial statements as if IFRS 16 has been applied since the start of the lease, and comparative amounts for 2018 are restated. The liability at the commencement of the lease is calculated as the future lease payments discounted at 7%.

The relevant calculations are as follows:

#### Lease liability

Year	Balance brought forward at 1 January	Lease payment	Interest expense	Balance carried forward at 31 December
2016	70,236	(10,000)	4,917	65,153
2017	65,153	(10,000)	4,560	59,713
2018	59,713	(10,000)	4,180	<b>53,893</b>
2019	53,893	(10,000)	3,773	47,666
2020	47,666	(10,000)	3,336	41,002
2021	41,002	(10,000)	2,870	33,872
2022	33,872	(10,000)	2,371	26,243
2023	26,243	(10,000)	1,837	18,080
2024	18,080	(10,000)	1,266	9,346
2025	9,346	(10,000)	654	-

#### Right-of-use asset

Year	Balance brought forward at 1 January	Depreciation	Balance carried forward at 31 December
2016	70,236	(7,024)	63,212
2017	63,212	(7,023)	56,189
2018	56,189	(7,024)	<b>49,165</b>
2019	49,165	(7,023)	42,142
2020	42,142	(7,024)	35,118
2021	35,118	(7,024)	28,094
2022	28,094	(7,023)	21,071
2023	21,071	(7,024)	14,047
2024	14,047	(7,023)	7,024
2025	7,024	(7,024)	-

On transition to IFRS 16 the financial statements will therefore include:

Year	1 January 2019	2018 restated comparatives
Right-of-use asset	<b>49,165</b>	56,189
Lease liability	<b>53,893</b>	59,713
Equity adjustment at 1 January	4,728	3,524

The impact on the balance sheet at the date of transition is a reduction of net assets of CU4,728.

The expenses post transition are as follows:

Year	Depreciation	Interest	Total
2019	7,023	3,773	10,796
2020	7,024	3,336	10,360
2021	7,024	2,870	9,894
2022	7,023	2,371	9,394
2023	7,024	1,837	8,861
2024	7,023	1,266	8,289
2025	7,024	654	7,678
<b>Total</b>	<b>49,165</b>	<b>16,107</b>	<b>65,272</b>

Under this method, the total expense post-transition to IFRS 16 is CU65,272.

### Analysis – Modified retrospective approach

The lease liability is measured at the present value of the remaining lease payments, discounted using the incremental borrowing rate at the date of initial application, which in this case is 10%. As mentioned above, there are two methods for valuing the right-of-use asset, and these methods are illustrated below.

#### Method 1 for calculating right-of-use asset

The right-of-use-asset is measured at an amount equal to the lease liability, adjusted by prepayments or accrued lease payments relating to that lease at the date of initial application. This produces the following amounts:

#### Lease liability

Year	Balance brought forward at 1 January	Lease payment	Interest expense	Balance carried forward at 31 December
2016				
2017				
2018				
2019	<b>48,684</b>	(10,000)	4,868	43,552
2020	43,552	(10,000)	4,355	37,907
2021	37,907	(10,000)	3,791	31,698
2022	31,698	(10,000)	3,170	24,868
2023	24,868	(10,000)	2,487	17,355
2024	17,355	(10,000)	1,736	9,091
2025	9,091	(10,000)	909	-

#### Right-of-use asset

Year	Balance brought forward at 1 January	Depreciation	Balance carried forward at 31 December
2016			
2017			
2018			
2019	48,684	(6,955)	41,729
2020	41,729	(6,955)	34,774
2021	34,774	(6,955)	27,819
2022	27,819	(6,955)	20,864
2023	20,864	(6,955)	13,909
2024	13,909	(6,955)	6,954
2025	6,954	(6,954)	-

On transition to IFRS 16 the financial statements will therefore include:

Year	1 January 2019	2018 restated comparatives
Right-of-use asset	<b>48,684</b>	N/A
Lease liability	<b>48,684</b>	N/A
Equity adjustment at 1 January	-	N/A

The impact on the balance sheet at the date of transition is zero reduction of net assets. The expenses post-transition are as follows:

Year	Depreciation	Interest	Total
2019	6,955	4,868	11,823
2020	6,955	4,355	11,310
2021	6,955	3,791	10,746
2022	6,955	3,170	10,125
2023	6,955	2,487	9,442
2024	6,955	1,736	8,691
2025	6,954	909	7,863
<b>Total</b>	<b>48,684</b>	<b>21,316</b>	<b>70,000</b>

Under this method, the total expense post-transition to IFRS 16 is CU70,000.

#### Method 2 for calculating right-of-use asset

The right-of-use asset is measured at the asset's carrying value as if the Standard had been applied since the commencement date of the lease. While the carrying value is determined from the commencement of the lease, it is discounted using the lessee's incremental borrowing rate at the date of initial application. This produces the following amounts:

#### Lease liability

Year	Balance brought forward at 1 January	Lease payment	Interest expense	Balance carried forward at 31 December
2016				
2017				
2018				
2019	<b>48,684</b>	(10,000)	4,868	43,552
2020	43,552	(10,000)	4,355	37,907
2021	37,907	(10,000)	3,791	31,698
2022	31,698	(10,000)	3,170	24,868
2023	24,868	(10,000)	2,487	17,355
2024	17,355	(10,000)	1,735	9,090
2025	9,090	(10,000)	910	-

#### Right-of-use asset

Year	Balance brought forward at 1 January	Depreciation	Balance carried forward at 31 December
2016	61,446	(6,145)	55,301
2017	55,301	(6,145)	49,156
2018	49,156	(6,144)	43,012
2019	<b>43,012</b>	(6,145)	36,867
2020	36,867	(6,144)	30,723
2021	30,723	(6,145)	24,578
2022	24,578	(6,144)	18,434
2023	18,434	(6,145)	12,289
2024	12,289	(6,144)	6,145
2025	6,145	(6,145)	-

On transition to IFRS 16 the financial statements will therefore include:

Year	1 January 2019	2018 restated comparatives
Right-of-use asset	<b>43,012</b>	N/A
Lease liability	<b>48,684</b>	N/A
Equity adjustment at 1 January	5,672	N/A

The impact on the balance sheet at the date of transition is a reduction of net assets of CU5,672. The expenses post transition are as follows:

Year	Depreciation	Interest	Total
2019	6,145	4,868	11,013
2020	6,144	4,355	10,499
2021	6,145	3,791	9,936
2022	6,144	3,170	9,314
2023	6,145	2,487	8,632
2024	6,144	1,735	7,879
2025	6,145	910	7,055
<b>Total</b>	<b>43,012</b>	<b>21,316</b>	<b>64,328</b>

Under this method, the total expense post-transition to IFRS 16 is CU64,328.

### Comparison of methods

	Full retrospective	Modified retrospective method 1	Modified retrospective method 2
Right of use asset on transition	49,165	48,684	43,012
Lease liability on transition	53,893	48,684	48,684
Impact on net assets	(4,728)	-	(5,672)
Post-transition expense	65,272	70,000	64,328

For contracts previously classified as operating leases under IAS 17, the various practical expedients identified above will also play a significant role in determining the amounts recognised as lease liabilities and right-to-use assets upon adoption and the related impacts on profit or loss.

## Disclosures on transition

If a lessee opts to use the modified retrospective approach for transition to IFRS 16, a lessee should disclose:

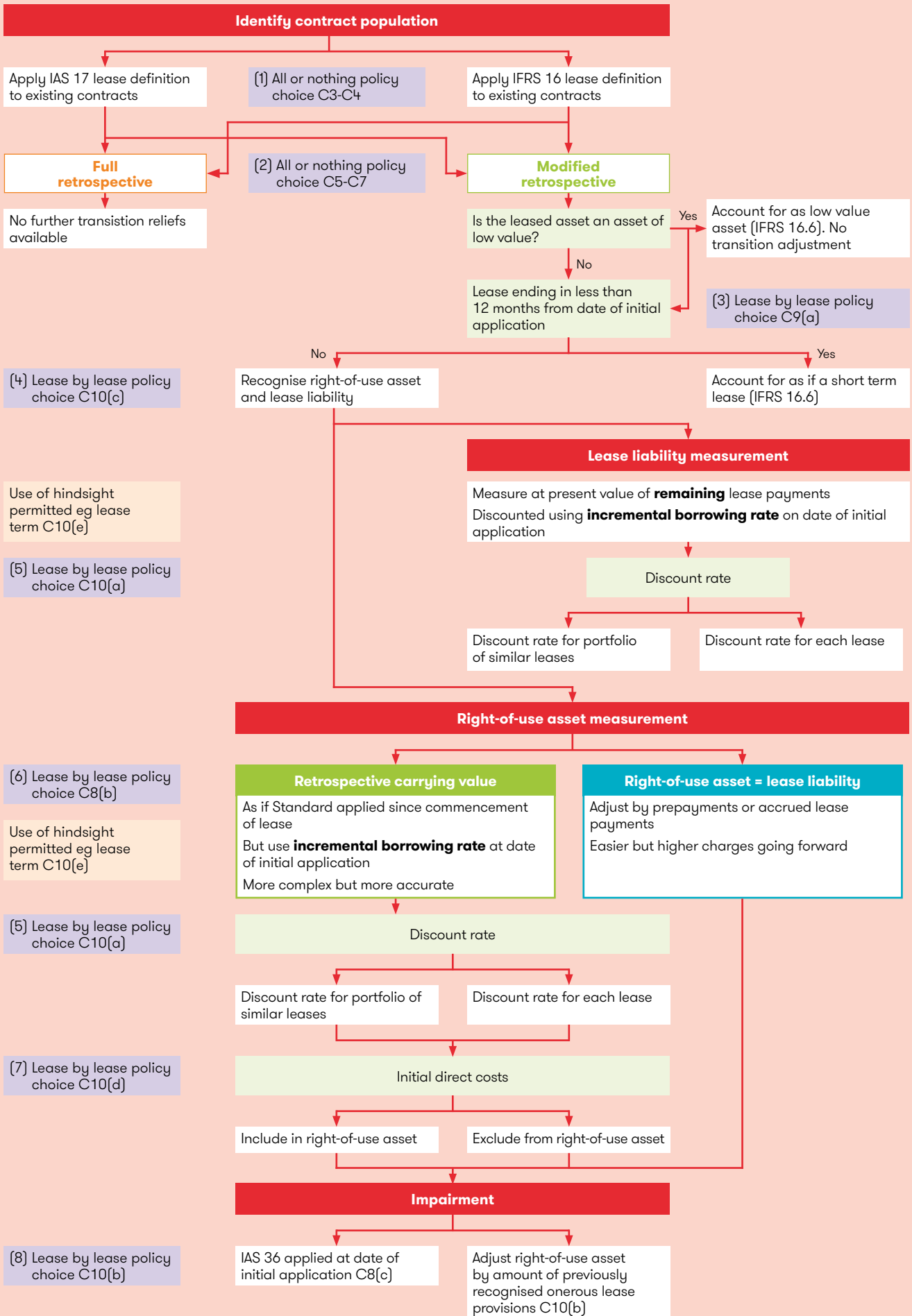
- the information required by IAS 8.28, including:
  - the fact IFRS 16 has been adopted
  - that the adoption is in accordance with IFRS 16's transitional provisions (and a description of them)
  - if applicable, any transitional provisions that might impact future periods
  - a description of the nature of the change in accounting policy
  - where practicable, the extent that the adjustment relates to periods before those presented.
- the lessee's incremental borrowing rate applied to lease liabilities that have been recognised in the balance sheet on transition, and
  - any differences that have arisen between:
    - operating lease commitments disclosed at the end of the previous annual reporting period when IAS 17 had been applied, discounted using the incremental borrowing rate at transition date; and
    - lease liabilities recognised in the balance sheet at the date of transition.

In addition, if a lessee has opted to use any of the practical expedients mentioned above on transition, it should disclose this information.

As mentioned previously, the main disadvantage of the modified retrospective approach is the lack of comparability. In our view, one way in which you can partially overcome this is to provide a set of proforma comparatives. These would explain what the prior period amounts would have been if IFRS 16 had been in place in the prior year.



**Choices available on transition to IFRS 16 for leases previously classified as operating under IAS 17**



## Contact us

We hope you find this article provides helpful insight into some of the decisions you will face when transitioning to IFRS 16. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit [www.grantthornton.global/](http://www.grantthornton.global/) locations to find your local member firm.



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