The leases lab

A lessee can choose to apply IFRS 16 through either a full retrospective approach or using a simplified approach. Can Professor Lee Singh and his assistant Nitassha Somai help you make the decision that's right for you? Let's experiment!

Hypothesis

Only the simplified approach has operational advantages for a lessee; ergo it is always a better approach for transition.

Testing and analysis

IFRS 16 is mandatory for reporting periods beginning on or after 1 January 2019. Earlier application is permitted but only if IFRS 15 is adopted at the same time.

The standard can be applied either fully retrospectively or through a simplified approach.

> Three key practical expedients and transition exemptions are available for lessees:
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> - Existing contracts do not have to be reassessed to determine if they contain leases. The expedient is applied to all contracts if used.
> - Leases with a remaining term of 12 months or less are exempt (a choice on a lease-by-lease basis).
> - Low value assets are exempt (a choice on a lease-by-lease basis).

There is no impact on transition for the lessee in a finance lease. The lease liability and carrying amount of the leased asset is carried forward.

Fully retrospective approach

Just like it sounds, the financial statements are presented as if IFRS 16 has always been applied. The impact of adoption is adjusted in the opening balance sheet of the earliest period presented and comparative amounts are restated for each prior period presented.

The implication? A lessee goes back to the point in time it entered into every lease and gathers the necessary information. This is complicated and could have significant cost implications.

Simplified approach

This approach is also applied retrospectively, but the impact of adoption is adjusted against the opening balance of retained earnings on the date of initial application (that is 1 January 2019 for calendar year ends). Comparatives are not restated.

> The impact is:
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> - Lease liability – measured at the present value of remaining lease payments using the incremental borrowing rate on date of initial application.
> - Right of use asset – the lessee can choose on a lease by lease basis either to measure the asset at an amount equal to the lease liability **or** as if the standard has always been applied. Again, the incremental borrowing rate on the date of initial application is used.

Practical application

Choosing a transition approach is not straightforward because the simplified approach also has some disadvantages.

> Disadvantages:
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> - Lacks comparability making it more difficult for users to assess performance over time.
> - Additional disclosures – a reconciliation must be provided of operating lease commitments previously disclosed under IAS 17 and lease liabilities initially recognised under IFRS 16.
> - The incremental borrowing rate must be used on date of initial application to measure the lease liability. This rate is generally lower than the interest rate implicit in the lease. Lease liabilities will be higher on adoption, impacting KPI's and key ratios.

Conclusion

The simplified approach has some operational advantages. There is no need to go back in time to lease commencement dates to measure the right-of-use asset and the lease liability. Information as at the date of initial application is used and comparatives are not restated.

However, the hypothesis that it is always a better choice is incorrect because there are also some disadvantages to the simplified approach. User expectations, impact on KPI's and key ratios and the impact of using the incremental borrowing rate should be considered when deciding which of the two approaches is more suitable.

> For more on transition, see our In depth, IFRS 16 – A new era of lease accounting. Our full range of leases content and videos can be found on PwC Inform.