In depth

A look at current financial reporting issues

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IFRS 16, 'Leases' – interaction with other standards

At a glance

Under IFRS 16, lessees will need to recognise virtually all of their leases on the balance sheet by recording a right of use asset and a lease liability.

While this 'gross up' in total assets and total liabilities is the most obvious impact of adopting IFRS 16, there are a number of less obvious impacts that adoption of IFRS 16 will have, since it intersects with other IFRSs. This In depth considers several consequences arising from IFRS 16, including some of the impacts that IFRS 16 will have for entities in applying:

- IAS 16, 'Property, plant and equipment';
- IAS 36, 'Impairment of assets';
- IFRS 3, 'Business combinations';
- IFRS 9, 'Financial instruments';
- IAS 12, 'Income taxes';
- IAS 37, 'Provisions, contingent liabilities and contingent assets';
- IFRS 8, 'Operating segments'; and
- IAS 21, 'The effects of changes in foreign exchange rates'.

Interaction between IFRS 16 and IAS 16

The determination of the lease term is a significant judgement in applying IFRS 16. In determining the lease term, an entity must assess whether it is reasonably certain to exercise extension or early termination options. This judgement is important, because it affects the amount recorded for the entity's lease obligation and related right of use asset ('RoU asset'). The consideration of economic penalties beyond contractual termination payments, in determining the lease term of a cancellable or renewable lease, was discussed at the June 2019 meeting of the IFRS Interpretations Committee. The Committee's tentative agenda decision suggested that an entity should consider the broader economics of the contract and not only contractual termination payments in applying paragraph B34 of IFRS 16.

PwC Observation:
Significant leasehold improvements undertaken (or expected to be undertaken) are considered when determining the lease term, because these leasehold improvements could provide economic benefit for the lessee when the option to extend or terminate the lease becomes exercisable. If significant leasehold improvements cannot be used beyond the date on which the lease contract could be terminated, this could indicate that the entity might incur more than an insignificant penalty if it terminates the lease before the end of the useful life of the improvements. The costs of abandoning or dismantling leasehold improvements might also need to be considered when determining the lease term.

While significant leasehold improvements can influence the lease term assessment under IFRS 16, expectations about lease term also have an impact on accounting for leasehold improvements in accordance with IAS 16. Paragraph 56(d) of IAS 16 states that the legal or similar limits on the use of the asset, *such as the expiry dates of related leases*, should be considered in determining the useful life of an asset.

Paragraph 57 of IAS 16 refers to the period in which an asset is expected to provide utility to the entity, whereas IFRS 16 requires optional periods to be included in the lease term where it is ‘reasonably certain’ that these options will be exercised. While it is possible that an entity could conclude that it expects to exercise an extension option even if not reasonably certain, in most cases it would be expected that the useful life (that is, the depreciation period) of the leasehold improvements is no longer than the lease term under IFRS 16.

In June 2019, the IFRS Interpretations Committee discussed a submission asking whether the useful life of *non-removable* leasehold improvements are limited to the lease term. Based on the fact pattern in the submission, the Committee tentatively decided that an entity might often reach a conclusion that it would only receive benefit from a leasehold improvement for as long as the lease term. The tentative agenda decision is currently out for exposure.

PwC Observation:
In cases where the entity is able to practically and economically dismantle and redeploy the leasehold improvements at the end of the lease term, it might be reasonable for the useful life of the leasehold improvements to exceed the term of the related lease.

Interaction between IFRS 16 and IAS 36

At what level do you test?

Impairment should be identified at the individual asset level if the individual asset generates cash inflows that are largely independent from other assets. Where the recoverable amount of the RoU asset cannot be determined individually, the impairment test moves to the level of the cash-generating unit (‘CGU’) to which the RoU asset belongs.

Typically, an RoU asset does not generate cash inflows that are largely independent from other assets, and it should be grouped within a CGU for an impairment test in these circumstances. One exception may be an asset that is subleased and therefore may generate cash inflows that are largely independent from other assets. Another common exception relates to leased investment properties, accounted for under IAS 40, ‘Investment Property’. In such a case, the leased investment property is an RoU asset that might have cash inflows (from tenants under a sublease) which are largely independent from other assets, and therefore this property could be considered for impairment at the individual asset level. However, an RoU asset classified as an investment property can be recorded at fair value under IAS 40 and, if it is carried at fair value, the property need not be assessed for impairment in accordance with IAS 36.

An entity that applies the fair value model to its owned investment property is also required (by para 34 of IFRS 16) to apply the fair value model to RoU assets meeting the definition of investment property. A lessee can choose whether to record RoU assets using the revaluation model of IAS 16 if the leased asset is part of a class of assets to which an entity applies the revaluation model.

When do you test?

The general requirement of IAS 36 is that assets are tested for impairment where there is an impairment indicator, and this includes RoU assets. Where the RoU asset is part of a CGU that contains goodwill, indefinite-life intangible assets, or intangible assets that are not yet ready for use, it will be included as part of the annual impairment requirement.

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PwC Observation:
A decline in fair value of an RoU asset due to market factors might not be considered an impairment indicator for a CGU if the RoU asset is not a significant component of the CGU.

How do you test?

Recoverable amount

IAS 36 tests carrying value of the asset/CGU against the higher of value in use ('VIU') and fair value less costs of disposal ('FVLCD').

The 'higher of' requirement means that, if there is no headroom on a VIU basis, FVLCD should also be tested before concluding that an impairment is required. Similarly, VIU must be considered if an entity first performs an FVLCD test which indicates that the asset/CGU is impaired.

Liabilities

While RoU assets are included in a CGU when testing VIU, the related lease liabilities should be excluded, because these are a form of financing, and all financing cash flows are explicitly excluded from VIU. [IAS 36 para 50(a)].

In some circumstances, liabilities cannot be separated from the related assets (for example, where a purchaser could not, or would not, acquire the asset or business without the liability). As discussed in In brief 2016-03, this apparent conflict was considered by the IFRIC in 2016, which noted that IAS 36 requires the carrying amount of a recognised liability to be deducted from both the carrying amount of a CGU and the amount determined under VIU without the cash outflows associated with the liability. What this means is that including the lease liabilities in the CGU would have a neutral impact on a VIU test.

PwC Observation:
While the position is clear for VIU it is less so for FVLCD models, since IAS 36 has little specific guidance on determining FVLCD generally and none on using FVLCD as the recoverable amount for a CGU with a non-separable liability. In general, if, when disposed of, the CGU would require the buyer to assume the lease liability, the FVLCD would also consider the liability. In this case, in order to prepare a meaningful comparison, the carrying amount of the liability would be deducted.

VIU – expected cash flow model

Generally, RoU assets and related lease liabilities will be considered in an IAS 36 VIU model. The CGU assets tested against VIU include the RoU assets and exclude the lease liabilities. The expected cash flow model will:

- exclude the lease payments included in the lease liability;
- use a pre-tax discount rate (typically estimated with reference to a post-tax weighted average cost of capital (WACC) discount rate) that should reflect a market assessment of capital structure rather than the entity's own structure;
- include cash outflows to replace leased assets at the end of the lease term which are essential to the ongoing operation of the CGU (that is, the RoU asset being tested for impairment only reflects the existing lease, so the most practical way to incorporate replacement is via a future capital expenditure cash outflow); and
- include cash outflows for expected future variable rents and short-term and low value leases that are not included in the lease liability.

VIU – discount rate

Projected future cash flows are discounted at a pre-tax rate that reflects both current market assessments of the time value of money and the risks specific to the asset/CGU for which the future cash flow estimates have not been adjusted. The rate is independent of the way in which the asset/CGU is financed. It is estimated from current market transactions for similar assets or from the WACC of a listed entity that has a single asset or portfolio of assets that are similar, in terms of service potential and risks, to the asset/CGU under review. [IAS 36 paras 55–56].

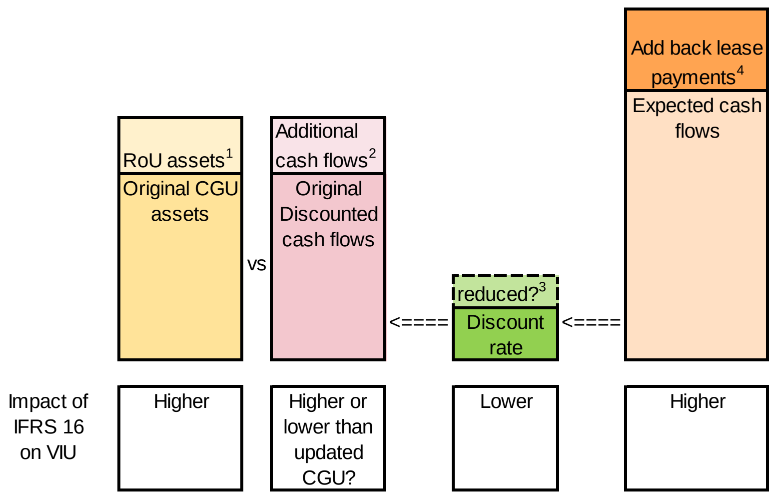
As a result, entities should be using a WACC that reflects market expectations of the market-based capital structure where both the cost of debt and cost of equity reflect the effects of new lease accounting. Areas to consider include:

- Lease liabilities would be expected to be considered as part of the capital structure. The peer group-based WACC needs to reflect the impact of IFRS 16. However, since historical lease liabilities under IFRS 16 are not available, it might be necessary to derive an estimate of the historical capital structure (for example, based on IAS 17 note disclosures) which can then be refined going forward, as capital structure data becomes available after adoption of IFRS 16.

- WACC depends on the market assessment of an adequate capital structure, represented by the respective peer group companies and not the entity's own capital structure. The impact of the application of IFRS 16 on the peer group's WACC and the entity's WACC might be different if the entity has relatively more or fewer lease liabilities in comparison to the peer group.

VIU – impact of the above items

IFRS 16 might cause a reduction in headroom if the change in VIU-discounted cash flows is lower than the increase in CGU assets being tested. This depends on the interaction of increased expected cash flows and lower discount rates, as illustrated below:



[1] There will be more assets in the CGU, because it now includes RoU assets.

[2] There could be a change in gross cash flows, because the lease payments that are part of the lease liability are excluded, although these could be somewhat offset by an increase in cash outflows to replace leased assets where the lease term is shorter than the model life.

[3] The discount rate could be lower due to the inclusion of debt-like leases which will increase the debt to equity ratio.

[4] If the increase in present value cash flows is lower than the increase in CGU assets being tested, headroom will reduce, possibly leading to an impairment of the CGU. However, this is not expected to be common.

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If there is an impairment

Any impairment arising on a separately tested RoU asset is allocated to that asset. Where the RoU asset is part of a CGU, the impairment of the CGU as a whole should be allocated to write down the CGU assets in the following order:

- recorded goodwill; and
- the other assets in the CGU on a pro rata basis, based on the carrying amount of each asset in the CGU.

However, within this allocation framework, each asset should be reduced only to the highest of:

- its FVLCD if measurable;
- its VIU, if this can be determined; and
- zero.

The amount of impairment loss that would otherwise have been allocated to the asset should be allocated pro rata to the CGU's other assets.

Interaction between IFRS 16 and IFRS 3

Impact in a business combination

The IFRS 3 measurement principle is that identifiable assets acquired and liabilities assumed are measured at their acquisition date fair values. However, an exception exists in IFRS 3 as it relates to leases in which the acquiree is the lessee. If an entity acquires an entity that is a lessee, it recognises the lease liability based on the present value of the *remaining* lease payments as if the acquired lease were a *new lease* at acquisition date. The lease term and discount rate will potentially be different from that used by the acquiree based on its IFRS 16 assessment done at lease inception. Therefore, this will likely result in a difference between an acquirer's accounting for a lease and the accounting for the same lease in the separate financial statements of the acquired entity.

Even though (1) RoU assets are generally recorded similarly to owned property, plant and equipment under IAS 16, and, (2) IAS 16 assets are recorded at fair value in a business combination, RoU assets are an exception to the general principle of measurement in IFRS 3. In a business combination, the acquirer measures the RoU asset at an amount equal to the recognised lease liability, adjusted to reflect favourable or unfavourable lease terms compared with market terms.

IFRS 3 also provides an exception for recognition of assets and liabilities related to short-term or low-value leases in a business combination, consistent with the exceptions provided in IFRS 16.

Impact in assessing whether a business has been acquired

In October 2018, the IASB issued an amended definition of a business. While the new definition only becomes mandatorily effective for acquisitions occurring after 1 January 2020, it can be early adopted (subject to endorsement in jurisdictions where endorsement is required).

In addition to clarifying the general definition of a business, a key change in the new definition of a business is the introduction of an optional concentration test which can be utilised to determine that an acquired set of activities and assets is *not* a business. This determination is reached when substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

An RoU asset meets the definition of an identifiable asset in performing the concentration test. Accordingly, RoU assets could impact the determination of whether a concentration test is met.

PwC Observation:
An entity will need to consider whether multiple lease RoU assets are similar assets for the purpose of the concentration test, if performed. For example, an entity that leases multiple office buildings, each of which represents a separate lease, should assess whether the leased assets are considered similar assets that should be grouped together for the purpose of the concentration test.

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Interaction between IFRS 16 and IFRS 9

Lease liabilities are a financial instrument, although they are outside the scope of certain parts of IFRS 7 / IFRS 9. Lease liabilities are within the scope for IFRS 7 disclosure (except for disclosure of fair value), within the scope of IFRS 9 for derecognition, and can be part of a designated hedging relationship. Derivatives embedded in leases are also subject to the IFRS 9 embedded derivative requirements.

As discussed in the IAS 21 section (see below), lease liabilities denominated in currencies other than an entity's functional currency will give rise to foreign exchange risk and (without hedge accounting) will be retranslated through profit or loss, causing volatility. Some entities might choose to apply hedge accounting, using the approaches summarised below. These approaches might not be appropriate in all circumstances. For more detailed analysis, refer to the Corporate Treasury industry supplement for IFRS 16, which also considers hedging interest rate risk inherent in leases and hedging foreign currency risk in committed or forecast leases and in intercompany leases.

Foreign currency lease liabilities as a hedged item

Similar to any recognised foreign currency financial liability, various derivative hedging instruments could be used, including forward contracts, swaps or purchased options.

The payments made under a lease are generally equal each year. However, for accounting purposes such payments include both a principal and an interest element, since the lease liability is treated as an amortising loan.

It would be possible to use an amortising foreign currency swap whose principal amount amortises to match the reductions in the lease liability over time. However, ultimately, the entity is still exposed to the aggregate payments that must be made, whether these are through interest or principal payments. Hence, a flat swap could be used as a hedge partly against principal and partly against the future foreign currency interest to be recognised on the liability. In the case where a flat swap is used, the accounting entries will need to ensure that, where the hedge is fully effective, the amounts booked to profit or loss are matched against the retranslation of the principal and interest reported in the period, and that amounts relating to future interest payments are deferred.

Although using a non-amortising swap requires more complex accounting for the hedging relationship, this would need to be weighed against the benefits of higher liquidity in the non-amortising swap market.

Foreign currency lease liabilities as the hedging instrument

Foreign currency lease liabilities are essentially a foreign currency financing arrangement. These liabilities can be designated as hedging instruments against eligible foreign currency risks.

One common designation of such foreign currency liabilities is to hedge against the foreign currency risk of net investments in foreign operations. For example, a parent with EUR functional currency could designate a USD lease liability as a hedge of its net investment in a USD subsidiary.

There are various ways that net investment hedges can be designated. IFRIC 16 provides more detail on designating net investment hedges within a group structure. In addition, the amortising nature of lease liabilities needs to be considered when designating them as hedging instruments.

Interaction between IFRS 16 and IAS 12

In many jurisdictions, tax treatment follows or is linked to accounting treatment whilst, in others, lease taxation regimes are divorced from the accounting standards. There might be different approaches taken to the introduction of a new accounting standard. Whether or not IFRS 16 changes the tax treatment should be assessed on a territory-by-territory basis. In circumstances where tax deductions are calculated without reference to accounting expenses, the creation of new accounting assets/liabilities by IFRS 16 gives rise to new temporary differences and might result in the need to recognise deferred tax balances that were not previously recorded.

A lessee normally recognises an asset and a lease liability when it enters into most leases under IFRS 16 (or a finance lease under IAS 17). Recognition of the asset and liability has no immediate tax impact in many jurisdictions, and tax deductions are often received when the lease payments are made. IAS 12 does not specifically address the tax effects of leases. There are two principal approaches to the deferred tax accounting for lessees. One approach considers the lease as a single transaction in which the asset and liability are integrally linked, so there is no net temporary difference at inception. The other approach considers the asset and the liability separately, in which case there might be a temporary difference on initial recognition, which would be subject to the initial recognition exemption described in paragraphs 15 and 24 of IAS 12. The choice of approach is a matter of accounting policy, to be applied on a consistent basis.

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PwC Observation:
The Interpretations Committee considered the deferred tax implications of finance leases in 2005 and noted that there was diversity in practice in applying the requirements of IAS 12 to assets and liabilities arising from finance leases. The Committee agreed not to develop any guidance, because the issue fell directly within the scope of the IASB's short-term convergence project on income taxes. Subsequently, this project was suspended. However, in October 2018, the IASB decided to propose a narrow scope amendment that would narrow the initial recognition exemption in paragraphs 15 and 24 of IAS 12 so that it would not apply to transactions that give rise to both taxable and deductible temporary differences to the extent that the amounts recognised for the temporary differences are the same. The exposure draft for this amendment has not yet been issued.

Interaction between IFRS 16 and other IFRSs

IAS 37 – asset retirement obligations

When recognising an asset, an entity is required to record in its cost an initial estimate of any costs of dismantling and removing the item and restoring the site on which it is located. An offsetting provision, commonly known as an 'asset retirement obligation', is recorded in accordance with IAS 37. In some industries (such as the extractive industries), these provisions can be substantial. In performing remediation activities to settle these obligations, entities might utilise leased assets.

Under IFRS 16, a lease usually gives rise to an RoU asset and a lease liability on the entity's balance sheet. It is only appropriate to reduce the IAS 37 asset retirement obligation as remediation work is complete. While some might view this as 'double counting' of the entity's liabilities, the leasing of equipment does not reduce the provision for remediation to be completed, and so it would not be appropriate to reduce the IAS 37 provision when the IFRS 16 lease liability is recognised.

PwC Observation:
This treatment is consistent with the accounting when equipment is purchased for the purpose of performing remediation activities. When equipment is purchased, an entity records an asset for the equipment and a liability for any obligation to pay for it, but it does not derecognise the IAS 37 obligation until remediation activity is undertaken.

IFRS 8 – segment reporting

In many circumstances, when disclosing entity-wide information about geographical areas in accordance with IFRS 8, an RoU asset would be included within the non-current asset disclosure required by paragraph 33 of IFRS 8. For most types of non-current assets (including RoU assets), an entity must disclose the amount of non-current assets located in the entity's country of domicile and all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets should be disclosed separately.

If a measure of segment assets and liabilities is provided to the chief operating decision maker (CODM), this amount should be disclosed for each segment, as required by paragraph 23 of IFRS 8. Disclosure of additions to non-current assets might also be required by paragraph 24 of IFRS 8. If RoU assets and lease liabilities are included in the information provided to the CODM, these should be included in these disclosures. If they are not included, the RoU assets and lease liabilities should be considered in reconciling to the entity's assets and liabilities in accordance with paragraph 28 of IFRS 8.

IAS 21 – the effects of changes in foreign exchange rates

When a reporting entity enters into a lease in a currency other than its functional currency, the resulting RoU asset is a non-monetary asset and it is not revalued, similar to owned property, plant and equipment. Lease liabilities related to the foreign currency lease are monetary and will be translated each reporting period, using the closing exchange rate. Changes in the exchange rate will give rise to a foreign exchange gain or loss recorded in profit and loss. RoU assets and lease liabilities of foreign operations must be translated into the reporting entity's presentation currency, which could give rise to a cumulative translation adjustment (recorded in other comprehensive income).

PwC Observation:
Where RoU assets and lease liabilities are attributable to a foreign entity but recorded in a group's consolidated financial statements as a consolidation adjustment (that is, where the foreign entity does not apply IFRS 16), these assets and liabilities should be considered in the currency translation process as if recorded within the foreign entity.

Where do I get more details?

If you have further accounting questions, please contact your usual PwC technical contacts.

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