IFRS™

STAFF PAPER

February 2015

REG IASB Meeting

Project	**Leases**		
Paper topic	Transition – Leases Previously Classified as Operating Leases		

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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Objective

1. The purpose of this paper is to discuss the transition requirements when first implementing the new leases standard. The paper discusses the transition requirements *only* for leases previously classified as operating leases.

2. On the basis of the feedback received, the staff think that the transition requirements for leases previously classified as finance leases do not need to be re-deliberated by the IASB. The staff are recommending that the transition requirements proposed for finance leases in the 2013 ED are retained in the new leases standard. Those requirements, in effect, mean that an entity would not change its accounting for finance leases existing at the date of initial application.

3. This paper also highlights those elements of the staff recommendation that we think should be applicable for first-time adopters in IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. When specific recommendations do not reference first-time adopters, this is because the staff think these recommendations should only be relevant for and/or apply to *existing* IFRS reporters (ie those transitioning from IAS 17 *Leases*) and, therefore, should not be applicable upon first-time adoption.

4. This paper is structured as follows:

   (a) Summary of staff recommendations

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(b) Background

(c) Staff analysis – fully retrospective versus modified retrospective approach for lessees

(d) Staff analysis – modified retrospective approach for lessees

    (i) Overview

    (ii) Comparative figures

    (iii) Measurement of the lease liability

    (iv) Measurement of the right of use (ROU) asset

    (v) Discount rate applied to a portfolio

    (vi) Existing onerous lease provisions

    (vii) Leases for which the term ends within 12 months or less of the date of initial application

    (viii) Initial direct costs

    (ix) Use of hindsight

    (x) Disclosure

(e) Staff analysis – lessors

(f) Staff analysis – first-time adoption

(g) Staff recommendations and questions for the IASB

(h) Appendix: Example of Proposed Modified Retrospective Approach as Compared to a Fully Retrospective Approach

5. Throughout this paper, the 'date of initial application' is used to describe the first day of the annual reporting period in which a lessee first applies the requirements of the new leases standard.

Summary of Staff Recommendations

6. The staff recommend the following with respect to the transition requirements for lessees relating to leases previously classified as operating leases:

(a) a lessee can choose either a fully retrospective approach or a modified retrospective approach (as described below) on transition. A lessee

should apply the approach chosen consistently across its entire operating lease portfolio.

(b) under the modified retrospective approach:

(i) a lessee should not restate comparative figures. This is similar to the modified retrospective transition requirements in IFRS 15 *Revenue from Contracts with Customers* and in IFRS 9 *Financial Instruments*;

(ii) a lessee should recognise the cumulative effect of initially applying the new standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application. This is similar to the modified retrospective transition requirements in IFRS 15 and IFRS 9;

(iii) a lessee should measure the lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application;

(iv) a lessee is permitted a choice of two measurement approaches for the ROU asset at the date of initial application, chosen on a lease-by-lease basis:

- measure the ROU asset as if the new leases standard had always been applied, but using a discount rate based on the lessee's incremental borrowing rate as at the date of initial application;
- measure the ROU asset at an amount equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments.

(v) a lessee can apply a single discount rate to a portfolio of leases with reasonably similar characteristics;

(vi) a lessee should adjust the ROU asset by the amount of any previously recognised onerous lease provisions;

(vii) a lessee can apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application (as

determined for the short-term lease exemption). A lessee could instead account for these leases in the same way as short-term leases, ie by continuing to apply operating lease accounting. The staff also recommend requiring disclosure of the cost associated with these leases within the disclosure of short-term lease expense in the annual reporting period that includes the date of initial application;

(viii) a lessee can apply the relief proposed in the 2013 ED that a lessee need not include initial direct costs in the measurement of the ROU asset;

(ix) a lessee can apply the relief proposed in the 2013 ED that a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease;

(x) in the annual reporting period that includes the date of initial application, the following disclosures replace the disclosure requirements of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 28(f):

- the operating lease commitments that would have been reported if IAS 17 had been applied in that reporting period;
- the weighted average incremental borrowing rate at the date of initial application;
- explanation of any differences between: (a) the result of discounting the operating lease commitments that would have been reported under IAS 17 at the end of the annual reporting period that includes the date of initial application using the incremental borrowing rate at the date of initial application; and (b) lease liabilities recognised on the balance sheet at the end of that reporting period;
- the rental expense that would have been recognised if IAS 17 had been applied in that reporting period.

7. The staff also recommend that the leases standard should require that, with the exception of accounting for subleases (Agenda Paper 3C), a lessor should continue to apply its current accounting for any leases that are ongoing at the date of initial application (ie those leases that were previously accounted for under IAS 17 and continue to be in place at the date of initial application).

8. With respect to first-time adoption of IFRS, the staff recommend that IFRS 1 should permit a first-time adopter to apply the modified retrospective approach described in paragraph 6(b) above. However, for a first-time adopter, the following elements of the modified retrospective approach would *not* be applicable:

   (a) the relief described in paragraph 6(b)(i) above that a lessee need not restate comparative figures. For a first-time adopter, the date of initial application should be regarded as the date of transition to IFRSs in accordance with IFRS 1 (in other words, the beginning of the earliest comparative period presented in the first IFRS financial statements);

   (b) the relief described in paragraph 6(b)(vii) above that a lessee can apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application; and

   (c) the special disclosure requirements described in paragraph 6(b)(x) above.

Background

9. The 2013 ED proposed a choice of two transition approaches for leases previously classified as operating leases, that would become Type A leases under the proposals:

   (a) a fully retrospective approach;

   (b) a modified retrospective approach requiring a lessee to recognise the following, at the beginning of the earliest comparative period presented:

(i) a lease liability measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application;

(ii) an ROU asset measured as the applicable proportion of the lease liability at the commencement date, imputed from the measurement of the lease liability. The applicable proportion is the remaining lease term at the beginning of the earliest comparative period presented relative to the total lease term. A lessee would adjust the ROU asset recognised by the amount of any previously recognised prepaid or accrued lease payments.

10. The 2013 ED also specified that, for leases previously classified as operating leases, a lessee could apply a single discount rate to a portfolio of leases with reasonably similar characteristics.

11. The following specific transition reliefs were also proposed in the 2013 ED:

(a) a lessee need not include initial direct costs in the measurement of the ROU asset;

(b) a lessee may use hindsight, such as in determining whether a contract contains a lease or in determining the lease term if the contract contains options to extend or terminate the lease;

(c) an entity need not provide the transition disclosures required in paragraph 28(f) of IAS 8. These requirements are as follows:

28 …..an entity shall disclose:

(f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:

(i) for each financial statement line item affected; and

(ii) if IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share.

Staff Analysis – Fully Retrospective versus Modified Retrospective Approach for Lessees

Feedback

12. Many constituents that commented on the transition proposals in the 2013 ED were supportive of the option for lessees to adopt either a fully retrospective approach or a modified retrospective approach. Most investors and analysts (“users”) noted that they generally prefer a fully retrospective approach to be adopted. They acknowledged, however, that this could give rise to substantial costs for preparers and thought that the additional option of a modified retrospective approach represented a pragmatic solution to a difficult problem.
13. Conversely, some user respondents to the 2013 ED did not think that a modified retrospective approach should be permitted and that all lessees should be required to apply a fully retrospective approach. These users noted that a choice of alternative approaches would lead to a lack of comparability of reported information.
14. Many constituents also noted that it was not clear from the 2013 ED whether the choice of a fully retrospective approach or modified retrospective approach was to be applied across an entire lease portfolio, by class of underlying asset or on a lease by lease basis.
15. Finally, a number of preparers thought that the new leases standard should be applied prospectively, ie a lessee should apply the proposals only to new leases entered into following the transition date. These preparers thought that the costs of implementing *any* retrospective approach would outweigh the benefits to users.

Staff Analysis

16. The staff think that the costs of requiring a fully retrospective approach without any relief could be significant and would be likely to outweigh the benefits for all lessees. A fully retrospective approach would require entities to calculate the carrying amounts of all outstanding leases at the earliest comparative period as if those leases had always been accounted for in accordance with the new leases standard. That could be impracticable for entities that have thousands of leases.

17. Nonetheless, the staff do not think that the IASB should prohibit entities from applying a fully retrospective approach should they wish to do so. This is because that approach would provide better information to users of financial statements than other approaches.

18. The staff therefore recommend that the IASB permit, but not require, lessees to apply the new leases standard retrospectively.

19. In addition, the staff recommend that the choice of whether to apply the new leases standard retrospectively should be applied consistently to a lessee's entire portfolio of former operating leases. This is because one of the main advantages of a fully retrospective approach is the provision of comparable information for all periods presented in the first year that an entity applies the new leases standard. This benefit would be lost if a fully retrospective approach were to be applied to some, but not all, of a lessee's lease portfolio.

20. The staff recommend that, as an alternative to the fully retrospective approach, the IASB should provide lessees with the choice of adopting a modified retrospective approach as described in this paper. The staff do not think that the IASB should consider prospective application of the new leases standard (as was suggested by some constituents) whereby new leases entered into after the date of initial application would be accounted for differently from ongoing leases. The staff think that this approach could significantly distort reported figures for many years following the application of the new leases standard, particularly for lessees with long term leases entered into before the date of initial application.

21. Under a fully retrospective approach, a lessee would transition all elements of its lease portfolio as if the requirements of the new leases standard had always been applied. This would include the restatement of comparative figures and disclosure about the effect of application of the new leases standard in accordance with IAS 8. The remainder of the discussion in this paper regarding transition requirements for lessees relates to the modified retrospective approach.

Staff Analysis – Modified Retrospective Approach for Lessees

Overview

22. There was general support for the inclusion of a modified retrospective approach as an option in the new standard. Nonetheless, many of those supporting its inclusion, and particularly preparers, made alternative suggestions to the modified retrospective approach that was proposed in the 2013 ED. Preparers generally thought that the modified retrospective approach, as proposed, would provide limited cost relief compared to applying a fully retrospective approach. Many preparers were also of the view that the modified retrospective approach proposed was overly complex and difficult to understand.

23. The detailed feedback and staff analysis relating to the modified retrospective approach is organised as follows:

    (a) Comparative figures

    (b) Measurement of the lease liability

    (c) Measurement of the ROU asset

    (d) Discount rate applied to a portfolio

    (e) Existing onerous lease provisions

    (f) Leases for which the term ends within 12 months or less of the date of initial application

    (g) Initial direct costs

    (h) Use of hindsight

    (i) Disclosure

Modified retrospective approach - comparative figures

Feedback

24. Many constituents suggested that the new requirements should *not* apply to any leases that end during the comparative periods presented.

25. A number of constituents suggested a modified retrospective approach similar to that permitted in IFRS 15 and IFRS 9, ie on transition a lessee would recognise the cumulative effect of initially applying the proposals to leases that are ongoing at the date of initial application, as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application. This approach would provide cost relief in two ways:

    (a) a lessee would not need to restate comparative figures;

    (b) a lessee would apply the new lease accounting requirements only to leases that are still ongoing at the date of initial application.

Staff Analysis

26. On the basis of feedback received, the staff think that there would be significant costs associated with restating comparative figures that are likely to outweigh the benefits. The staff think that this would be the case under any retrospective approach, and in particular for entities that report more than one year of comparatives.

27. As an alternative to restating comparative figures, the staff think that a lessee could apply the new leases standard retrospectively (subject to particular additional reliefs as described below), and recognise the cumulative effect of initial application in the opening equity balances at the date of initial application. Such an approach is referred to as the 'cumulative catch-up' transition method and is consistent with the transition requirements in IFRS 15 and in IFRS 9.

28. The staff think that a cumulative catch-up transition method would provide lessees with significant cost relief on transition. This would relate to the costs of both preparation and the audit of comparative figures.

29. The primary drawback of a cumulative catch-up transition method would be the resulting lack of comparability at transition between the amounts reported in relation to leases in the current period and those reported in the comparative periods. However, the staff think that this concern can be substantially mitigated by including transition disclosure requirements (refer to paragraphs 77-103 of this paper).

30. Consequently, under the modified retrospective approach, the staff recommend that the IASB does not require the restatement of comparative figures. Furthermore, the staff recommend that a lessee should recognise the cumulative effect of initially applying the new leases standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) in the reporting period that includes the date of initial application.

Modified retrospective approach – measurement of the lease liability

Feedback

31. Constituents did not provide any significant feedback relating to the measurement of the lease liability on transition that was proposed as part of the modified retrospective approach in the 2013 ED.

Staff Analysis

32. The staff recommend that the IASB retain the proposal in the 2013 ED, ie a lessee using the modified retrospective approach should measure the lease liability on transition at the present value of the remaining lease payments, discounted using the lessee’s incremental borrowing rate at the date of initial application.

Modified retrospective approach – measurement of the ROU asset

Feedback

33. A number of constituents provided specific feedback on the measurement of the ROU asset on transition proposed under the modified retrospective approach in the 2013 ED. Many of those constituents thought that the proposal was overly complex and difficult to understand and apply.

34. Many preparers noted that the measurement of the ROU asset proposed in the 2013 ED would be particularly costly to apply because it required the use of historical information. The proposed measurement approach would require the commencement date of each individual lease to be known. Constituents thought that this would be extremely costly and time consuming to apply for entities with a large volume of leases.

35. A number of preparers suggested that, on transition, a lessee should be allowed to measure the ROU asset at an amount equal to the lease liability. These constituents acknowledged that such an approach would give rise to higher amortisation expenses in future periods (and, thus, artificial front loading of the lease expense). Nonetheless, they thought that, for many leases, the cost relief of a less onerous transition approach would make the higher amortisation expense worthwhile:

> Allowing an option to recognize a right of use asset equal to the lease liability on the date of transition would reduce the workload otherwise required on transition to identify the commencement date, which does not appear to be needed for any other purpose. While this would reintroduce the frontloaded income statement expense that was criticised by some in the 2010 ED, it would allow preparers to balance the costs and benefits depending on their individual circumstances. ***(CL 596)***

36. The staff note that this suggestion is similar to the simplified retrospective approach that was proposed in the 2010 ED, which required the ROU asset on transition to be measured at an amount equal to the lease liability (subject to particular adjustments).

37. In response to the 2010 ED, many respondents were concerned about the higher future amortisation expense that would result from the proposed simplified retrospective approach. Under the simplified approach, a lessee would measure the ROU asset at a higher amount than it would if it applied a fully retrospective approach. Consequently, if applying this approach, a lessee would recognise artificially high amortisation expense in periods after transition, which would in turn create an artificial front-loaded expense effect.

38. Some user respondents to the 2010 ED also expressed concerns regarding the comparability of new and existing leases for an entity. This was because a lessee would not take account of the pre-transition period when accounting for existing leases after transition.

Staff Analysis

39. Based on the feedback received, the staff do not recommend retaining the ROU measurement aspects of the modified retrospective approach that was proposed in the 2013 ED. Feedback indicated that the proposed approach would be difficult for preparers to apply and would provide only limited cost relief. We do not think that the cost relief achieved is sufficient to justify the use of this approach compared to a fully retrospective approach.

40. Instead, the staff think that there are two alternatives to the ROU asset measurement proposed as part of the modified retrospective approach in the 2013 ED which could be considered by the IASB.

Approach 1

41. Firstly, the staff have considered a modified retrospective approach under which the only reliefs offered to preparers would be those already described elsewhere in this paper, ie:

    (a) eliminating the need to restate comparative figures (paragraphs 24-30);

    (b) using a discount rate to calculate the lease liability and ROU asset on transition based on the lessee's incremental borrowing rate at the date of initial application (paragraphs 31-32);

    (c) in addition to only requiring the new standard to be applied to leases ongoing as at the date of initial application, not requiring the new leases standard to be applied to leases for which the term ends within 12 months or less of the date of initial application (paragraphs 64-69);

    (d) not requiring a lessee to include initial direct costs in the measurement of the ROU asset (paragraphs 70-72);

    (e) permitting the use of hindsight (paragraphs 73-76).

    In all other respects, the figures reported under this approach (from the date of initial application) would be identical to those arising had the requirements of the new leases standard been applied retrospectively. In order to achieve this, a lessee would need to use historical information relating to the start date and payment schedule of each individual lease in order to arrive at the transition value of the ROU asset (ie establish the profile of the ROU asset from

commencement to obtain its carrying value at the date of initial application. The main simplification would be the use of the incremental borrowing rate at the date of initial application as the discount rate for determining the commencement value of the ROU asset).

42. This approach would have the advantage of getting to a more 'correct' set of reported figures from the date of initial application. In other words, it would avoid the higher amortisation expense effect about which many expressed concerns in response to the transition proposals in the 2010 ED.

43. The main drawback of this approach would be the cost to preparers. Costs would arise in respect of needing to use historical information about individual leases on transition. In addition, it would be difficult to apply this approach to groups of leases because the approach would require the use of start dates and payment schedules throughout the life of the lease.

44. The staff think that the benefits of this approach would likely outweigh the costs for leases of high value assets or leases with a long life. In these cases, the potential higher amortisation expense effect of a less costly transition approach could be significant. The staff think that for these leases, a more costly transition approach would be justified by the improved quality of reported information in the years following transition.

45. The staff note that under this approach, a lessee would still obtain substantial cost relief compared to a fully retrospective approach if the IASB decides to adopt the recommendations for (a) eliminating the need to restate comparatives (paragraphs 24-30); and (b) in respect of leases for which the term ends within 12 months of the date of initial application (paragraphs 64-69). Nonetheless, the staff question whether the costs of this approach would be justified for leases that are high in volume but not individually significant.

Approach 2

46. Secondly, the staff have considered an approach whereby, on transition, a lessee would measure the ROU asset at an amount equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments.

47. The staff think that this approach would provide significant cost relief to lessees for two main reasons:

    (a) firstly, this approach would not require any historical information about individual leases to be input on transition;

    (b) secondly, this approach could be applied to portfolios of leases with the same end date rather than needing to be applied on a lease by lease basis.

48. However, under this approach, a lessee would recognise a higher future amortisation expense on the ROU asset compared to the amounts that would be recognised under a fully retrospective approach. This effect would occur for the remainder of the term of each lease, and would be greater for leases with high discount rates or long terms.

49. The staff think that the cost relief provided by this approach would outweigh the negative effect it would have on a lessee’s income statement for those leases that are high in volume but not significant in value. However, for more significant leases (such as long term leases of property, ships or aircraft), the income statement effect of this approach could be significant and could remain for many years following the date of initial application. In these cases, the benefits of this approach are unlikely to outweigh its limitations in terms of reported information.

Choice of Approaches

50. The staff think that it is not possible to provide one method of ROU asset measurement under the modified retrospective transition approach which avoids the artificial higher lease expense effects after transition *and* addresses the cost concerns of preparers. Approaches 1 and 2 as described above present those approaches that the staff consider to be the ‘best’ options in terms of the quality of reported information (Approach 1) and cost concerns (Approach 2).

51. Nonetheless, the staff think that permitting a lessee to choose between these alternatives on a lease by lease basis would provide a pragmatic and largely self-policing solution. As noted above, the effect of the less costly option (Approach 2) is an increase in operating expense for the remainder of the term of the lease. This would occur because of the higher post-transition amortisation expense under

Approach 2 as compared to using an approach that measures the ROU asset to more properly reflect retrospective application of the new requirements. Consequently, the staff think that a lessee would select this option only for those leases for which the costs of applying a more accurate transition approach to measurement of the ROU asset would not outweigh the benefit of achieving a 'correct' post transition income statement. This is likely to apply to leases that are high in volume but low in value, for which the negative effect on operating profit under Approach 2 would be less significant than the costs of transitioning these leases more 'accurately'.

52. In contrast, for significant leases such as long term leases of property, the staff think that the benefits of achieving a 'correct' income statement would make the costs of applying the more accurate transition method worthwhile for a lessee.

53. Therefore, the staff recommend that the IASB provide a choice of two options for measurement of the ROU asset on transition under the modified retrospective approach. The staff think that this choice should be made on a lease by lease basis. This is in order to maximise the benefits of the choice to both preparers (in terms of cost savings on high volume, low value leases) and users (in terms of the quality of reported information on individually significant leases).

Modified retrospective approach – discount rate applied to a portfolio

Feedback

54. No significant feedback was received in respect of the 2013 ED proposal that a lessee can apply a single discount rate to a portfolio of leases with reasonably similar characteristics. This would apply, for example, to contracts with a similar remaining lease term for a similar class of underlying asset in a similar economic environment.

Staff Analysis

55. The staff think that the transition relief provided in the 2013 ED for the modified retrospective approach relating to the application of a single discount rate to a portfolio of leases with reasonably similar characteristics would provide cost relief to preparers and would not have a significant effect on reported information.

If the IASB decides to adopt the staff recommendation for ROU asset measurement under the modified retrospective approach as described above, application of a portfolio discount rate would provide even greater cost relief to preparers than it did under the proposals of the 2013 ED. This is because, when combining the option to measure ROU assets at an amount equal to lease liabilities with the application of a single discount rate, a lessee would be able to apply the transition requirements collectively to portfolios of leases of similar assets in similar economic environments with the same end date.

56. Therefore, the staff recommend that the IASB retain this exemption in the new leases standard.

Modified retrospective approach – existing onerous lease provisions

Feedback

57. A small number of respondents to the 2013 ED observed that the transition proposals did not address how a lessee should account for existing onerous lease provisions on leases that were previously classified as operating leases.

Staff Analysis

58. An onerous lease provision under the existing requirements of IAS 17 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* occurs when the expected cash inflows from using a leased asset are less than the expected cash outflows under the lease. Consequently, if a lease is considered onerous under the existing requirements, the ROU asset arising from accounting for the lease under the requirements of the new leases standard is likely to be impaired.

59. The staff therefore recommend that a lessee should be required to adjust the opening balance of the ROU asset on transition by the amount of any previously recognised onerous lease provisions.

60. In addition, the staff have considered whether a lessee should be required to review all of its existing onerous lease provisions on transition. This might arguably be required under a retrospective approach because the basis of measuring a provision under IAS 37 is slightly different from the measurement of an asset impairment under IAS 36 *Impairment of Assets*. Under IAS 37, a

provision is measured at the best estimate of the expenditure required to settle the provision. Under IAS 36, an asset impairment is based on an estimate of the recoverable amount of the asset (being the higher of the asset's value in use and fair value less costs to sell).

61. The staff note that a lessee would reallocate onerous lease provisions to ROU asset 'impairments' on the first day of an annual reporting period. In other words, a lessee would reallocate onerous lease provisions on the basis of information reported in audited year-end financial statements on the day immediately preceding the date of initial application. Consequently, we do not think that a lessee should be required to reassess onerous lease provisions at the date of initial application.

62. In addition, we would not expect a lessee to re-review on transition those operating leases against which no onerous lease provision had been recognised. The staff think that such a review would be costly to do and would provide relatively little benefit in terms of reported information. This is because, if an ROU asset recognised on transition to the new leases standard is impaired, an entity would have taken into account the expected cash inflows on that asset in determining the onerous lease provision immediately before transition. Because of this, the staff think that there would be relatively little difference in outcomes between:

    (a) adjusting the ROU asset on transition by the amount of any existing onerous lease provisions; and

    (b) reviewing ROU assets for impairment on the date of initial application.

63. The staff therefore do not recommend requiring a lessee to review its onerous lease provisions on transition to the new leases standard.

Modified retrospective approach - leases for which the term ends within 12 months or less of the date of initial application

Feedback

64. Many of those that provided feedback on the 2013 ED suggested that the proposals should *not* apply to any leases terminating shortly after the date of initial application. Constituents provided various suggestions as to how long after

the date of initial application this exemption should apply. Suggestions ranged from leases terminating within one year to three years after the date of initial application.

65. Those that provided this feedback think that the costs of transitioning these leases would not outweigh the benefits to users.

Staff Analysis

66. Elsewhere in this paper, the staff recommend eliminating the need for a lessee to restate comparative figures on adoption of the new leases standard – this has the effect that the new standard need not be applied to leases that terminate in comparative periods/before the date of initial application. If the IASB decides to adopt this recommendation, then the staff think that a transition exemption for leases for which the term ends within 12 months or less (as determined for the short-term lease exemption) of the date of initial application would be very similar to the short-term lease exemption that was decided upon by the boards at the March 2014 board meeting.

67. The staff think that this exemption would provide significant cost relief to lessees on transition for leases previously classified as operating leases.

68. This relief does introduce a risk of short-term leases that are material in the aggregate being excluded from the balance sheet on transition. The staff have considered applying this relief to a smaller population of contracts in order to mitigate this concern. This could be achieved by permitting the relief to be applied only to those leases with a *legal expiry* date within 12 months or less from the date of initial application. Consequently, the relief would not apply to those leases with termination or extension options structured such that the lease term *could* extend beyond 12 months from the date of initial application. However, the staff do not recommend that the IASB define the exemption in this way. This is because it would be inconsistent with the IASB's decisions on the short-term lease exemption. The staff note that the risk of exempting leases that are material in the aggregate also exists under the short-term lease exemption more generally.

69. Therefore, the staff recommend that the IASB provide an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application. Instead, a lessee would account for these

leases in accordance with the short-term lease exemption (ie similarly to existing operating leases). The staff also recommend requiring disclosure of the lease expense associated with these leases within the disclosure of short-term lease expense in the period of initial application.

Modified retrospective approach - initial direct costs

Feedback

70. No significant feedback was received in respect of the 2013 ED proposal that a lessee need not include initial direct costs in the measurement of the ROU asset.

Staff Analysis

71. The staff think that the transition relief provided in the 2013 ED relating to initial direct costs would provide some cost relief for lessees and would not have a significant effect on reported information.

72. Therefore, the staff recommend retaining this exemption in the new leases standard.

Modified retrospective approach - use of hindsight

Feedback

73. Very little feedback was received in respect of the 2013 ED proposal that a lessee may use hindsight in applying the leases transition proposals. A small number of constituents did, however, comment that it would be difficult *not* to use hindsight if there is retrospective application (whether full or modified). These constituents noted that it would be difficult for them to establish and substantiate a position on judgements that were not considered at the time without the application of hindsight.

Staff Analysis

74. The staff think that permitting lessees to apply hindsight on transition would result in better quality reported information. This would apply, in particular, to areas of judgement such as the determination of the lease term for contracts that contain options to extend or terminate the lease. We think that the use of hindsight may

also be necessary in order for an entity to achieve meaningful retrospective application of the new leases standard.

75. In addition, the feedback received in this area indicates that permitting the use of hindsight would make application of the transition proposals slightly easier for lessees.

76. Therefore, the staff recommend retaining this exemption in the new leases standard.

Modified retrospective approach - disclosure

Feedback

77. A number of constituents were supportive of the proposal in the 2013 ED to provide an exemption from the disclosure requirements in paragraphs 28(f) of IAS 8. These requirements are as follows:

> 29 …..an entity shall disclose:
>
> (f) for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
>
> (i) for each financial statement line item affected; and
>
> (ii) if IAS 33 *Earnings per Share* applies to the entity, for basic and diluted earnings per share.

78. Those that did comment on disclosures generally did so in the context of suggesting that the IASB not require a lessee to restate comparative figures on transition to the new leases standard. In the absence of restated comparatives, these constituents thought that disclosure should be sufficient to enable users to perform a meaningful comparison of current and prior period figures and to enable them to understand the effect of adopting the new leases standard. Preparers thought that providing this information via disclosure would be less costly than restating comparative figures in the financial statements.

Background – Other Recently Issued Standards

79. In considering disclosure requirements on transition, the staff have considered the requirements in other recently issued standards.

80. As discussed above, IFRS 15 contains transition requirements that are similar to the staff recommendations in this paper in that it permits a cumulative catch-up transition method.

81. In terms of disclosure, IFRS 15 requires an entity to provide both of the following additional disclosures in the reporting period that includes the date of initial application if the cumulative catch-up transition method is adopted:

> (a) the amount by which each financial statement line item is affected in the current reporting period by the application of this Standard as compared to IAS 11, IAS 18 and related interpretations that were in effect before the change; and
>
> (b) an explanation of the reasons for significant changes identified.

82. The IASB decided to require these additional disclosures to help users to understand the effect of IFRS 15 on trend information. In doing so, the IASB acknowledged that this requirement would mean that an entity needs to account for revenue transactions under two different sets of requirements in the period of initial application. However, this was considered to be less costly than applying the requirements of IFRS 15 retrospectively and would still provide the trend information needed by users.

83. IFRS 9 also allows a form of cumulative catch-up on transition and does not require that comparative information be presented. In addition IFRS 9 made a consequential amendment to IFRS 7 *Financial Instruments – Disclosure*, which specifies that:

> 42Q In the reporting period that includes the date of initial application of IFRS 9, an entity is not required to disclose the line item amounts that would have been reported in accordance with the classification and measurement requirements of:
>
> (a) IFRS 9 for prior periods; and
>
> (b) IAS 39 for the current period.

84. Regarding transition disclosures for IFRS 9, the IASB concluded that requiring disclosure of the line item amounts that would have been reported in prior reporting periods in accordance with IFRS 9 would contradict the fact that an entity is not required to restate prior periods.

85. In making the decision not to require disclosure of current period amounts under IAS 39 *Financial Instruments: Recognition and Measurement*, the IASB considered the usefulness of these disclosures, the cost of providing them and whether the existing transition disclosure requirements were sufficient to enable users to assess the effect of transition to IFRS 9. The IASB noted that it would be very difficult to provide hedge accounting information 'as if applied in the current period' because it would be based on highly speculative assumptions. The IASB also noted that requiring disclosure of IAS 39 amounts in the period of initial application could be very costly due to the need to run parallel systems. Specific disclosures were instead introduced in IFRS 7 to enable users to understand the effect of moving from IAS 39 to IFRS 9 on initial application of IFRS 9.

Staff Analysis

86. On transition to the new leases standard, the staff think that a lessee should not be required to comply with the existing disclosure requirements in paragraph 28(f) of IAS 8. This is because we think that these disclosures are costly to prepare and there are alternative disclosures that would provide meaningful information to users.

87. The staff also note that these paragraphs of IAS 8 would require a lessee to report prior period information in accordance with the new leases standard. This requirement would contradict the recommendation that a lessee should not be required to restate comparatives under the modified retrospective approach. It would also largely eliminate the cost relief provided by that recommendation.

88. The staff think that the most relevant information for users on transition to the new leases standard would be that which would enable them to properly assess the effect on reported figures of applying the standard. The staff have considered what this information would constitute in respect of the Balance Sheet, the Income Statement and the Statement of Cash Flows.

Balance Sheet

89. On application of the new leases standard, we would expect that a lessee's assets and liabilities would increase by an amount similar to the previously reported operating lease commitments, measured on a discounted basis. If this is not the

case, users are likely to want to understand why. For example, if lease liabilities recognised on transition increase by significantly more than the disclosed operating lease commitments previously reported under IAS 17, a user would want to understand the extent to which this increase relates to:

(a) new leasing activity during the period; or

(b) any differences in judgements applied under the new leases standard as compared to the assessment of operating lease commitments in the prior period (eg changes in judgements about lease term).

90. The staff therefore recommend that the following disclosures are required in the reporting period that includes the date of initial application:

(a) the operating lease commitments that would have been reported at the end of the first annual reporting period that includes the date of initial application if IAS 17 had applied in that period;

(b) the weighted average incremental borrowing rate at the date of initial application;

(c) explanation of significant differences between:

  (i) the result of discounting the operating lease commitments that would have been reported at the end of the first annual reporting period that includes the date of initial application under IAS 17 using the weighted average incremental borrowing rate at the date of initial application; and

  (ii) lease liabilities recognised at the end of the first annual reporting period that includes the date of initial application.

91. The staff think that this disclosure requirement would satisfy the information need described in paragraph 89 above. For example, under this requirement, a lessee would need to explain (as at the end of the first annual reporting period that the new leasing requirements are applied):

(a) any significant differences in judgements applied under the new leases standard as compared to the assessment of operating lease commitments under IAS 17;

(b) if a significant proportion of former operating lease commitments have been excluded from capitalisation under the short-term lease or small asset lease recognition and measurement exemptions.

92. In addition, this disclosure would give users a like-for-like comparison of IAS 17 operating lease commitments in the annual reporting period of initial application and in the comparative period as the old IAS 17 operating lease commitment disclosures would be required for both periods. This will enable users to identify any changes in leasing activity that are not related to the adoption of the new leases standard. The staff think that providing this comparison on an IAS 17 basis will be significantly less costly for preparers than requiring comparative information to be reported in accordance with the new leases standard. This is because a lessee provides information about operating lease commitments under IAS 17 within disclosures only and that information is often maintained separately from the double entry system used to prepare the financial statements. The staff acknowledge that there would be costs associated with capturing this information for one additional year following the date of initial application. However, we think that this would be significantly *less* costly than presenting comparative information in accordance with the new leases standard. This is because any restatement of comparatives would require adjustment to a number of areas of the financial statements and would, therefore, require a lessee to run parallel systems during the year preceding the date of initial application.

Income Statement

93. With respect to the income statement, users are interested in trend information. For example, if a lessee reported a significant improvement in operating result following transition, a user would want to know the extent to which this related to:

(a) the effective reallocation of the interest component of former operating lease payments from operating expenses to finance costs; and

(b) improvements in the operating result because of improved performance.

94. At the January 2015 board meeting, the IASB decided to require a lessee to disclose the amortisation of ROU assets and the interest expense on lease liabilities. In the annual reporting period that includes the date of initial

application, the staff also recommend that the IASB require a lessee to disclose the rental expense that would have been recognised if IAS 17 had still been applied. The staff think that these disclosures would provide users with sufficient information to reasonably estimate the effect of transitioning to the new leases standard on the income statement.

95. The staff note that, under the existing requirements of IAS 17, a lessee is not required to specifically disclose the amortisation and interest expenses relating to existing finance leases. In addition, under the new leases standard, it would not be possible for a user to distinguish those amortisation and interest expenses that relate to former finance leases and those that relate to former operating leases. Similarly, the disclosure of the lease expense under the new leases standard would not distinguish that which relates to new leasing activity during the period. Consequently, disclosed information would not enable a user to isolate the exact numerical effect of re-allocating former operating lease rentals in the income statement as amortisation and interest expense.

96. The staff have considered the alternative approach of requiring a lessee to disclose the income statement lease expenses in the annual reporting period that includes the date of initial application split between former operating leases and former finance leases. Such an approach would provide users with a precise numerical assessment of the effect of transitioning former operating leases to the new leases standard. However, this requirement would be costly for a lessee to implement in that it would require a system set-up that would distinguish between former operating leases and former finance leases whilst simultaneously accounting for all leases recognised on the balance sheet under the single lessee accounting model. A lessee would also be required to classify new leases entered into after the date of initial application using the 'old' IAS 17 classification criteria. The benefits obtained in terms of reported information would be unlikely to outweigh these costs.

97. If the income statement leases information disclosed in the annual reporting period that includes the date of initial application contains any significant amounts relating to former finance leases or new lease activity during the period, the staff think that this would be evident from the other disclosures proposed in this paper and decided upon by the IASB at the January 2015 board meeting. For example,

new leasing activity would be evident from the requirement for a lessee to disclose additions to ROU assets in the period. Similarly, if a lessee had a significant level of finance lease activity under IAS 17, this would be evident from the explanation of differences between IAS 17 operating lease commitments and lease liabilities recognised on the balance sheet under the new leases standard that is recommended elsewhere in this paper. We therefore think that the proposed disclosure is sufficient to enable users to understand the effect of transitioning to the new leases standard on the income statement.

98. Overall, the staff think that the proposed disclosure provides a reasonable balance between the information needs of users and costs to preparers.

Statement of Cash Flows

99. Cash flow statement presentation was discussed by the IASB in the June 2014 board meeting. Agenda Paper 3C from that meeting described the feedback received from constituents with respect to the cash flow statement. Most users of financial statements wanted to see a single figure for lease cash outflows and considered this to be the most important piece of information about lease cash flows. In the light of this feedback, the IASB tentatively decided to require disclosure of a single figure for lease cash outflow at the June 2014 board meeting.

100. IAS 17 does not require any particular disclosure about lease cash flows. Under both IAS 17 and the new leases standard, lease cash flows will be split between cash from operating activities and cash from financing activities in the cash flow statement (albeit that *more* cash outflows will appear as financing activities under the new leases standard). However, neither IAS 17 nor the new leases standard require these amounts to appear as individual line items on the face of the cash flow statement.

101. The staff think that the key information that users would like to see with respect to lease cash outflows is one total figure – which has already been tentatively decided by the IASB. We acknowledge however that this disclosure will not provide users with the ability to compare lease cash flows between the annual reporting period that includes the date of initial application and the prior period. The staff have considered the option of requiring a lessee to disclose, in the annual

reporting period that includes the date of initial application, the total lease cash outflow for the prior period. This would provide users with comparable information. However, we do not recommend this approach because we think that it contradicts the overall recommendation *not* to require any retrospective restatement of comparative information.

102. The staff have also considered the option of requiring a lessee to disclose, in the annual reporting period that includes the date of initial application, the amount included within cash flows from operating activities relating to leases for both that period and the prior period. This would enable a user to understand the extent to which any improvement in cash flows from operating activities is a consequence of lease cash outflows being reallocated to cash flows from financing activities. However, this would require information to be disclosed that is neither required today under IAS 17, nor would be required under the new leases standard. The reason this information is not required to be disclosed under the new leases standard is because users thought that a total cash flow figure was more useful. The staff do not think it is appropriate to require this information only on transition.

103. The staff think that the decisions made in June 2014 with respect to cash flow presentation and disclosure will ensure that users get the most useful information about lease cash flows going forward. We recommend that the new leases standard does not require any additional information to be disclosed with respect to lease cash flows in the annual reporting period that includes the date of initial application.

Staff Analysis – Lessors

104. In the March 2014 board meeting, the IASB decided to substantially retain the IAS 17 lessor accounting model. Accordingly, the staff think that detailed transition guidance for lessors is not required in the new leases standard.

105. Adoption of the new leases standard could, however, affect lessor accounting in three ways:

    (a) Application of the new definition of a lease guidance: Agenda Paper 3D recommends permitting both lessees and lessors to grandfather the definition of a lease for existing leases on transition to the new leases standard;

    (b) Application of the new accounting guidance for subleases: specific transition recommendations are detailed in Agenda Paper 3C;

    (c) Application of the revised definition of initial direct costs: this guidance *could* lead to less initial direct costs being recognised under the new leases standard. The staff think that the costs of requiring any retrospective accounting or cumulative catch up adjustments in respect of this difference would not outweigh any benefits in terms of reported information.

106. Accordingly, we recommend that the new leases standard should require that, with the exception of accounting for subleases (Agenda Paper 3C), a lessor should continue to apply its current accounting for any leases that are ongoing at the date of initial application.

Staff Analysis – First-Time Adoption

107. The staff recommend that a number of the reliefs described in this paper should also be permitted for first-time adopters of IFRS under IFRS 1. This applies to those reliefs that are not dependent on the accounting applied by an entity immediately before adopting IFRS (ie reliefs for which the transition methodology is not dependent on an entity transitioning from *existing* IFRS accounting). We think that it is appropriate for a first-time adopter of IFRS to be permitted these same reliefs.

108. In particular, we recommend that a first-time adopter should be permitted to apply the modified retrospective approach described in paragraphs 22-103 above. However, for a first-time adopter, the following elements of the modified retrospective approach would *not* be applicable:

(a) the relief described in paragraphs 24-30 above that a lessee need not restate comparative figures. For a first-time adopter, the date of initial application should be regarded as the date of transition to IFRSs in accordance with IFRS 1 (in other words, the beginning of the earliest comparative period presented in the first IFRS financial statements);

(b) the relief described in paragraphs 64-69 above that a lessee can apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application. For a first-time adopter, all elements of the financial statements would need to be transitioned to IFRS and, consequently, the new leases standard should be applicable to all leases; and

(c) the special disclosure requirements described in paragraphs 77-103 of this paper. A first-time adopter would need to provide disclosure in accordance with IFRS 1 to explain how the transition from previous GAAP to IFRSs affected its financial statements. The staff think that the disclosure requirements described in this paper relate to a lessee transition from existing IFRS requirements (ie IAS 17). Accordingly, a first-time adopter should not be required to apply these lease transition disclosures in addition to the disclosures required by IFRS 1.

Staff Recommendations and Questions for the IASB

Questions: Lessee transition of leases previously classified as operating leases

Lessees: Fully Retrospective versus Modified Retrospective Approach

1. Does the IASB agree with the staff recommendation to permit a lessee to choose either a fully retrospective approach or a modified retrospective approach on transition, to be applied consistently across its entire operating lease portfolio?

Lessees: Modified Retrospective Approach

2. Does the IASB agree with the following staff recommendations relating to the modified retrospective approach:

   (a) a lessee should not restate comparative figures;

(b) a lessee should recognise the cumulative effect of initially applying the proposals as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application;

(c) a lessee should measure the lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application;

(d) a lessee is permitted a choice of two measurement approaches for the ROU asset on transition, chosen on a lease-by-lease basis:

   (i) measure the ROU asset as if the new leases standard had always been applied, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application;

   (ii) measure the ROU asset at an amount equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments.

(e) a lessee can apply a single discount rate to a portfolio of leases with reasonably similar characteristics;

(f) a lessee should adjust the ROU asset on transition for operating leases by the amount of any previously recognised onerous lease provisions;

(g) a lessee can apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application (as determined for the short-term lease exemption). A lessee would instead account for these leases in the same way as short-term leases, ie by applying existing operating lease accounting. Under this exemption, a lessee would be required to include the cost associated with these leases within the disclosure of short-term lease expense in the annual reporting period of initial application;

(h) a lessee can apply the relief proposed in the 2013 ED that a lessee need not include initial direct costs in the measurement of the ROU asset;

(i) a lessee can apply the relief proposed in the 2013 ED that a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease;

(j) in the annual reporting period that includes the date of initial application, the following disclosures replace the disclosure requirements of IAS 8 paragraph 28(f):

   (i) the operating lease commitments that would have been

reported if IAS 17 had been applied in that reporting period;

(ii) the weighted average incremental borrowing rate at the date of initial application;

(iii) explanation of any differences between:

- the result of discounting the operating lease commitments that would have been reported under IAS 17 at the end of the annual reporting period that includes the date of initial application using the incremental borrowing rate at the date of initial application; and
- lease liabilities recognised at the end of that reporting period.

(iv) the rental expense that would have been recognised if IAS 17 had been applied in that period?

Lessors

3. Does the IASB agree with the staff recommendation to require that a lessor should continue to apply its current accounting for any leases that are ongoing at the date of initial application, with the exception of accounting for subleases (Agenda Paper 3C)?

First-Time Adoption

4. Does the IASB agree with the staff recommendation to permit a first-time adopter of IFRS to apply the modified retrospective approach described in paragraphs 22-103 of this paper, with the following exceptions:

(a) the relief described in paragraphs 24-30 that a lessee need not restate comparative figures. For a first-time adopter, the date of initial application should be regarded as the date of transition to IFRSs in accordance with IFRS 1;

(b) the relief described in paragraphs 64-69 that a lessee can apply an explicit recognition and measurement exemption for leases for which the term ends within 12 months or less of the date of initial application; and

(c) the special disclosure requirements described in paragraphs 77-103 of this paper?

Appendix: Example of Proposed Modified Retrospective Approach as Compared to a Fully Retrospective Approach

A1. This Appendix is based on Illustrative Example 24 included in the 2013 ED. It demonstrates the effect of applying the modified retrospective approach as proposed in this paper.

EXAMPLE

Scenario:

Lease start Date:	01/01/20X1
Duration:	5 years
Rent:	£31k yr 1-2; £33k yr 3-5
Date of Initial Application:	01/01/20X2
Incremental Borrowing Rate at Date of Initial Application:	5%
Incremental Borrowing Rate at Lease Inception:	6%

	FULLY RETROSPECTIVE APPROACH		
	Lease Liability	**ROU Asset**	**Depreciation Charge**
31/12/20X1	112,462	108,273	(27,068)
31/12/20X2	88,209	81,205	(27,068)
31/12/20X3	60,502	54,136	(27,068)
31/12/20X4	31,132	27,068	(27,068)
31/12/20X5	-	-	(27,068)

	MODIFIED RETROSPECTIVE APPROACH 1 *(Measure ROU asset as if new leases standard always applied; discount rate = incremental borrowing rate at date of initial application)*		
	Lease Liability	**ROU Asset**	**Depreciation Charge**
01/01/20X2	115,112	111,323	N/A
31/12/20X2	89,867	83,492	(27,831)
31/12/20X3	61,361	55,662	(27,831)
31/12/20X4	31,429	27,831	(27,831)
31/12/20X5	-	-	(27,831)

	MODIFIED RETROSPECTIVE APPROACH 2 *(Measure ROU asset as being equal to lease liability, adjusted for any previously recognised prepaid or accrued rent)*		
	Lease Liability	**ROU Asset**	**Depreciation Charge**
01/01/20X2	115,112	113,912	N/A
31/12/20X2	89,867	85,434	(28,478)
31/12/20X3	61,361	56,956	(28,478)
31/12/20X4	31,429	28,478	(28,478)
31/12/20X5	-	-	(28,478)