STAFF PAPER

March 2015

REG IASB Meeting

Project	**Leases**		
Paper topic	Sweep Issue: Disclosures on Transition		

CONTACTS	Kathryn Donkersley	kdonkersley@ifrs.org	+44 207 246 6970
	Patrina Buchanan	pbuchanan@ifrs.org	+44 207 246 6468

Objective

1. The purpose of this paper is to discuss disclosure requirements in the annual reporting period in which a lessee first applies the requirements of the new leases standard. In particular, it discusses the approach that a lessee should take in explaining the effect of adopting the new leases standard in its financial statements.

2. This topic was discussed by the IASB in February 2015 (Agenda Paper 3A). This paper does not revisit the analysis presented by the staff at that meeting. Instead, as requested by some board members, it presents example disclosures under two different approaches to explain the effect of adopting the new standard.

3. This paper is structured as follows:

   (a) Background

   (b) Example disclosures

   (c) Staff analysis

   (d) Staff recommendations and question for the IASB

Background

4. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to disclose the following information on initial application of an IFRS:

> 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.

5. In February 2015 Agenda Paper 3A, the staff recommended that in the annual reporting period that includes the date of initial application of the new leases standard, the following disclosures should replace the disclosure requirements of IAS 8 paragraph 28(f) in a lessee's financial statements:

(a) the operating lease commitments that would have been reported if IAS 17 had been applied in that reporting period;

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

(c) explanation of any differences between:

(i) 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

(ii) lease liabilities recognised on the balance sheet at the end of that reporting period;

(d) the rental expense that would have been recognised if IAS 17 had been applied in that reporting period.

This disclosure approach is referred to as ***Approach 1*** in this paper.

6. All of the IAS 17 figures recommended under Approach 1 are based on rolling forward existing IAS 17 records for one additional year – the information would not include data relating to new and extended leases in the annual reporting period

that includes the date of initial application. The recommendation was made with the intention of achieving a reasonable cost benefit balance between the information needs of investors and analysts (users) and the cost concerns of preparers during transition to the new leases standard.

7. During the February 2015 board meeting, some board members suggested an alternative approach which would require a lessee to disclose:

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

   (b) explanation of any differences between:

      (i) the result of discounting the operating lease commitments reported under IAS 17 at the end of the annual reporting period preceeding the date of initial application; and

      (ii) lease liabilities recognised on the balance sheet immediately after posting the cumulative catch up adjustment on the date of initial application.

   This disclosure approach is referred to as ***Approach 2*** in this paper.

8. The board members suggesting this approach thought that it would provide better information to users because the explanation of the effect of adopting the new leases standard would not be affected by new lease activity during the annual reporting period that includes the date of initial application.

Example Disclosures

9. The paragraphs below show the following disclosures that would be provided by a lessee in the annual reporting period that includes the date of initial application:

   (a) “normal” year-on-year lease disclosures, ie those that would be made each year by a lessee in accordance with the tentative decisions made by the board in January 2015. These disclosures would be provided by a lessee under both Approach 1 and Approach 2;

   (b) Approach 1 transition disclosures;

   (c) Approach 2 transition disclosures.

10. In this example, all disclosures relevant to the lessee's portfolio are included for completeness, ie we have not excluded any items because they are immaterial. The disclosures below may therefore be more comprehensive than a lessee would typically present. Comparative information has only been presented where similar disclosure is also required under IAS 17.

11. The date of initial application is 1 January 20X8.

"Normal" year-on-year disclosures

12. The disclosures in this paragraph would be provided by a lessee under both approaches described in this paper.

Year Ended 31 December 20X8	**20X8** ***CU'm***
Income Statement Disclosures:	
Amortisation of ROU assets	611
Interest on lease liabilities	166
	777
Amortisation of ROU assets comprises:	
Property	547
Other classes of underlying asset	64
	611
Short term lease expense†	152
Small asset lease expense	13
Variable lease expense	100
Cash Flow Statement Disclosures:	
Total cash flow for leases	853
Balance Sheet Disclosures:	
Carrying amount of Property ROU assets	5,111
Carrying amount of other classes of ROU assets	251
Total ROU assets	5,362
Additions to ROU assets	766
Lease liabilities	5,558

†The short term lease expense is higher than short term lease payments committed to in the next 12 months. This is because this figure includes amounts relating to those leases whose term ends within 12 months of 31/12/20X8 but which are not short term leases (because the total lease term is greater than 12 months). Short term lease payments committed to in the year ended 31/12/20X9 are CU 40m.

Year Ended 31 December 20X8	20X7 CU'm	20X7 CU'm	20X8 CU'm
Maturity Analysis (Undiscounted):	*(Finance leases)*	*(Operating leases)*	
Lease payments due within:			
One year	15	718	685
2-5 years	55	2,681	3,002
6-10 years	30	1,810	1,946
More than 10 years	-	1,145	900
	100	6,354	6,533

Approach 1 transition disclosures

13. The table below shows the additional disclosures provided in the annual reporting period that includes the date of initial application for a lessee adopting Approach 1 as described in this paper.

Year Ended 31 December 20X8		**20X8** *CU'm*
Effect of adopting IFRS [XX] Leases:		
Undiscounted commitments relating to leases previously classified as operating leases at 31/12/20X8		5,636
Weighted average incremental borrowing rate at 01/01/20X8		3%
Discounted commitments relating to leases previously classified as operating leases at 31/12/2018		4,776
Less: Commitments relating to leases of small assets		(34)
Add: Commitments relating to leases previously classified as finance leases		76
Add: Commitments relating to new and extended leases during 20X8		680
Add: Payments in optional extension periods not recognised at 31/12/20X7		59
Lease liabilities at 31/12/20X8		**5,558**
Other Disclosures:	**20X7** *CU'm*	**20X8** *CU'm*
IAS 17 rental expense relating to leases previously classified as operating leases during the year ended 31/12/20X8	1,150	691

Approach 2 transition disclosures

14. The table below shows the additional disclosures provided in the annual reporting period that includes the date of initial application for a lessee adopting Approach 2 as described in this paper.

Year Ended 31 December 20X8	**20X8** *CU'm*
Effect of adopting IFRS [XX] Leases:	
Operating lease commitments disclosed at 31/12/20X7	6,354
Weighted average incremental borrowing rate at 01/01/20X8	3%
Discounted operating lease commitments at 01/01/20X8	5,334
Less: Commitments relating to short term leases	(143)
Less: Commitments relating to leases of small assets	(46)
Add: Commitments relating to leases previously classified as finance leases	89
Add: Payments in optional extension periods not recognised at 31/12/20X7	58
Lease liabilities at 01/01/20X8	**5,292**

Staff Analysis

15. The staff acknowledge that neither of the approaches described in this paper produce a similar quality of reported information to presenting either comparative figures under the requirements of the new leases standard or transition year figures on an IAS 17 basis. As discussed in the February 2015 board meeting, we think that this compromise in terms of quality of reported information is justified because of the significant cost that would be associated with reporting of directly comparable information between the two years. These significant costs would be incurred because a lessee would need to run parallel reporting systems for either the transition year or the comparative period.

16. Accepting that this is the case, the staff analysis below provides a high level comparison of Approach 1 and Approach 2 with respect to the quality of reported information and costs.

Reported information

Balance Sheet

17. The staff think that the combination of the "normal" disclosures described in paragraph 12 and the specific transition year disclosures described in paragraph 13 (Approach 1) or paragraph 14 (Approach 2) would enable a user to obtain a reasonable understanding of the effect of adopting the new leases standard on a lessee's balance sheet. We think that the information produced under either approach is similar, albeit that a user would arrive at information in different ways under the two approaches. For example:

    (a) Less information is available under Approach 1 regarding the effect of short term leases on transition. However, we think that adequate information is alternatively available via the short term lease expense and footnote information described in paragraph 12;

    (b) Less information is available under Approach 2 regarding the extent to which changes in lease liabilities in the year of initial application are affected by new lease activity rather than adoption of the new standard. However, we think that adequate information on new lease activity is alternatively available via the disclosure of additions to ROU assets described in paragraph 12.

18. We note however that, whilst similar balance sheet information can be obtained from either approach, Approach 2 is likely to be easier for users to understand. This is because the reconciliation between IAS 17 lease liabilities and those under the requirements of the new standard will not be complicated by the inclusion of new lease activity during the annual reporting period that includes the date of initial application.

Income Statement

19. With respect to income statement disclosures, we think that better information is available under Approach 1 because this approach includes disclosure of the IAS 17 rental expense relating to leases previously classified as operating leases. Together with information about the level of former finance lease activity that appears in the comparative figures, this disclosure enables a user to perform a

reasonable estimate of the extent to which changes in lease expenses are the result of adopting the new standard rather than being due to new lease activity in the annual reporting period that includes the date of initial application.

20. Based on the above example, a user would be able to estimate that approximately CU251m of the 20X8 lease expense relates to new and extended leases (because, of the CU1,042m total disclosed lease expense, CU691m relates to former operating lease commitments and CU100m relates to variable lease payments. The finance lease maturity disclosures at 31/12/20X7 demonstrate only minimal former finance lease activity). This information would enable a user to better compare the income statement effect of leasing activities between the year that includes the date of initial application and the comparative period than would be possible under Approach 2.

Costs

21. The table below provides a brief comparison of the costs that would be incurred by a lessee in complying with the disclosure proposals of Approach 1 and Approach 2. For each disclosure item, the table indicates which approach we think will be the *more* costly.

Year Ended 31 December 20X8	***COST ANALYSIS – HOW WOULD A LESSEE GET THIS FIGURE?***		**Which is MORE costly?**
	APPROACH 1	***APPROACH 2***	
Impact of adopting IFRS [XX] Leases:			
Undiscounted commitments relating to leases previously classified as operating leases	Roll forward of operating lease system to 31/12/20X8. Low incremental cost expected because this is outside of double entry system	Zero incremental cost – disclosed in 31/12/20X7 Annual Report	**APPROACH 1**
Weighted average incremental borrowing rate Discounted commitments relating to leases previously classified as operating leases	Apply incremental borrowing rate (IBR) to undiscounted commitments. Cost increases as the number of IBR lease 'portfolios' increase	Apply incremental borrowing rate (IBR) to undiscounted commitments. Cost increases as the number of IBR lease 'portfolios' increase	**SIMILAR**
Less: Commitments relating to short term leases	Figure not relevant under Approach 1	Identify short term leases from existing operating lease portfolio, discount the related commitments	**APPROACH 2**
Less: Commitments relating to leases of small assets	Identify small asset leases from former operating lease portfolio, discount the related commitments	Identify small asset leases from former operating lease portfolio, discount the related commitments	**SIMILAR**
Add: Commitments relating to leases previously classified as finance leases	Various possible methods of determining this figure based on 31/12/20X7 disclosure of finance lease commitments (IAS 17 requirement includes maturity analysis of both undiscounted and discounted commitments)	Zero incremental cost – disclosed in 31/12/20X7 Annual Report	**APPROACH 1**

Add: Commitments relating to new and extended leases during 20X8	Various possible methods of determining this, similar to 'additions to ROU assets' figure disclosed as described in Para 12.	Figure not relevant under Approach 2	**APPROACH 1**
Add: Payments in optional extension periods not recognised at 31/12/20X7	Extract from discounted commitments at 31/12/20X8 those which were not previously recognised as operating lease commitments	Extract from discounted commitments *after* posting cumulative catch up adjustment on 01/01/20X8 those which were not previously recognised as operating lease commitments.	**SIMILAR**
Lease liabilities	Zero incremental cost – disclosed on 31/12/20X8 balance sheet	Balance sheet position *after* posting cumulative catch up adjustment on 01/01/20X8. Systems cost associated with recording an additional balance sheet close position.	**APPROACH 2**
Other Disclosures:			
IAS 17 rental expense relating to leases previously classified as operating leases during the year ended 31/12/20X8	Roll forward of operating lease system to 31/12/20X8. Low incremental cost expected because this is outside of double entry system	Figure not relevant under Approach 2	**APPROACH 1**

22. The staff think that the most significant cost appearing in the table in paragraph 21 would be the systems cost associated with establishing an additional balance sheet close position *after* posting the cumulative catch up transition adjustment on the date of initial application under Approach 2. We think that in many cases it will be *less* costly for a lessee to continue running their existing operating lease system for one additional year as required under Approach 1. This is because IAS 17 operating lease commitments are not recognised on the balance sheet today and consequently are recorded outside of a lessee's double entry system.

Staff Recommendations and Question for the IASB

23. Consistently with February 2015 Agenda Paper 3A, the staff continue to recommend Approach 1 as described in this paper. This is because we think that this will be the less costly approach, and will provide a similar quality of reported information to Approach 2.

24. If the board decide not to adopt the staff recommendation, then we think that the board could instead consider either:

    (a) Approach 2 as described in this paper; or

    (b) an objectives based approach which would require a lessee to disclose sufficient information to enable a user to understand the effect of adopting the new leases standard on its financial statements.

Question for the IASB
Does the IASB agree with the staff recommendation that a lessee should adopt disclosure Approach 1 as described in this paper in the annual reporting period that includes the date of initial application of the new leases standard? If not, what approach does the IASB prefer?