IFRS 16 / ASC 842 Accounting Challenges

"It sounds very simple to put your operating leases on the balance sheet but it's actually very complex. In order to do that the standard requires a number of very complex calculations and a number of judgments within those calculations to actually get the numbers on the financial statements so that's a huge challenge for finance functions."

-Lucy Newman, Partner, Deloitte

At Aptitude Software we believe that the accounting complexities of the new lease standard are under appreciated. Moving hundreds or even thousands of lease contracts onto the balance sheet will require a new level of data collection and consolidation and a new range of lease accounting scenarios that were not previously required.

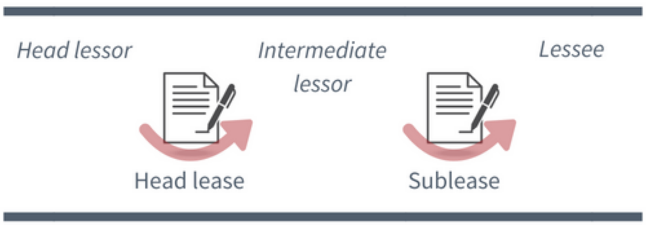
Our time in the marketplace discussing accounting and leasing focused issues around IFRS 16 and ASC 842 have uncovered several common areas we see companies struggle with. Three of these issues we discuss in depth here: the complexity of subleases, supporting standards that are not identical, and the impact of the transition approach taken.

The challenge of subleases

One of the most difficult aspects of the new lease accounting standards is identifying and understanding the lease types in your portfolio. While there are several lease types to be aware of, we frequently hear from prospects and clients that accounting for subleases are one of the most challenging.

What is a sublease?

A sublease originates when a lessee decides to rent out an asset they already lease, to a third party. The third party must have the right to control the use of the underlying asset for a period of time in exchange for consideration, thus meeting the definition of a lease. When this happens the original lessee, often called the head lessee or intermediary lessor, must determine how to account for this change.



When making accounting decisions on how to account for a sublease, there are a few things to consider:

Initial evaluation

Entering into a sublease is a significant event that is within the control of the lessee, subject to the terms of their lease. Since this action could affect things like the potential to exercise an option, it is advisable for the head lessee to reassess the lease term of the head lease before signing the sublease. As is the case under IAS 17 and ASC 840, subleases must be classified as either a finance or operating lease.

Follow the liability

In some cases, the sublease is a separate lease agreement. In other cases, a third party assumes the original lease, but the original lessee remains the primary obligor under the original lease. Exactly how the sublease is accounted for by the head lessee ultimately depends on who maintains primary liability under the head lease. If the intermediate lessor maintains primary liability, they will continue to account for the head lease on their balance sheet as a lessee and account for the new sublease as a lessor. If the head lessee is relieved of the primary obligation of the original lease but maintains a secondary liability, they would account for the transaction as a termination of the original lease and recognize a guarantee obligation.

De-recognition requirements

One potential area of complexity around subleases has to do with the concept of de-recognition. When a lessee decides to sublease an asset and it's classified as a finance lease, they must de-recognize the right of use asset attached to the head lease.

The tests applied to a sublease to determine whether it is a finance lease differ between IFRS 16 and ASC 842 and mean that de-recognition is likely to be a more frequent requirement under IFRS 16.

Accounting challenges under the new standards

The new sublease accounting rules are a significant departure from those outlined in the current standard which were already quite complex. We are seeing the following accounting challenges around subleases:

- The intermediate lessor typically accounts for the head lease and sublease as separate contracts and will need to apply both lessee and lessor accounting models.
- The sublease classification tests for IFRS 16 differ from the regular lessor classification tests.
- Modifications to either the head lease or the sublease must also account for the impact on de-recognition where appropriate.
- Multiple subleases can be associated with one head lease.

Subleases are just one of several complex lease types that will have to be understood, modeled and accounted for correctly under the new leasing standards. We've compiled a list of 5 complex lease types to keep your eye out for when evaluating your lease portfolio.

5 LEASE TYPES TO LOOK OUT FOR

INTER-COMPANY LEASE — 1

An inter-company lease occurs when the two parties of a contract, both the legal entity and the counter party, are in the same group of companies. This requires the appropriate offsetting entries to be recorded for correct reflection in consolidated reporting.

SUBLEASE — 2

A sublease originates when a lessee decides to sublease a leased asset to a third party. When this happens, the original lessee must determine how to account for this change. Under the new standards, subleases require the organization to generate lessor accounting.

EMBEDDED LEASE — 3

The new lease accounting standards also apply to any leases embedded in other arrangements, like supply contracts, data center agreements, and outsourcing agreements. Identifying embedded leases is important to avoid misstating the balance sheet.

SALE AND LEASEBACK — 4

A sale leaseback transaction occurs where an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor. Under U.S. GAAP the transfer of the asset must meet the revenue recognition requirements in ASC 606 for a sale to occur.

VARIABLE PAYMENT LEASE — 5

Leases can include variable lease payments - the portion of the lease payment that varies based on something other than the passage of time. These payments can be linked to a consumer price index (CPI), a benchmark interest rate (such as LIBOR), or payments that vary to reflect changes in market rental rates.

The challenge of multi-GAAP reporting

The lease accounting standards, IFRS 16 and ASC 842 were designed in parallel by the IASB and FASB. So, it's not surprising that they seem to align in many ways. However, the Boards' views diverged over the course of the project and resulted in some significant differences.

In fact, while the two standards look very similar, in almost any real-world scenario, the correct application of IFRS 16 and ASC 842 accounting will lead to different balance sheet numbers. Companies may need to maintain different processes, controls and accounting systems for each framework to comply with the different lessee reporting requirements. This creates complexity for organizations that must report under both GAAPs.

So, if your organization needs to report under both IFRS 16 and ASC 842, what should you look for in a solution to help you navigate the challenges of dual reporting?

First, it's important to make sure the solution supports multi-GAAP reporting as standard. Look for a solution that allows different entities to report under any or all of the leasing standards (ASC 842, IFRS 16, ASC 840 or IAS 17) and where entering lease once will produce multiple versions of the accounting.

Make sure the solution natively supports the differences between the standards and adjusts the lease liability (or not) as required. The solution should apply entity specific accounting policies to inform the correct configuration of the settings to ensure that the accounting aligns with the entity's reporting requirements.

The IFRS and GAAP leasing standards certainly have a number of similarities and will both improve the ability of financial statement users to better understand an organization's overall financial position. However, dual preparers must be aware of the differences and be prepared to address the complexities and questions that arise.

LEASING ASPECT	IFRS 16 VS ASC 842
Variable lease payments	The reassessments of indices, interest rates or rent reviews linked to lease payments are incorporated into the lease liability and right-of-use asset under IFRS 16 but not under ASC 842.
Lease classification	Dual reporters will have to separately track leases that have a different classification under US GAAP and IFRS because they will need to be accounted for differently. Under IFRS 16, lessees no longer classify their leases between operating and finance. Instead, all leases will be treated in a standard manner, similar to that of finance leases under current IAS 17.
Low value lease exemptions	IFRS 16 has an exemption for low value leases while ASC 842 does not.
Sublease accounting	The classification tests under IFRS 16 are with reference to the right-of-use asset, not the underlying asset.
Sale leaseback transactions	There are significant differences in the treatment of sale and leaseback transactions between the two standards.
Transitions	Depending on the transition options and expedients selected, the transition data required may be significantly different across the two standards.

The challenge of choosing a transition method

The decision of which transition method to adopt when implementing IFRS 16 is an important one, predominantly for lessees. This decision will impact the total amount of liabilities presented on a company's balance sheet which in turn could impact their borrowing capabilities, earnings-per-share and other KPIs.

The choice of transition will not just impact the initial period after the standard goes into effect – this decision "could affect your financial statements for years to come – until the last lease in place at transition has expired."[1] This is not a decision to make lightly and it will require detailed modeling to work out the correct application of the chosen transition method and the lease-by-lease assignment of practical expedients.

IFRS 16 reporting companies will need to carefully consider either a full retrospective transition or a modified retrospective transition.

Why did the IASB make these two options available?

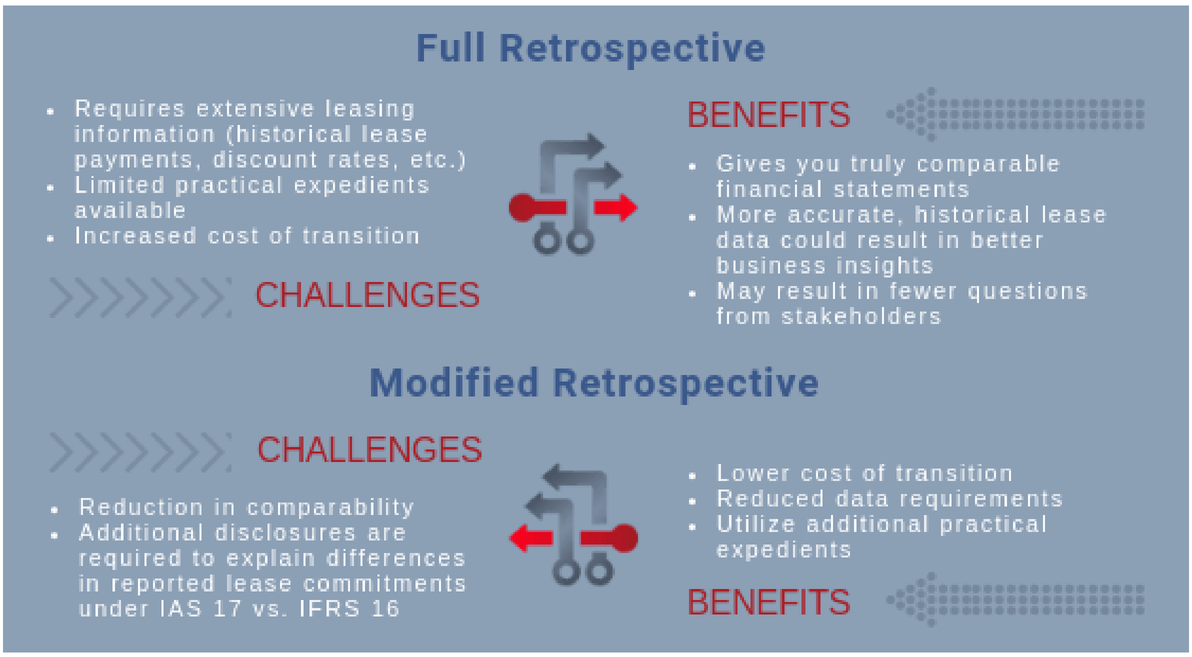
The accounting standard boards typically makes these types of options available during the implementation of a new standard. Essentially, they offer organizations tradeoffs in cost (both time and money) and accuracy. A full retrospective transition requires organizations to account for all leases as if IFRS 16 had always been applied. This means gathering all lease contract data and restating prior period financial statements under the IFRS 16 standard. Alternately, choosing a modified retrospective transition option will impact the balance sheet from transition date onwards and does not require restating accounting for prior periods.

While a modified approach is considered simpler to adopt and requires less time, money and effort, in some cases it may be worth choosing the more laborious and complicated full retrospective approach. Adopting this approach will lead to a more accurate and holistic representation of lease obligations, whilst granting greater comparability.

Your adopted transition option should be influenced by your current lease portfolio. If you have lots of long term leases then full retrospective may be the best choice for your balance sheets, while modified retrospective may be more appropriate for a portfolio heavy with shorter term leases.

"Your choice of transition option and practical expedients will affect the costs and timing of your implementation project – and your financial statements for years to come."

-KPMG Report: IFRS 16 – Transition to the new leases standard



1 https://home.kpmg.com/content/dam/kpmg/ie/pdf/2016/11/ie-leases-transition-options.pdf

Summary

Non-compliance with the new lease accounting standards is not an option and could have severe ripple effects throughout your business.

Aptitude Software's pre-packaged and purpose-built lease accounting solution, delivers IFRS 16 and ASC 842 compliance and core lease management capabilities, for the most complex leasing requirements.

The solution is flexible, highly configurable and integrates seamlessly with existing systems, finance workflows and surrounding architecture.

Next steps

As financial software specialists, we know accounting and we know software solutions. You are the experts within your company and Aptitude's Lease Accounting Engine puts the power back in the hands of finance. Aptitude Software has extensive experience implementing compliance initiatives with medium to large organizations. Let us help you achieve your strategies and ambitions, contact us to walk through your complex lease accounting scenarios that may be creating headaches for your organization.

Arrange a demo

Visit our lease accounting resource hub

Watch our lease accounting video

www.aptitudesoftware.com

Why choose Aptitude?

Aptitude Software combines specialist regulatory knowledge with accounting expertise and industry leading software products. With sharp focus on accounting, a global network of partnerships and over 20 years of proven success with the largest companies globally, Aptitude is the software vendor to support your journey to comply with regulatory and reporting standards.

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