2020

Financial Reporting Supervision

Information Note

IFRS 16 *Leases* – Review of disclosures on initial application

IAASA
Irish Auditing & Accounting Supervisory Authority

MISSION

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest

1. CONTENTS

1. EXECUTIVE SUMMARY

This Information Note summarises the key findings of IAASA's desktop review relating to the IFRS 16 *Leases* disclosures in issuers' first set of annual financial statements following their adoption of the Standard.

Overall, IAASA noted that most issuers sampled provided sufficient information to enable users of the financial statements to understand the impact of adopting IFRS 16.

The desktop review identified areas where issuers could further improve their disclosures in future financial statements and thereby enhance users' understanding of the impact of leasing on the issuer's operations.

IAASA's key findings are that improvements could be made in a number of areas:

Significant accounting judgements and sources of estimation uncertainty	
Significant accounting judgements Disclosure of the judgements made by management regarding IFRS 16 were not always sufficiently granular and failed to provide users with a clear understanding as to what were the specific judgements, why it was necessary for management to exercise such judgements and the factors management considered when making those judgements	**Sources of estimation uncertainty** Certain disclosures did not provide sufficient information on how the weighted average incremental borrowing rate for leases was determined or include sufficient detail on the material assumptions applied by management in determining the rate

Accounting policies	
Measurement of lease liabilities Disclosures contained boilerplate language to describe issuers' accounting policies relating to the measurement of lease liabilities, with a lack of issuer-specific information	**Short-term transitional expedients v. short-term recognition exceptions** Issuers did not clearly distinguish between IFRS 16.C10 and IFRS 16.5 and amalgamated on-going accounting policy choices in the same paragraphs as the transitional expedients

Disclosures	
Future cash outflows potentially exposed to that are not reflected in the measurement of the lease liability Additional information required by IFRS 16.59(b) was not clearly disclosed. This omission could impede users' understanding of the potential impact on lease balances of judgements made about unrecognised options	**Variable lease payments** Although most issuers stated within the accounting policies that the lease liability included variable payments, some did not disclose the amount of variable lease payments included in their lease liability measurement and failed to provide the information required by IFRS 16.51 and, in certain cases, IFRS 16.B49
Maturity analysis In certain instances, it was noted that issuers provided broad time bands when disclosing the liquidity analysis for lease liabilities, especially for instances where more than 50% of their overall lease liabilities fell due after more than five years	**Changes in liabilities arising from financing activities** In certain instances, lease liabilities were not separately disclosed in the movements in liabilities arising from financing activities table (IAS 7.44A)

IAASA recognises that, as a whole, disclosures provided by issuers in the first full year of application of IFRS 16 were broadly in compliance with the Standard. IAASA will continue to monitor the IFRS 16 accounting treatments in issuers' future financial statements and, in particular, will likely closely examine the areas noted above.

Finally, IAASA notes that the amendment to IFRS 16 introduced to address COVID-19-related rent concessions, may be of particular relevance for issuers in 2020 annual financial statements.

2. PURPOSE

The purpose of this Information Note is to outline the key findings of IAASA's desktop review relating to the IFRS 16 *Leases* disclosures in entities' first set of annual financial statements following their adoption of the Standard.

3. BACKGROUND AND SCOPE

Ireland's accounting enforcer, IAASA, examines the annual financial statements and half-yearly financial reports of certain equity issuers, debt issuers and closed-end fund issuers (collectively 'issuers') to ensure that the reports are compliant with the relevant financial reporting framework.

IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019 and replaces IAS 17 *Leases*. IFRS 16 specifies how entities recognise, measure, present and disclose leases. The Standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases, unless the lease term is 12 months or less, or the underlying asset has a low value.

The 2019 annual reports are the first annual financial statements for which the application of IFRS 16 is mandatory, and disclosure of the impact of transition to the Standard is required.

IAASA has previously reviewed half-yearly reports[1] and concluded that although disclosures in relation to the requirement of IAS 34 *Interim Financial Reporting* to provide a description of the nature and effect of the change in accounting policies were of a high quality, further improvement could have been made in areas disclosing the key judgements and estimates made in the recognition and measurement of the right-of-use assets and lease liabilities.

IAASA has now completed a desk-top review of the 2019 annual financial reports of 23 equity issuers (see Appendix) falling within IAASA's financial reporting examination remit.

This review examines the level of compliance by those issuers with the transitional disclosures relating to the adoption of IFRS 16, along with an evaluation of the quality of the ongoing disclosure requirements of IFRS 16.

4. DESKTOP REVIEW OBSERVATIONS

4.1 Significant accounting judgements and sources of estimation uncertainty

4.1.1. Significant accounting judgements

IFRS 16 does not expressly require further disclosures regarding significant judgements applied upon adoption of the Standard. However, paragraph 122 of IAS 1 *Presentation of Financial Statements* requires disclosure of the judgements, apart from those involving estimations, that management has made in the process of applying the issuer's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Five of the issuers in our sample of 23 issuers (22%) disclosed areas relating to IFRS 16 in their significant accounting judgements section. Two further issuers presented (i) the determination of the lease term and (ii) the incremental borrowing rate as 'other judgements and estimates'; however, did not deem the judgements to be significant.

[1] http://iaasa.ie/getmedia/3b1fcdc1-4eb6-479b-b54e-34d72ab11bd2/Info-Note-Transition-to-IFRS-16-28oct19.pdf?ext=.pdf

IAASA's assessment is that the disclosures in relation to these significant judgements is an area where improvements could be made by issuers. In many instances, the disclosures failed to provide sufficient entity-specific information that provided the user of the financial statements with a clear understanding of the specific significant judgements made by the issuer.

For example, in relation to the determination of the lease term, IAASA expects entity-specific information outlining the factors that were considered in evaluating whether or not the issuer was highly likely to exercise options for extensions or terminations together with the rationale for the judgements made regarding these options.

It was noted that three of the issuers which disclosed the determination of the lease term as a significant judgement did not provide any of the additional information required by IFRS 16.59(b) outlining the future cash outflows that the issuer is potentially exposed to that are not reflected in the measurement of the lease liability (see 3.3.1 below).

IAASA reminds management and those charged with governance that, when a significant judgement is identified, the financial statements should provide sufficient disclosure that provides users with a clear understanding as to what is the specific judgement, why it is necessary for management to exercise such judgement and the factors management considered when making that judgement.

4.1.2. Sources of estimation uncertainty

IAS 1.125 requires the disclosure of major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year. Paragraph 129 provides examples of the disclosures issuers make to address these requirements (i.e. the disclosure of key sensitivities or range of reasonably possible outcomes).

Three issuers included aspects of IFRS 16 as sources of estimation uncertainty. All three included the estimation of an appropriate discount rate for lease payments with regard to the application of IFRS 16 as a source of estimation uncertainty. In addition, one of these issuers, stated the determination of the lease term was a source of estimation uncertainty.

IAASA noted that two of the three issuers above did not provide sufficient information as to how the weighted average incremental borrowing rate for leases was determined and did not include sufficient detail on the material assumptions applied by management in determining the rate. Furthermore, IAASA noted that only one of the issuers provided a sensitivity analysis in relation to the incremental borrowing rate.

IAASA reminds management and those charged with governance that IAS 1.125 requires sufficient entity-specific information be disclosed about the assumptions made for areas identified as major sources of estimation uncertainty. Furthermore, IAASA highlights the examples of the disclosures issuers make to address these requirements as set out in IAS 1.129.

4.2 Accounting policies

4.2.1. Measurement of lease liabilities

In IAASA's assessment, a number of issuers used boilerplate language to describe their accounting policy relating to the measurement of lease liabilities with a lack of entity-specific information.

Twelve of the twenty-three issuers (52%) reiterated the wording set out in IFRS 16.26. These disclosures did not provide users with a clear understanding of whether there were circumstances where the interest rate implicit in the lease could be readily identified or not.

> **IFRS 16 paragraph 26**
>
> *'… the lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate'*

It was noted that five of the above twelve issuers broadly stated in the accounting policy that 'generally' the incremental borrowing rate is used as the discount rate. However, it is IAASA's expectation that issuers will provide clarity in the accounting policy the interest rate they have applied to discounting lease liabilities and to set out the specific circumstances when each rate is applied.

Higher quality disclosures evident in certain of the reports examined clearly identified the circumstances where the issuer had applied either the interest rate implicit in the lease or the incremental borrowing rate. In those cases where issuers could not determine the interest rate implicit in the lease, that fact was clearly stated in the accounting policy

4.2.2. Short-term transitional expedients vs. short-term recognition exceptions

> **IFRS 16 paragraph C10(c)**
>
> *'… a lessee may elect not to apply the requirements in paragraph C8 to leases for which the lease term ends within 12 months of the date of initial application …'*

$\neq$

> **IFRS 16 paragraph 5**
>
> *'… a lessee may elect not to apply the requirement in paragraphs 22-49 to:*
>
> (a) *short-term leases*
>
> (b) *leases for which the underlying asset is of low value …'*
>
> *lease term of less than 12 months

IAASA notes the importance for issuers to clearly identify whether or not they have applied the transitional practical expedients (IFRS 16.C10) and recognition exemptions (IFRS 16.5), especially in relation to short-term leases. It is important to provide clarity to the users of financial statements to enable them to understand whether the choice has a one-off impact (IFRS 16.C10) or is an on-going accounting policy choice (IFRS 16.5).

IAASA is pleased to note that most issuers provided this clarity and clearly identified their accounting choices as to whether or not they elected to avail of the transition exemption for leases with less than 12 months remaining at transition, and/or the on-going accounting policy choices for leases of less than 12 months.

However, it was noted that four of the issuers examined (17%) did not clearly distinguish between IFRS 16.C10 and IFRS 16.5 and included their on-going accounting policy choices in the same paragraphs as the transitional expedients.

The higher quality disclosures examined also clearly disclosed the issuer's threshold for determining what constitutes a low value lease and the definition of a short-term lease.

4.3 Disclosure requirements

4.3.1. Future cash outflows that the issuer is potentially exposed to that are not reflected in the measurement of the lease liability

IFRS 16 paragraph 59(b)

'*… a lessee shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 51… this additional information may include, but is not limited to, information that helps users of financial statements to assess:*

(a) …

(b) future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:

(i) variable lease payments …;

(ii) extension options and termination options …;

(iii) residual value guarantees …; and

(iv) leases not yet commenced to which the lessee is committed …'

Of the 23 reports examined by IAASA, two issuers provided the additional information outlined under IFRS 16.59(b) in relation to future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. A further six issuers clearly stated that the effect of excluding future cash outflows arising from variable lease payments, termination options, residual value guarantees and leases not yet commenced from lease liabilities was not material.

However, the remaining 15 issuers, which includes three issuers which disclosed the determination of the lease term as a significant judgement, did not provide any additional information in relation to the requirements of IFRS 16.59(b). This omission could impede users' understanding of the potential impact on lease balances of different judgements made about unrecognised options.

IAASA reminds issuers that, particularly when significant judgement is involved, they should disclose the amounts required in IFRS 16.59(b), if applicable. Furthermore, in instances where the amounts involved are immaterial, it may be helpful for the users of the financial statements if the issuer states that fact.

4.3.2. Variable lease payments

Most of the issuers examined stated in their accounting policy that the lease liability included variable payments that are dependent on a rate or index known at the commencement date. However, only five issuers disclosed the amount of variable lease payments included in their lease liability measurement. It is important that issuers address the disclosure requirements of IFRS 16.51 to aid users' understanding of the impact of significant variable payments.

> **IFRS 16 paragraph 51**
>
> *'… disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.'*

In addition, IFRS 16.B49 specifies additional disclosures that may be warranted, depending on the circumstances, in relation to variable lease payments.

> **IFRS 16 paragraph B49**
>
> *'Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:*
>
> *(a) the lessee's reasons for using variable lease payments and the prevalence of those payments;*
>
> *(b) the relative magnitude of variable lease payments to fixed payments;*
>
> *(c) key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and*
>
> *(d) other operational and financial effects of variable lease payments.'*

IAASA noted that one issuer disclosed variable lease payments that amounted to approximately half of the total cash out flow for lease payments; however, it did not provide any additional information relating to the variable lease payments. Given the magnitude of the variable lease payments to fixed payments, IAASA would expect the additional information outlined in IFRS 16.B49 to be provided in such instances in order to meet the objective of IFRS 16.51.

IAASA reminds issuers that:

(a) where variable lease payments are included in the measurement of lease liabilities and those variable payments are significant, the financial statements should clearly disclose the amount of the lease liabilities that relate to variable lease payments; and

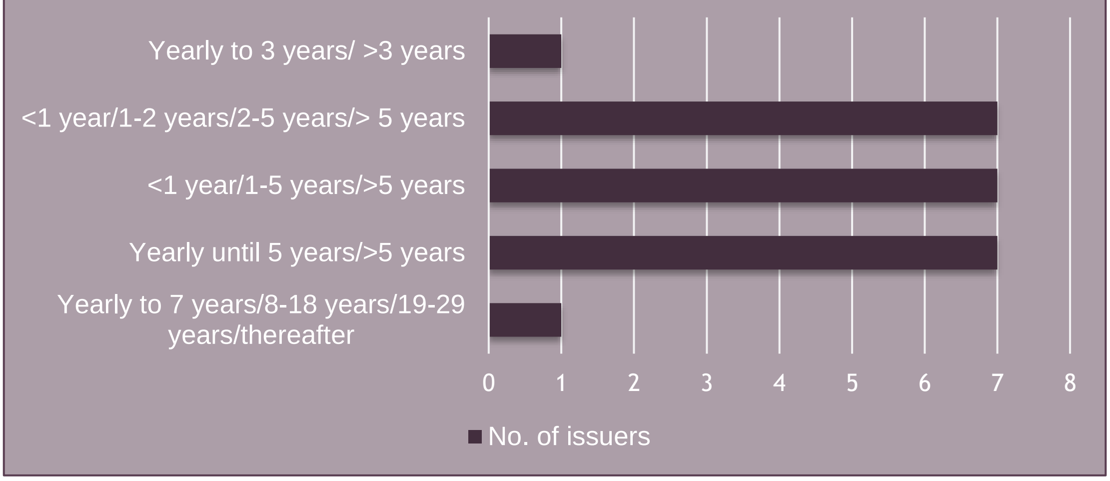
(b) where variable lease payments are significant, especially in comparison with the fixed lease payments, the additional information outlined in IFRS 16.B49 may be required to provide a basis for users to assess the effect that leases have on the financial position, financial performance and cash flows of the issuer.

4.3.3. Maturity analysis

Given the current COVID-19 environment, liquidity risk disclosures will be of significant importance for many stakeholders of the issuers. IAASA reminds issuers that the time bands disclosed must be consistent with the information provided internally to key management personnel. Figure 2 shows that there are differing approaches applied by issuers to the time bands in the liquidity risk disclosures related to lease liabilities.

> ***IFRS 16 paragraph 58***
>
> *'… a lessee shall disclose a maturity analysis of lease liabilities applying paragraph 39 and B11 of IFRS 7* Financial Instruments: Disclosures *separately from the maturity analyses of other liabilities.'*

Figure 2: Timebands used in liquidity analysis



While recognising that the appropriate split of time bands will differ between issuers, IAASA noted the following:

(a) seven issuers combined significant figures into a single time band for 1 to 5 years while a further seven issuers combined figures into one time band for 2 to 5 years. Taking into account the COVID-19 environment, IAASA notes that issuers may be examining the liquidity profile of financial liabilities in greater detail and, if so, the tables disclosed in financial reports should reflect that greater granularity; and

(b) eight issuers disclosed that more than 50% of their overall lease liabilities fell due after more than five years. However, only one issuer applied wider time bands (2027 to 2036, 2037 to 2046, and 2047 onwards) to incorporate these longer lease terms. One issuer did not include further time bands but did provide qualitative information on the remaining terms of on leases. The remaining six issuers did not appear to provide any additional information to enable users to better understand the lease liability liquidity profile.

IAASA reminds issuers that the time bands disclosed need to be consistent with the information provided internally to key management personnel and while the appropriate level of disaggregation of time bands will differ between issuers, IAASA expects issuers to consider whether a greater degree of disaggregation is required, especially in situations where the maturity profile for lease liabilities is heavily weighted to some years rather than others.

4.3.4. Changes in liabilities arising from financing activities

As lease liabilities constitute liabilities arising from financing activities, they fall within disclosures required by paragraph 44A of IAS 7 *Statement of Cash Flows*.

IAS 7 paragraph 44A

'… provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes.'

Overall, IAASA noted that the disclosures in relation to IAS 7.44A were of high quality for most of the issuers examined. Sixteen issuers clearly disclosed information about the movements relating to leases separately in the changes in financing activities table.

The higher quality disclosures reviewed further analysed the lease information into cash and non-cash movements which provided clear information for the user to understand the movements in liabilities arising from financing activities.

Three issuers disclosed tables showing the movements in liabilities arising from financing activities; however lease liabilities were not separately disclosed in the tables which made it difficult to readily understand the impact lease liabilities had on the movements in liabilities arising from financing activities.

Four issuers appeared not to provide the disclosure required of the changes in liabilities arising from financing activities.

IAASA reminds issuers of the requirement to disclose the information outlined in IAS 7.44A and to consider the illustrative examples accompanying IAS 7 which highlight the disclosures expected from issuers, in order to provide clear and understandable information for users.

IAASA recommends to issuers that, in order to provide informative disclosures, they consider separately presenting the movements relating to lease liabilities from other balances disclosed and clearly distinguishing material cash and non-cash movements.

APPENDIX

ISSUERS INCLUDED WITHIN THIS REVIEW

	ISSUER	ANNUAL REPORT REVIEWED
1	AIB Group plc	31 December 2019
2	Aminex Plc	31 December 2019
3	Bank of Cyprus Holdings plc	31 December 2019
4	Bank of Ireland Group plc	31 December 2019
5	C&C Group plc	29 February 2020
6	Cairn Homes plc	31 December 2019
7	CRH Plc	31 December 2019
8	Dalata Hotel Group plc	31 December 2019
9	Datalex plc	31 December 2019
10	DCC plc	31 March 2020
11	F.B.D. Holdings plc	31 December 2019
12	Flutter Entertainment plc	31 December 2019
13	Glenveagh Properties plc	31 December 2019
14	Grafton Group plc	31 December 2019
15	Irish Continental Group plc	31 December 2019
16	Irish Residential Properties REIT plc	31 December 2019
17	Kenmare Resources plc	31 December 2019
18	Kerry Group plc	31 December 2019
19	Kingspan Group plc	31 December 2019
20	Linde plc	31 December 2019
21	Permanent TSB Group Holdings plc	31 December 2019
22	Ryanair Holdings plc	31 March 2020
23	Smurfit Kappa Group plc	31 December 2019

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