PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS

Q&A No. 2019-09

Accounting for Prepaid Rent or Rent Liability Arising from Straight-lining under PAS 17 on Transition to PFRS 16 and the Related Deferred Tax Effects

This Q&A aims to provide guidance on the following:

1. How a lessee should account for its transition from PAS 17 to PFRS 16 using the modified retrospective approach. Specifically, this aims to address how a lessee should, on transition, account for any existing prepaid rent or rent liability arising from straight-lining of an operating lease under PAS 17, and

2. How to account for the related deferred tax effects on transition from PAS 17 to PFRS 16.

Fact pattern

Assume that prior to adoption of PFRS 16, a lessee has a 5-year lease contract which commenced on January 1, 2018. The lease was accounted for as operating lease under PAS 17. Accordingly, the lessee recognized rent expense on a straight-line basis over the lease term, even though the lease payments escalate annually by 5%. At date of transition to PFRS 16 (January 1, 2019), the lessee has rent liability amounting to CU1,000 because of the application of the straight-lining concept.

In the entity's tax jurisdiction, lease payments become deductible for tax on a cash basis, accordingly, there is a deductible temporary difference on which deferred tax asset amounting to CU300 (assume tax rate of 30%) is recognized.

Issue 1

On transition to PFRS 16, how should the entity account for the rent liability that arose out of the straight-lining under PAS 17?

Consensus

PFRS 16 allows an entity to apply either the a) full retrospective approach or b) modified retrospective approach in transitioning to PFRS 16. The approach selected should be applied consistently to all leases where the entity doing the transition is a lessee.

a. Under the full retrospective approach, a lessee will measure the right-of-use asset and lease liability in accordance with PAS 8 and will restate all comparative information. Under this method, a lessee will assume that PFRS 16 had always been applied and accordingly, will adjust any effect of transition (including any effect of reversing any outstanding prepaid rent or rent liability arising from straight-lining under PAS 17) to retained earnings as of the beginning of the earliest period presented.

b. Under the modified retrospective approach, a lessee will apply PFRS 16 with cumulative effect of initial application recognized in retained earnings or other component of equity, as appropriate, at date of initial application, and will not restate any comparative information. Under this approach, a lessee in a previously classified operating lease recognizes a lease liability at date of initial application at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at date of initial application. At the same time, such lessee recognizes a right-of-use (ROU) asset at date of initial application, measured using either of two methods chosen on a lease-by-lease basis:

   Method 1 - at an amount as if PFRS 16 had been applied since commencement date, but discounted using the lessee's incremental borrowing rate at date of initial application; or

   Method 2 - at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognized in the statement of financial position immediately before the date of initial application.

   As indicated above, under Method 2, any prepaid rent or rent liability arising from straight-lining under PAS 17 is capitalized as part of the ROU asset on transition. If straight-lining resulted in prepaid rent, that would have increased the ROU asset on transition; had it resulted in rent liability, it would have otherwise decreased the ROU asset. There is therefore no expected adjustment to retained earnings in so far as straight-lining effect under PAS 17 is concerned. On the other hand, under Method 1, there may be an adjustment to retained earnings at transition date.

Please refer to Appendix 1 for the illustrative entries.

Issue 2

How should the deferred tax be accounted for at the transition date?

Consensus

Accounting for the deferred tax at transition date depends on which of the acceptable approaches below is selected by the entity.

Approach 1A: - Recognize deferred tax on initial recognition - consider asset and liability separately. The entity recognizes: (1) a deferred tax asset for the temporary difference on the lease liability and (2) a deferred tax liability for the temporary difference on the right-of-use asset.

Approach 1B: Recognize deferred tax - consider asset and liability as in-substance linked to each other. The entity regards the right-of-use asset and the lease liability as a single item. On this basis, the net asset or liability is compared to its tax base and deferred tax is recognized on that net amount. On this basis, the net carrying amount of the right-of-use asset and the lease liability is zero on initial recognition, as is the tax base. Consequently, there is no temporary difference and the initial recognition exemption (IRE) does not apply. Deferred tax is recognized on subsequent temporary differences that arise when the net asset changes from zero.

Approach 2: Apply the IRE. The entity recognizes neither the deferred tax asset for the temporary difference on the lease liability nor the corresponding deferred tax liability for the temporary difference on the right-of-use asset.

IFRS Development

The International Accounting Standards Board has issued an Exposure Draft proposing a narrow-scope amendment to IAS 12. That narrow-scope amendment proposes that the IRE in paragraphs 15 and 24 of IAS 12 should not apply to transactions that give rise to both deductible and taxable temporary differences to the extent that an entity would otherwise recognize a deferred tax asset and deferred tax liability of the same amount in respect of those temporary differences. The Exposure Draft is currently under comment period (comment period ends November 14, 2019). Pending finalization of this Exposure Draft, Approach 2 described above will remain acceptable.

Effective date

The effective date of the consensus in this Q&A follow that of Appendix C of PFRS 16, upon approval by the FRSC.

Date approved by PIC: <u>December 17, 2019</u>

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Appendix:

Accounting for related deferred tax effect on transition:

Full Retrospective Approach
ROU asset and lease liability are calculated as of January 1, 2018 (the lease commencement date), using information available at that date. Assuming ROU asset and lease liability of CU45,000, the following transition entry is made at January 1, 2018:

Dr. ROU Asset	CU45,000	
Cr. Lease Liability		CU45,000

In addition, the straight-lining effect under PAS 17 is also reversed as of January 1, 2018.

For years 2018 and 2019, the lessee will also recognize amortization of ROU asset and accretion of lease liability. These might trigger restatement of previously issued financial statements of 2018.

Modified Retrospective Approach
Method 1
The ROU asset is calculated as of January 1, 2018 (the lease commencement date) using the incremental borrowing rate as of January 1, 2019 (the initial application date) and amortized up to January 1, 2019. If the amortized cost of the ROU asset as of January 1, 2019 is CU37,500 while the lease liability is CU40,000, the following transition entries are made:

Dr. ROU Asset	CU37,500	
Dr. Retained Earnings*		CU2,500
Cr. Lease Liability		CU40,000

** difference between the ROU asset and the lease liability*

Dr. Rent Liability	CU1,000	
Cr. Retained Earnings**		CU1,000

*** for the reversal of the rent liability arising from straight-lining under PAS 17*

Method 2
The ROU asset, which is initially equal to the lease liability of CU40,000, is adjusted for any prepaid or accrued lease payments recognized under PAS 17. In accordance with the transition provision of PFRS 16, the rent liability amounting to CU1,000 under PAS 17 is closed against the ROU asset. The following transition entry is made:

Dr. ROU Asset	CU39,000	
Dr. Accrued Rent Liability		CU1,000
Cr. Lease Liability		CU40,000

Accounting for related deferred tax effect on transition:

Full Retrospective Approach

Depending on the applied approach, the following transition entry is made with respect to the deferred tax effect of the lease at its initial recognition as of January 1, 2018 (the lease commencement date):

	Approach 1A		Approach 1B		Approach 12	
Dr. Deferred Tax Asset	CU13,500		Nil		Nil	
Cr. Deferred Tax Liability		CU13,500		Nil		Nil

In addition, any deferred tax previously recognized on the straight-lining effect under PAS 17 is also reversed as of January 1, 2018 (consistent with the reversal of such straight-lining effect).

Modified Retrospective Approach

Approach 1A

Recognize deferred tax on initial recognition - consider asset and liability separately (gross basis). Under this approach, the entity will derecognize the existing deferred tax asset amounting to CU300 and recognize deferred tax based on the new temporary differences arising from the initial recognition of the ROU asset and lease liability:

	Method 1		Method 2	
Dr. Retained Earnings*	CU300		CU300	
Cr. Deferred Tax Asset		CU300		CU300
** to derecognize deferred tax asset on the effect of the straight-lining concept*				
Dr. Deferred Tax Asset	CU12,000		CU12,000	
Cr. Retained Earnings		CU750		CU300
Cr. Deferred Tax Liability		CU11,250		CU11,700

Approach 1B

Recognize deferred tax - consider asset and liability as in-substance linked to each other (net basis).

Same as approach 1A, but the deferred tax asset and liability are recognized on a net basis:

	Method 1		Method 2	
Dr. Retained Earnings*	CU300		CU300	
Cr. Deferred Tax Asset		CU300		CU300
** to derecognize deferred tax asset on the effect of the straight-lining concept*				
Dr. Deferred Tax Asset - net	CU750		CU300	
Cr. Retained Earnings		CU750		CU300

Approach 2

Apply the IRE (deferred tax is not recognized). The IRE applies to the balance of the ROU asset, net of the accrued rent liability. The initial recognition of the ROU asset, net of the accrued rent liability, happens at the transition date - accordingly, the entity can invoke the IRE on the balance of the ROU asset. The related deferred tax asset on the rent liability amounting to CU300 should be derecognized and charged against retained earnings.

	Method 1		**Method 2**	
Dr. Retained Earnings	CU300		CU300	
Cr. Deferred Tax Asset		CU300		CU300