

Brief facts of the enquiry:

The Accounting Standards Board (the Board) received an enquiry, wherein, the enquirer highlighted the significant adverse impact of change in foreign currency exchange rates related to lease liabilities under IFRS 16 *Leases* on the financial statements of the Company (operating in aviation industry) and requested the Board to consider following measures to address the same:

- A. Issuance of Technical Release by the ICAP to define right-of-use asset as a monetary item so that impacts of foreign currency translations of right-of-use asset and lease liability offset each other;
- B. Issuance of Technical Release by the ICAP to allow recognition of foreign exchange gain/(loss) on translation of lease liabilities over the lease term;
- C. Deferment of adoption of IFRS 16 for aviation industry; or
- D. Issuance of any other Technical Release to provide relief to the aviation industry.

The Accounting Standards Board comments and conclusion:

1. The Board noted that IFRS 16 requires that the right-of-use asset should be measured at cost model or revaluation model.

IFRS 16 in its Basis of Conclusions (paragraphs BC196-BC199) explains that:

- Any foreign currency exchange differences relating to lease liabilities denominated in a foreign currency should be recognised in profit or loss; and
- Subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item i.e. right-of-use asset.

In other words, lease liability would be revalued through profit and loss at the current exchange rate (similar to a foreign currency loan) while the right-of-use asset would remain at the historical exchange rate (similar to an item of property, plant and equipment).

2. The Board observed that paragraph 23 of IAS 21 *Effect of Changes in Foreign Exchange Rates*, explains that at the end of reporting period the:
 - a) Foreign currency monetary items shall be translated using the closing rate;
 - b) Non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of transaction.

Paragraph 16 of IAS 21 outlines that right-of-use asset is a non-monetary asset as this right does not contain any right to receive a fixed or determinable number of units of currency.

3. The Board noted that the Financial Accounting Standards Board (FASB) of USA also issued the new leasing standard i.e. Accounting Standards Codification (ASC) 842. In context of the nature of right-of-use asset and the possible impact of exchange rate changes on the right-of-use asset, paragraph 842-20-55-10 of ASC 842 explains that:
 - The right-of-use asset is a non-monetary asset;
 - Lease liability is a monetary liability; and
 - The lease liability is re-measured using the current exchange rate, while the right-of-use asset is measured using the exchange rate as of the commencement date.

4. The Board also noted that International Air Transport Association (IATA) formed an Industry Accounting Working Group (IAWG) for developing application guidance on IFRS 16.

In its publication (titled IATA Industry Accounting Working Group Guidance IFRS 16, Leases) IATA also explained that right-of-use asset is a non-monetary asset and foreign exchange rate changes would only impact the lease liability.

This publication also highlighted and discussed the adverse effects of exchange rate movement and resultant management of foreign currency mismatch. It noted that there are a number of viable approaches to eliminating or minimizing the foreign exchange volatility created in the financial statements (by IFRS 16).

5. The Board noted that in general, it is understood that businesses are likely to be exposed to foreign exchange risk/s arising from volatility in the currency markets.

The Board considered that changes in foreign exchange rate (US dollar to Pakistan Rupee) are market driven, affecting all entities in Pakistan. The IFRS Standards contain accounting guidance on the financial risk management, and accordingly expect entities to properly identify, anticipate and manage volatility in equity and the income statement through financial risk management objectives and strategies. In this regard, companies that are reporting under IFRS can use different techniques, including hedging to safeguard against unfavorable foreign currency risks. Accordingly, under IAS 21, the presentation of a foreign currency liability in functional currency provides relevant information to users about measurement and level of economic resources to settle the obligation. Further, the exchange losses arising on the translation of foreign currency lease liabilities are an indicative of the performance of the company, and are accordingly reported in the statement of profit or loss.

6. The Board noted that changes in a reporting entity's economic resources and claims result from that entity's financial performance. Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. In this regard, the statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period.

In view of above, it is important to reflect the adverse impact of translation of foreign currency lease liabilities in the statement of profit or loss as this has resulted from events and conditions during the year, representing possible outflow of economic resources in Pakistan Rupees, and impacting company's returns adversely.

7. The Board observed that the ICAP issues Accounting Technical Releases (TRs) on matters that have relevance and implications on financial accounting and reporting at wider-scale, and such matters are not explained in the financial reporting framework. Fundamentally, a Technical Release while explaining an accounting requirement cannot be in conflict with the requirements of IFRS Standards.
8. The Board also noted that based on the requirements and explanations contained in IFRS Standards, including IFRS 16 and IAS 21, adequate basis and guidance is available to company to determine the required accounting. Further, there is no evidence that a widespread financial reporting problem exists.

The Board noted that IASB, in the exposure draft of IFRS 16 as well as in the final issued standard, has discussed the matter of accounting of exchange losses related to lease liabilities.

The IASB standard-setting is based on the areas where wide-spread implications are noted across various jurisdictions. In context of the enquired matter, IASB has already considered and concluded that the accounting of right-of-use assets should be principally similar to the items of property, plant and equipment.

The Board noted that no other entity, regulator or other stakeholder in Pakistan has raised this matter with the Board; therefore, the matter lacks the widespread and material effect (if any)

on the entities reporting under IFRS Standards in Pakistan. Approaching IASB, accordingly, as suggested by the enquirer would not provide additional input or change in the requirements of the standard.

9. Based on the above analysis, the Board concluded that:
- a) Under IFRS Standards, the right-of-use asset is a non-monetary asset.
 - b) In accordance with IFRS 16 as well as IAS 21, foreign currency exchange differences relating to lease liabilities (denominated in a foreign currency) should not be included in the carrying amount of the related right-of-use asset.
 - c) IFRS 16 provides sufficient guidance on accounting of foreign currency exchange impacts. IFRS 16 in its Basis of Conclusions provides detailed discussion and rationale for not allowing re-measurement of right-of-use asset due to change in foreign exchange rates. In consideration of requirements and discussion available in relevant IFRS Standards, Institute is not required to issue a Technical Release / Accounting directive.
 - d) In consideration of all the relevant factors, including guidance and requirements contained in IFRS Standards, approaching IASB and IFRIC for consideration of the Company's specific scenario would not be appropriate.
 - e) To ensure compliance with the accounting and reporting standards as applicable in Pakistan, company in context of the submitted matter should apply IFRS 16 and IAS 21 for measurement of right-of-use assets and lease liabilities.

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