

# Applying IFRS

A closer look at  
IFRS 16 *Leases*

Updated December 2020

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## What you need to know

- ▶ IFRS 16 *Leases* requires lessees to put most leases on their balance sheets.
- ▶ Lessees apply a single accounting model for all leases, with certain exemptions.
- ▶ For lessors, the accounting is substantially unchanged from the accounting under IAS 17 *Leases*.
- ▶ IFRS 16 is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.

IFRS 16 requires lessees to recognise most leases on their balance sheets.

## Overview

IFRS 16 *Leases* requires lessees to recognise assets and liabilities for most leases. The International Accounting Standards Board (IASB or the Board) issued the standard after joint deliberations with the Financial Accounting Standards Board (FASB), which issued a similar standard (ASC 842 *Leases*). However, there are significant differences between the IASB and FASB standards (e.g., lessees classify leases as finance or operating leases under the FASB standard). These differences will result in certain transactions being accounted for differently under IFRS and US GAAP. Appendix C of this publication summarises the key differences between IFRS 16 and ASC 842.

IFRS 16 replaces IAS 17 *Leases*. It requires lessees to recognise most leases on their balance sheets and provides enhanced disclosure requirements. The IASB believes this will result in a more faithful representation of lessees' assets and liabilities and greater transparency of lessees' financial obligations and leasing activities.

Under IFRS 16, leases are accounted for based on a 'right-of-use model'. The model reflects that, at the commencement date, a lessee has a financial obligation to make lease payments to the lessor for its right to use the underlying asset during the lease term. The lessor conveys that right to use the underlying asset at lease commencement, which is the time when it makes the underlying asset available for use by the lessee.

Entities will need to focus on whether an arrangement contains a lease or a service agreement because there are significant differences in the accounting. Although IFRS 16 changes how the definition of a lease is applied, we believe that the assessment of whether a contract contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements, particularly those that include significant services.

Lessor accounting under IFRS 16 is substantially unchanged from the accounting under IAS 17. Lessors continue to classify all leases as operating or finance leases.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, has been applied, or is applied at the same date as IFRS 16.

This publication discusses how IFRS 16 is applied and is intended to help companies consider the effects of adopting and applying it. We encourage preparers and users of financial statements to read this publication carefully and consider the potential effects of the new standard.

The views we express in this publication represent our perspectives as of December 2019. We may identify additional issues as we continue to analyse the standard and entities interpret it, and our views may evolve during that process.

# 1. Objective and scope of IFRS 16

## 1.1 Objective of IFRS 16

IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information 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 an entity.

IFRS 16 requires an entity to consider the terms and conditions of contracts and all relevant facts and circumstances, and to apply the standard consistently to contracts with similar characteristics and in similar circumstances.

## 1.2 Scope of IFRS 16

### Extract from IFRS 16

3 An entity shall apply this Standard to all leases, including leases of *right-of-use assets* in a *sublease*, except for:

- (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- (b) leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee;
- (c) service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*
- (d) licences of intellectual property granted by a lessor within the scope of IFRS 15 *Revenue from Contracts with Customers*; and
- (e) rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

4 A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3(e).

IFRS 16 applies to all leases, including leases of right-of-use assets in a sublease, except for the following:

- ▶ Leases to explore for, or use, minerals, oil, natural gas and similar non-regenerative resources
- ▶ Leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee
- ▶ Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*. Entities should evaluate the applicability of IFRIC 12 before evaluating whether an arrangement contains a lease.
- ▶ Licences of intellectual property granted by a lessor within the scope of IFRS 15
- ▶ Rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights

A lessee is not required to apply IFRS 16 to leases of intangible assets not covered by the exceptions above. However, a lessee could choose to account for leases of such intangible assets under IFRS 16.

There are differing views about whether a licence of software is excluded from the scope of IFRS 16 based on interpretations of paragraph 3(e) of IFRS 16. If an entity determines that a licence of software is not excluded from the scope of IFRS 16, paragraph 4 of IFRS 16 permits, but does not require, an entity to account for the licence of software as a lease.

If a cloud computing arrangement contains a lease of an asset other than a licence of software (or the entity has determined that a licence of software is not excluded from the scope of IFRS 16 and has elected to account for leases of intangible assets under IFRS 16), an entity should apply the provisions of IFRS 16 to the cloud computing arrangement. This includes identifying and separating lease and non-lease components and allocating contract consideration, which is discussed at 3.2 below.

### **1.3 Recognition exemptions**

IFRS 16 allows a lessee to elect not to apply the recognition requirements to:

- a) Short-term leases; and
- b) Leases for which the underlying asset is of low value.

These recognition exemptions are discussed further in section 4.1

## 2. What is a lease?

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

IFRS 16 requires an entity to determine whether a contract is a lease or contains a lease at the inception of the contract. The assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging. We discuss this further below.

### 2.1 Determining whether an arrangement contains a lease

#### Extract from IFRS 16

##### Appendix A

##### Defined terms

##### Lease

A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.

##### Contract

An agreement between two or more parties that creates enforceable rights and obligations.

##### Period of use

The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).

**9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.**

B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:

- (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and
- (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

B10 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.



### Extract from IFRS 16 (cont'd)

B11 A contract to receive goods or services may be entered into by a joint arrangement, or on behalf of a joint arrangement, as defined in IFRS 11 *Joint Arrangements*. In this case, the joint arrangement is considered to be the customer in the contract. Accordingly, in assessing whether such a contract contains a lease, an entity shall assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use.

B12 An entity shall assess whether a contract contains a lease for each potential separate lease component. Refer to paragraph B32 for guidance on separate lease components.

#### 2.1.1 Joint arrangements

Entities often enter into joint arrangements with other entities for certain activities (e.g., exploration of oil and gas fields, development of pharmaceutical products).

A contract for the use of an asset by a joint arrangement might be entered into in a number of different ways, including:

- ▶ Directly by the joint arrangement, if the joint arrangement has its own legal identity
- ▶ By each of the parties to the joint arrangement (i.e., the lead operator and the other parties, commonly referred to as the non-operators) individually signing the same arrangement
- ▶ By one or more of the parties to the joint arrangement on behalf of the joint arrangement. Generally, this would be evidenced in the contract and the parties to the joint arrangement would have similar rights and obligations as they would if they individually signed the arrangement. In these situations, the facts and circumstances, as well as the legal position of each entity, need to be evaluated carefully
- ▶ By the lead operator of the joint arrangement in its own name, i.e., as principal. This may occur when the lead operator leases equipment which it then uses in fulfilling its obligations as the lead operator of the joint arrangement and/or across a range of unrelated activities, including other joint arrangements with unrelated activities, such as with other joint operating parties

A contract to receive goods or services may be entered into by a joint arrangement or on behalf of a joint arrangement, as defined by IFRS 11 *Joint Arrangements*. In this case, the joint arrangement is considered to be the customer in the contract. Accordingly, in determining whether such a contract contains a lease, an assessment needs to be made as to which party (e.g., the joint arrangement or the lead operator) has the right to control the use of an identified asset throughout the period of use.

If the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use as a result of their collective control of the operation, the joint arrangement is the customer to the contract that may contain a lease. It would be inappropriate to conclude that the contract does not contain a lease on the grounds that each of the parties to the joint arrangement either has rights to a non-physically distinct portion of an underlying asset and, therefore, does not have the right to substantially all

of the economic benefits from the use of that underlying asset or does not unilaterally direct its use. Determining if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use would require a careful analysis of the rights and obligations of each party.

In the first three scenarios above, if it has been determined that a contract is, or contains, a lease, each of the parties to the joint arrangement (i.e., the joint operators comprising the lead operator and the non-operators) will account for their respective interests in the joint arrangement (including any leases) under paragraphs 20-23 of IFRS 11. Therefore, they will account for their individual share of any right-of-use assets and lease liabilities, and associated depreciation and interest.

In the fourth scenario (i.e., where the lead operator enters the arrangement in its own name), the lead operator will need to assess whether the arrangement is, or contains, a lease. If the lead operator controls the use of the identified asset, it would recognise the entire right-of-use asset and lease liability on its balance sheet. This would be the case even if it is entitled to bill the non-operator parties their proportionate share of the costs under the joint operating agreement (JOA).

If the lead operator determines that it is the lessee, it would also evaluate whether it has entered into a sublease with the joint arrangement (as the customer to the sublease). For example, the lead operator may enter into a five-year equipment lease with a supplier, but may then enter into a two-year arrangement with one of its joint arrangements, thereby yielding control of the right to use the equipment to the joint arrangement during the two-year period. In many cases, the lead operator will not meet the requirements to recognise a sublease because the arrangement does not create legally enforceable rights and obligations that convey the right to control the use of the asset to the joint arrangement. However, the conclusion as to whether the joint arrangement is a customer, i.e., the lessee in a contract with a lead operator, by virtue of the JOA, would be impacted by the individual facts and circumstances.

If there is a sublease with the lead operator, IFRS 11 would require the non-operators to recognise their respective share of the joint arrangement's right-of-use asset and lease liability and the lead operator would have to account for its sublease to the joint arrangement separately. However, if no sublease existed, the non-operators would recognise joint interest payables when incurred for their share of the costs incurred by the lead operator in respect of the leased asset.

In limited cases, the lead operator and non-operators will enter into a contract directly with the supplier, in which the lead operator and non-operators are proportionately liable for their share of the arrangement. In this case, the parties with interests in the joint operation would recognise their proportionate share of the leased asset, liability and lease expense in accordance with IFRS 11.

There has been considerable debate as to how the term "on behalf of the joint arrangement" should be interpreted and applied in practice. The IFRS Interpretations Committee (the Committee) discussed a question (in September 2018) relating to lease arrangements in a joint operation (JO) under IFRS 16. The question asked was how a lead operator (the party responsible for undertaking the operations on behalf of the other joint operators) of a JO, which is not structured through a separate vehicle, recognises a lease liability.

The question specifically focused on situations where the lead operator, as the sole signatory, enters into a lease contract with a third-party supplier (lessor) for an item of property, plant and equipment that will be operated jointly as part of the JO's activities. The lead operator has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual and other arrangements governing the JO.

The Committee concluded, in the agenda decision published in March 2019, that in accordance with IFRS 11, a joint operator identifies and recognises both:

- (a) liabilities it incurs in relation to its interest in the JO; and
- (b) its share of any liabilities incurred jointly with other parties to the joint arrangement.

The Committee observed that identifying the liabilities that a joint operator incurs and those incurred jointly, requires an assessment of the terms and conditions in all contractual arrangements that relate to the JO, including consideration of the laws pertaining to those agreements. The Committee further observed, in accordance with IFRS 11, the liabilities a joint operator recognises include those for which it has primary responsibility. Therefore, as sole signatory and where a lead operator has primary responsibility for a lease, the lead operator recognises 100% of the lease liability.

The Committee also highlighted the importance of disclosing information about joint operations that is sufficient for a user of financial statements to understand the activities of the joint operation and a joint operator's interest in that operation. Therefore, the Committee concluded that the principles and requirements in IFRS standards provide an adequate basis for the lead operator to identify and recognise its liabilities in relation to its interest in a JO and did not to add this matter to its standard-setting agenda.

### **2.1.2 Identified asset**

#### **Extract from IFRS 16**

B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

An arrangement only contains a lease if there is an identified asset. Under IFRS 16, an identified asset can be either implicitly or explicitly specified in a contract.

### Illustration 1 – Implicitly specified asset

Customer X enters into a five-year contract with Supplier Y for the use of rolling stock specifically designed for Customer X. The rolling stock is designed to transport materials used in Customer X's production process and is not suitable for use by other customers. The rolling stock is not explicitly specified in the contract, but Supplier Y owns only one rolling stock that is suitable for Customer X's use. If the rolling stock does not operate properly, the contract requires Supplier Y to repair or replace the rolling stock. Assume that Supplier Y does not have a substantive substitution right. Refer to section 2.1.3 *Substantive substitution rights*.

*Analysis:* The rolling stock is an identified asset. While the rolling stock is not explicitly specified in the contract (e.g., by serial number), it is implicitly specified because Supplier Y must use it to fulfil the contract.

### Illustration 2 – Identified asset - implicitly specified at the time the asset is made available for use by the customer

Customer X enters into a five-year contract with Supplier Y for the use of a car. The specification of the car is specified in the contract (brand, type, colour, options etc.). At inception of the contract the car is not yet built.

*Analysis:* The car is an identified asset. Although the car cannot be identified at inception of the contract, it is apparent that it will be identifiable at the commencement of the lease. The car is identified by being implicitly specified at the time that it is made available for use by the customer (i.e., at the commencement date).

An identified asset can be a physically distinct portion of a larger asset.

A capacity portion of an asset is an identified asset if it is physically distinct (e.g., a floor of a building). A capacity or other portion of an asset that is not physically distinct (e.g., a capacity portion of a fibre optic cable) is not an identified asset unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

### How we see it

- ▶ Some contracts involve a dedicated cable that is part of the larger network infrastructure (e.g., unbundled network element arrangements for the 'last mile' to a customer location, 'special access' arrangements for a dedicated connection between two locations). IFRS 16 does not specify or provide examples that clarify that these arrangements are identified assets. However, the FASB's standard ASC 842 includes an additional example that is similar to a dedicated cable (i.e., a segment of a pipeline that connects a single customer to a larger pipeline). The example clarifies that such segments of a larger pipeline are identified assets. As the IASB has stated that both it and the FASB have reached the same conclusions on the definition of a lease, we believe that, under IFRS 16, the last mile of a network that connects a single customer to a larger network may be an identified asset. However, such arrangements may, or may not, meet the definition of a lease. Entities will need to be sensitive to this matter in both these and other similar arrangements.

### Illustration 3 – Identified asset – physically distinct portion of a larger asset

Customer X enters into a 12-year contract with Supplier Y for the right to use three fibres within a fibre optic cable between New York and London. The contract identifies three of the cable's 20 fibres for use by Customer X. The three fibres are dedicated solely to Customer X's data for the duration of the contract term. Assume that Supplier Y does not have a substantive substitution right (refer to section 2.1.3 *Substantive substitution rights*).

*Analysis:* The three fibres are identified assets because they are physically distinct and explicitly specified in the contract.

### Illustration 4 – Identified asset – capacity portion of an asset

#### Scenario A

Customer X enters into a five-year contract with Supplier Y for the right to transport oil from Country A to Country B through Supplier Y's pipeline. The contract provides that Customer X will have the right to use of 95% of the pipeline's capacity throughout the term of the arrangement.

*Analysis:* The capacity portion of the pipeline is an identified asset. While 95% of the pipeline's capacity is not physically distinct from the remaining capacity of the pipeline, it represents substantially all of the capacity of the entire pipeline and thereby provides Customer X with the right to obtain substantially all of the economic benefits from use of the pipeline.

#### Scenario B

Assume the same facts as in Scenario A, except that Customer X has the right to use 60% of the pipeline's capacity throughout the term of the arrangement.

*Analysis:* The capacity portion of the pipeline is not an identified asset because 60% of the pipeline's capacity is less than substantially all of the capacity of the pipeline. Customer X does not have the right to obtain substantially all of the economic benefits from use of the pipeline.

Land easements or rights of way are rights to use, access or cross another entity's land for a specified purpose. For example, a land easement might be obtained for the right to construct and operate a pipeline or other assets (e.g., railway line, utility pipes or telecommunication lines) over, under or through an existing area of land or body of water while allowing the landowner continued use of the land for other purposes (e.g., farming), as long as the landowner does not interfere with the rights conveyed in the land easement. A land easement may be perpetual or for a specified term. It may provide for exclusive or non-exclusive use of the land and may be prepaid or paid over a defined term.

Perpetual easements are outside the scope of IFRS 16, as the definition of a lease requires the contract to be for a period of time. Therefore, entities must carefully evaluate easement contracts to determine whether the contract is perpetual or for a period of time. Examples of contracts that may appear perpetual but are term-based include:

- ▶ Very long-term contracts (e.g., the FASB indicated in the Basis for Conclusions (BC113) to ASC 842 that very long-term leases of land (e.g., 999 years) are in the scope of ASC 842)

- ▶ Contracts with a stated non-cancellable lease term that “automatically renews” if the lessee pays a periodic renewal fee. This is an in-substance fixed term contract with optional renewal periods
- ▶ Contracts that define the period of use as the period over which the assets are used (e.g., as long as natural gas flows through a gathering system) is a fixed term contract (i.e., terminated when production ceases) rather than a perpetual contract because the gas reserves will ultimately be depleted

When determining whether a contract for a land easement or right of way is a lease, entities will need to assess whether there is an identified asset and whether the customer obtains substantially all of the economic benefits of the identified asset and has the right to direct the use of that asset throughout the period of use.

In June 2019, the IFRS Interpretations Committee discussed a contract for subsurface rights. In the contract described, a pipeline operator obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use. The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

The Committee noted the following in the agenda decision:

- ▶ Paragraph 3 of IFRS 16 requires an entity to apply IFRS 16 to all leases, with limited exceptions. In the contract described in the request, none of the exceptions in paragraphs 3 and 4 of IFRS 16 apply (see 1.2 above). In particular, the Committee noted that the underground space is tangible. Accordingly, if the contract contains a lease, IFRS 16 applies to that lease. If the contract does not contain a lease, the entity would then consider which other IFRS standard applies.
- ▶ Applying paragraph B9 of IFRS 16, to meet the definition of a lease, the customer must have both:
  - ▶ the right to obtain substantially all the economic benefits from use of an identified asset throughout the period of use; and
  - ▶ the right to direct the use of the identified asset throughout the period of use.
- ▶ The specified underground space is physically distinct from the remainder of the land. The contract’s specifications include the path, width and depth of the pipeline, thereby defining a physically distinct underground space. The space being underground does not in itself affect whether it is an identified asset – the specified underground space is physically distinct in the same way that a specified area of space on the land’s surface would be physically distinct. As the landowner does not have the right to substitute the underground space throughout the period of use, the Committee concluded that the specified underground space is an identified asset as described in paragraphs B13-B20.

- ▶ The customer has the right to obtain substantially all the economic benefits from use of the specified underground space throughout the 20-year period of use. The customer has exclusive use of the specified underground space throughout that period of use.
- ▶ The customer has the right to direct the use of the specified underground space throughout the 20-year period of use because the customer has the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions. How and for what purpose the specified underground space will be used (i.e., to locate the pipeline with specified dimensions through which oil will be transported) is predetermined in the contract. The customer has the right to operate the specified underground space by having the right to perform inspection, repairs and maintenance work. The customer makes all the decisions about the use of the specified underground space that can be made during the 20-year period of use.

Consequently, the Committee concluded that the contract described in the request contains a lease as defined in IFRS 16. The customer would therefore apply IFRS 16 in accounting for that lease.

### 2.1.3 Substantive substitution rights

#### Extract from IFRS 16

B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

- (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and
- (b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

B15 If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

B16 An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include:

- (a) an agreement by a future customer to pay an above market rate for use of the asset;

#### Extract from IFRS 16 (cont'd)

- (b) the introduction of new technology that is not substantially developed at inception of the contract;
- (c) a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and
- (d) a substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract.

B17 If the asset is located at the customer's premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier's premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

B18 The supplier's right or obligation to substitute the asset for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available does not preclude the customer from having the right to use an identified asset.

B19 If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.

Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use (i.e., the total period of time that an asset is used to fulfil a contract with a customer, including the sum of any non-consecutive periods of time). A supplier's right to substitute an asset is substantive when both of the following conditions are met:

- ▶ The supplier has the practical ability to substitute alternative assets throughout the period of use (e.g., the customer cannot prevent the supplier from substituting an asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
- ▶ The supplier would benefit economically from the exercise of its right to substitute the asset (i.e., the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

The IASB indicated in the Basis for Conclusions (BC113) that the conditions above are intended to differentiate between substitution rights that result in a supplier controlling the use of an asset, rather than the customer, and rights that do not change the substance or character of the contract.

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date, or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract. At inception of the contract, an entity should not consider future events that are not likely



to occur. IFRS 16 provides the following examples of circumstances that, at inception of the contract, are not likely to occur and, thus, are excluded from the evaluation of whether a supplier's substitution right is substantive throughout the period of use:

- ▶ An agreement by a future customer to pay an above market rate for use of the asset
- ▶ The introduction of new technology that is not substantially developed at inception of the contract
- ▶ A substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract
- ▶ A substantial difference between the market price of the asset during the period of use, and the market price considered likely at inception of the contract

The requirement that a substitution right must benefit the supplier economically in order to be substantive is a new concept. The IASB indicated in the Basis for Conclusions (BC113) that, in many cases, it will be clear that the supplier will not benefit from the exercise of a substitution right because of the costs associated with substituting an asset. The physical location of the asset may affect the costs associated with substituting the asset. For example, if an asset is located at the customer's premises, the cost associated with substituting it is generally higher than the cost of substituting a similar asset located at the supplier's premises. However, simply because a supplier concludes that the cost of substitution is not significant does not automatically mean that it would economically benefit from the right of substitution.

IFRS 16 further clarifies that a customer should presume that a supplier's substitution right is not substantive when the customer cannot readily determine whether the supplier has a substantive substitution right. This requirement is intended to clarify that a customer is not expected to exert undue effort to provide evidence that a substitution right is not substantive. We believe that the Board did not include a similar provision for suppliers, because they should have sufficient information to make a determination of whether a substitution right is substantive.

Contract terms that allow or require a supplier to substitute alternative assets only when the underlying asset is not operating properly (e.g., a normal warranty provision) or when a technical upgrade becomes available do not create a substantive substitution right.

## Illustration 5 – Substitution rights

### Scenario A

Assume that an electronic data storage provider (supplier) provides services through a centralised data centre, that involve the use of a specified server (Server No. 9). The supplier maintains many identical servers in a single accessible location and determines, at inception of the contract, that it is permitted to and can easily substitute another server without the customer's consent throughout the period of use. Further, the supplier would benefit economically from substituting an alternative asset, because doing this would allow the supplier to optimise the performance of its network at only a nominal cost. In addition, the supplier has made clear that it has negotiated this right of substitution as an important right in the arrangement, and the substitution right affected the pricing of the arrangement.

*Analysis:* The customer does not have the right to use an identified asset because, at the inception of the contract, the supplier has the practical ability to substitute the server and would benefit economically from such a substitution. However, if the customer could not readily determine whether the supplier had a substantive substitution right (e.g., there is insufficient transparency into the supplier's operations), the customer would presume the substitution right is not substantive and conclude that there is an identified asset.

### Scenario B

Assume the same facts as in Scenario A except that Server No. 9 is customised, and the supplier does not have the practical ability to substitute the customised asset throughout the period of use. Additionally, it is unclear whether the supplier would benefit economically from sourcing a similar alternative asset.

*Analysis:* Because the supplier does not have the practical ability to substitute the asset and there is no evidence of economic benefit to the supplier for substituting the asset, the substitution right is non-substantive, and Server No. 9 would be an identified asset. In this case, neither of the conditions of a substitution right is met. As a reminder, both conditions must be met for the supplier to have a substantive substitution right.

A lease conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

#### 2.1.4 Right to obtain substantially all of the economic benefits from use of the identified asset

##### Extract from IFRS 16

B21 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

B22 When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset (see paragraph B30). For example:

- (a) if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory, and not beyond.
- (b) if a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond.

B23 If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (e.g., by having exclusive use of the asset throughout that period). The term 'substantially all' is not defined in IFRS 16. However, entities might consider the term similarly to how it is used in IAS 17 in the context of lease classification.

A customer can obtain economic benefits either directly or indirectly (e.g., by using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through the use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). However, economic benefits arising from construction or ownership of the identified asset (e.g., tax

benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset. Therefore, they are not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.

When assessing whether the customer has the right to obtain substantially all of the economic benefits from the use of an asset, an entity must consider the economic benefits that result from use of the asset within the defined scope of the customer's right to use the asset. A right that solely protects the supplier's interest in the underlying asset (e.g., limits on the number of miles a customer can drive a supplier's vehicle) does not, in and of itself, prevent the customer from obtaining substantially all of the economic benefits from use of the asset and, therefore, are not considered when assessing whether a customer has the right to obtain substantially all of the economic benefits.

If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from the use of an asset as consideration (e.g., a percentage of sales from the use of retail space), those cash flows are considered to be economic benefits that the customer derives from the use of the asset.

#### **2.1.5 Right to direct the use of the identified asset**

##### **Extract from IFRS 16**

B24 A customer has the right to direct the use of an identified asset throughout the period of use only if either:

- (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25-B30); or
- (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
  - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
  - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

Requiring a customer to have the right to direct the use of an identified asset is a change from IFRIC 4. A contract may have met IFRIC 4's control criterion if, for example, the customer obtained substantially all of the output of an underlying asset and met certain price-per-unit-of-output criteria even though the customer did not have the right to direct the use of the identified asset as contemplated by IFRS 16. Under IFRS 16, such arrangements would no longer be considered leases.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

- ▶ The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- ▶ The relevant decisions about how and for what purpose an asset is used are predetermined and the customer either: (1) has the right to operate

the asset, or to direct others to operate the asset in a manner that it determines, throughout the period of use, without the supplier having the right to change those operating instructions; or (2) designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

#### **2.1.5.1 The right to direct how and for what purpose an asset is used throughout the period of use**

##### **Extract from IFRS 16**

B25 A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

B26 Examples of decision-making rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used, within the defined scope of the customer's right of use, include:

- (a) rights to change the type of output that is produced by the asset (for example, to decide whether to use a shipping container to transport goods or for storage, or to decide upon the mix of products sold from retail space);
- (b) rights to change when the output is produced (for example, to decide when an item of machinery or a power plant will be used);
- (c) rights to change where the output is produced (for example, to decide upon the destination of a truck or a ship, or to decide where an item of equipment is used); and
- (d) rights to change whether the output is produced, and the quantity of that output (for example, to decide whether to produce energy from a power plant and how much energy to produce from that power plant).

B27 Examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used include rights that are limited to operating or maintaining the asset. Such rights can be held by the customer or the supplier. Although rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and are often dependent on the decisions about how and for what purpose the asset is used. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph B24(b)(i)).

A customer has the right to direct the use of an identified asset whenever it has the right to direct how and for what purpose the asset is used throughout the period of use (i.e., it can change how and for what purpose the asset is used throughout the period of use). How and for what purpose an asset is used is

a single concept (i.e., 'how' an asset is used is not assessed separately from 'for what purpose' an asset is used).

When evaluating whether a customer has the right to change how and for what purpose the asset is used throughout the period of use, the focus should be on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract.

The IASB indicated in the Basis for Conclusions (BC120) that decisions about how and for what purpose an asset is used can be viewed as similar to the decisions made by a board of directors. Decisions made by a board of directors about the operating and financing activities of an entity are generally the most relevant decisions rather than the actions of individuals in implementing those decisions.

IFRS 16 provides the following examples of decision-making rights that grant the right to change how and for what purpose an asset is used:

- ▶ The right to change the type of output that is produced by the asset (e.g., deciding whether to use a shipping container to transport goods or for storage, deciding on the mix of products sold from a retail unit)
- ▶ The right to change when the output is produced (e.g., deciding when an item of machinery or a power plant will be used)
- ▶ The right to change where the output is produced (e.g., deciding on the destination of a truck or a ship, deciding where a piece of equipment is used or deployed)
- ▶ The right to change whether the output is produced and the quantity of that output (e.g., deciding whether to produce energy from a power plant and how much energy to produce from that power plant)

IFRS 16 also provides the following examples of decision-making rights that do not grant the right to change how and for what purpose an asset is used:

- ▶ Maintaining the asset
- ▶ Operating the asset

Although the decisions about maintaining and operating the asset are often essential to the efficient use of that asset, the right to make those decisions, in and of itself, does not result in the right to change how and for what purpose the asset is used throughout the period of use.

The customer does not need the right to operate the underlying asset to have the right to direct its use. That is, the customer may direct the use of an asset that is operated by the supplier's personnel. However, as discussed below, the right to operate an asset will often provide the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined.

## How we see it

We believe that the assessment of whether a contract is or contains a lease will be straightforward in most arrangements. However, judgement may be required in applying the definition of a lease to certain arrangements. For example, in contracts that include significant services, we believe that determining whether the contract conveys the right to direct the use of an identified asset may be challenging.

### ***2.1.5.2 The relevant decisions about how and for what purpose an asset is used are predetermined***

In some cases, it will not be clear whether the customer has the right to direct the use of the identified asset. This could be the case when the most relevant decisions about how and for what purpose an asset is used are predetermined by contractual restrictions on the use of the asset (e.g., the decisions about the use of the asset are agreed to by the customer and the supplier in negotiating the contract, and those decisions cannot be changed). This could also be the case when the most relevant decisions about how and for what purpose an asset is used are, in effect, predetermined by the design of the asset. The IASB indicated in the Basis for Conclusions (BC121) that it would expect decisions about how and for what purpose an asset is used to be predetermined in few cases. In such cases, a customer has the right to direct the use of an identified asset throughout the period of use when the customer either:

- ▶ Has the right to operate the asset, or direct others to operate the asset in a manner it determines, throughout the period of use without the supplier having the right to change those operating instructions
- ▶ Designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use

Significant judgement may be required to assess whether a customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use. See Example 9 in *IFRS 16 Leases Illustrative Examples*, for an example of the evaluation of whether a customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

In January 2020, the IFRS Interpretations Committee issued an agenda decision about whether the customer has the right to direct the use of a ship throughout the five-year term of a contract. In the fact pattern described in the request:

- a. There is an identified asset (the ship) applying paragraphs B13-B20 of IFRS 16
- b. The customer has the right to obtain substantially all of the economic benefits from use of the ship throughout the five-year period of use applying paragraphs B21-B23 of IFRS 16.
- c. Many, but not all, decisions about how, and for what purpose, the ship is used are predetermined in the contract. The customer has the right to make the remaining decisions about how, and for what purpose, the ship is used throughout the period of use (i.e., the order of the voyages to the designated ports during the contract term). In the fact pattern described in

the request, the customer has determined that this decision-making right is relevant because it affects the economic benefits to be derived from use of the ship

d. The supplier operates and maintains the ship throughout the period of use

The Committee observed that, in the fact pattern described in the request, because not all relevant decisions about how and for what purpose the ship is used are predetermined, the customer considers paragraph B24(a) of IFRS 16 in assessing whether it has the right to direct the use of the ship.

Paragraph B24(a) specifies that a customer has the right to direct the use of an identified asset throughout the period of use if it has 'the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30)'. To have the right to direct how and for what purpose the asset is used, within the scope of its right of use defined in the contract, the customer must be able to change how and for what purpose the asset is used throughout the period of use (paragraph B25). In assessing whether that is the case, an entity considers rights to make decisions during the period of use that are most relevant to changing how and for what purpose the asset is used throughout that period. Decision-making rights are relevant when they affect the economic benefits to be derived from use (paragraph B25). An entity does not consider decisions that are predetermined before the period of use unless the conditions in paragraph B24(b)(ii) exist (paragraph B29).

The Committee observed that, in the fact pattern described in the request, the customer has the right to direct how and for what purpose the ship is used throughout the period of use. Within the scope of its right of use defined in the contract, the customer can change how and for what purpose the ship is used (i.e., the customer can change the order of the voyages to the designated ports during the contract term). Despite many decisions about how and for what purpose the ship is used being predetermined, such decisions define the scope of the customer's right of use. Therefore, in this fact pattern, the customer has the right to make the decisions that are most relevant to changing how and for what purpose the ship is used.

The Committee also observed that, although the operation and maintenance of the ship are essential to its efficient use, the supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used.

The Committee concluded that, in the fact pattern described in the request, the customer has the right to direct the use of the ship throughout the period of use. Consequently, the contract contains a lease. The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine whether the contract described in the request contains a lease and, therefore, decided not to add the matter to its standard-setting agenda.



### 2.1.5.3 Specifying the output of an asset before the period of use

#### Extract from IFRS 16

B28 The relevant decisions about how and for what purpose the asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

B29 In assessing whether a customer has the right to direct the use of an asset, an entity shall consider only rights to make decisions about the use of the asset during the period of use, unless the customer designed the asset (or specific aspects of the asset) as described in paragraph B24(b)(ii). Consequently, unless the conditions in paragraph B24(b)(ii) exist, an entity shall not consider decisions that are predetermined before the period of use. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

If a customer can only specify the output from an asset before the beginning of the period of use and cannot change that output throughout the period of use, the customer does not have the right to direct the use of that asset unless it designed the asset, or specific aspects of the asset, as contemplated in paragraph B24(b)(ii) of IFRS 16. If the customer did not design the asset or aspects of it, the customer's ability to specify the output in a contract that does not give it any other relevant decision-making rights relating to the use of the asset (e.g., the ability to change when, whether and what output is produced) gives the customer the same rights as any customer that purchases goods or services in an arrangement (i.e., a contract that does not contain a lease).

### 2.1.5.4 Protective rights

#### Extract from IFRS 16

B30 A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset, (ii) require a customer to follow particular operating practices, or (iii) require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

A supplier's protective rights, in isolation, do not prevent the customer from having the right to direct the use of an identified asset. Protective rights typically define the scope of the customer's right to use the asset without removing the customer's right to direct the use of the asset. Protective rights are intended to protect a supplier's interests (e.g., interests in the asset, its personnel, compliance with laws and regulations) and might take the form of a specified maximum amount of asset use, a restriction on where an asset may be used or a requirement to follow specific operating instructions.

#### Illustration 6 – Right to direct the use of an asset

Customer X enters into a contract with Supplier Y to use a vehicle for a three-year period. The vehicle is identified in the contract. Supplier Y cannot substitute another vehicle unless the specified vehicle is not operational (e.g., it breaks down).

Under the contract:

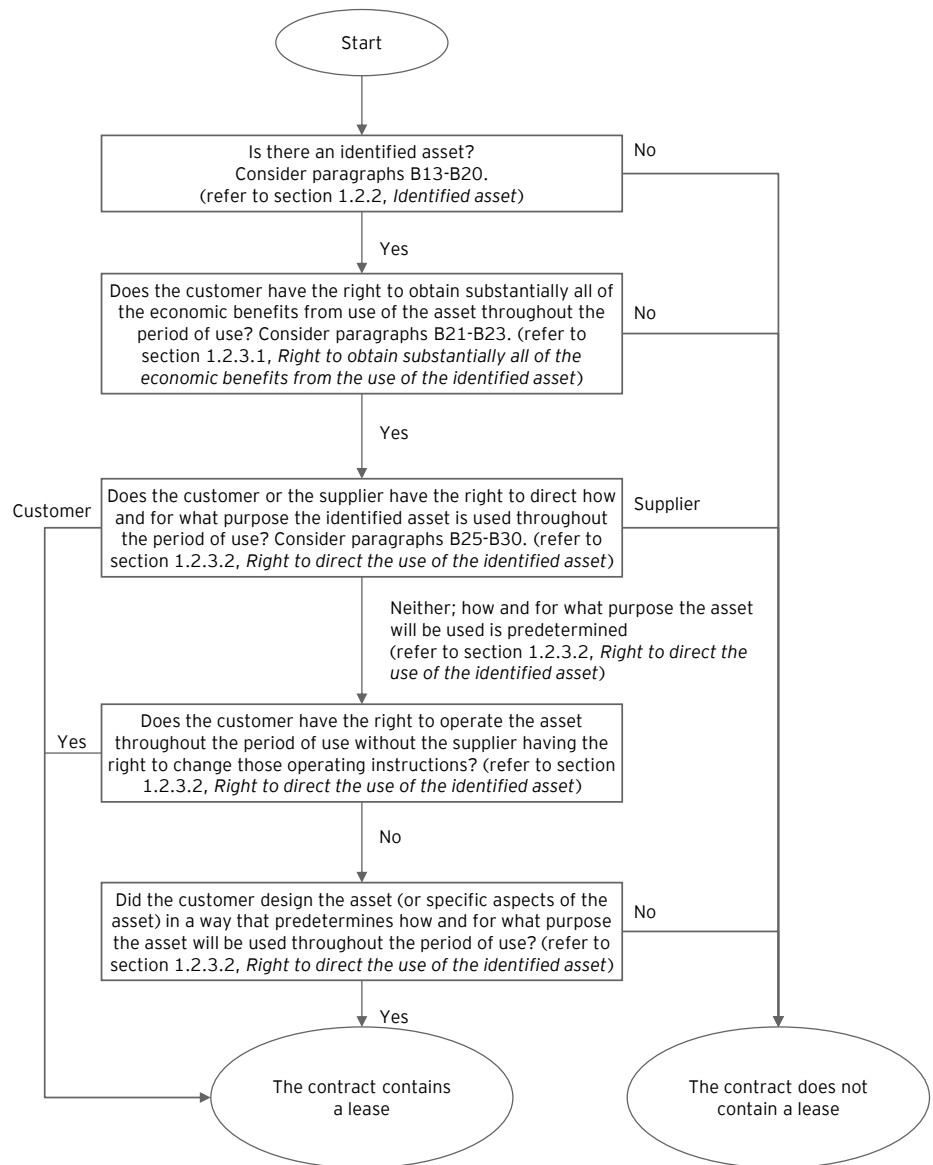
- ▶ Customer X operates the vehicle (i.e., drives the vehicle) or directs others to operate the vehicle (e.g., hires a driver).
- ▶ Customer X decides how to use the vehicle (within contractual limitations, discussed below). For example, throughout the period of use, Customer X decides where the vehicle goes, as well as when or whether it is used and what it is used for. Customer X can also change these decisions throughout the period of use.
- ▶ Supplier Y prohibits certain uses of the vehicle (e.g., moving it overseas) and modifications to the vehicle to protect its interest in the asset.

*Analysis:* Customer X has the right to direct the use of the identified vehicle throughout the period of use. Customer X has the right to direct the use of the vehicle because it has the right to change how the vehicle is used, when or whether the vehicle is used, where the vehicle goes and what the vehicle is used for.

Supplier Y's limits on certain uses for the vehicle and modifications to it are considered protective rights that define the scope of Customer X's use of the asset, but do not affect the assessment of whether Customer X directs the use of the asset.

### 2.1.6 Flowchart

The following flowchart is included in IFRS 16's application guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease:



### 2.1.7 Reassessment of the contract

#### Extract from IFRS 16

11 An entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.

An entity reassesses whether a contract contains a lease only if the terms and conditions of the contract are changed.

Under IFRS 16, an entity reassesses whether a contract is or contains a lease only if the terms and conditions of the contract are changed. A change in the terms and conditions of a contract does not include the exercise of an option (e.g., renewal option) or failure to exercise an option that is included in the contract.

Refer to Appendix D for a summary of lessee and lessor reassessment and remeasurement requirements.

## 2.2 Identifying and separating lease and non-lease components of a contract and allocating contract consideration

### 2.2.1 Identifying and separating lease components of a contract

#### Extract from IFRS 16

12 For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 15. Paragraphs B32-B33 set out guidance on separating components of a contract.

B32 The right to use an underlying asset is a separate lease component if both:

- (a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and
- (b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets.

B33 A contract may include an amount payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease, that do not transfer a good or service to the lessee. Such amounts payable do not give rise to a separate component of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract.

16 Unless the practical expedient in paragraph 15 is applied, a lessee shall account for non-lease components applying other applicable Standards.

B55 When a lease includes both land and buildings elements, a lessor shall assess the classification of each element as a finance lease or an operating lease separately applying paragraphs 62-66 and B53-B54. In determining

### Extract from IFRS 16 (cont'd)

whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life.

B56 Whenever necessary in order to classify and account for a lease of land and buildings, a lessor shall allocate lease payments (including any lump-sum upfront payments) between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

B57 For a lease of land and buildings in which the amount for the land element is immaterial to the lease, a lessor may treat the land and buildings as a single unit for the purpose of lease classification and classify it as a finance lease or an operating lease applying paragraphs 62-66 and B53-B54. In such a case, a lessor shall regard the economic life of the buildings as the economic life of the entire underlying asset.

For contracts that contain the rights to use multiple assets (e.g., a building and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following criteria are met:

- ▶ The lessee can benefit from the use of the asset either on its own or together with other resources that are readily available to the lessee (i.e., goods or services that are sold or leased separately, by the lessor or other suppliers, or that the lessee has already obtained from the lessor or in other transactions or events).
- ▶ The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

If one or both of these criteria are not met, the right to use multiple assets is considered a single lease component.

### Illustration 7 – Identifying and separating lease components

#### Scenario A

Assume that a lessee enters into a lease of an excavator and the related accessories (e.g., excavator attachments) that are used for mining purposes. The lessee is a local mining company that intends to use the excavator at a copper mine.

*Analysis:* From the perspective of the lessee, the contract contains one lease component. The lessee would be unable to benefit from the use of the excavator without also using the accessories. Therefore, the excavator is dependent upon the accessories.

#### Scenario B

Assume the same facts as in Scenario A, except that the contract also conveys the right to use an additional loading truck. This loading truck could be deployed by the lessee for other uses (e.g., to transport iron ores at another mine).

#### Illustration 7 – Identifying and separating lease components (cont'd)

*Analysis:* From the perspective of the lessee, the contract contains two lease components: a lease of the excavator (together with the accessories) and a lease of the loading truck. Because the loading truck could be deployed for other uses independent of the excavator, the lessee can benefit from the loading truck on its own or together with other readily available resources. The lessee can also benefit from the use of the excavator on its own or together with other readily available resources.

For contracts that involve the right to use land and land improvements (e.g., buildings), IFRS 16 requires a lessor to classify (refer to section 5.1 *Lease classification*) and account for the right to use land as a separate lease component, unless the accounting effect of doing so is immaterial to the lease. For example, separation of the land may not be necessary when the amount that would be recognised for the land lease component is immaterial to the lease. If the lease payments cannot be allocated reliably between the land and the buildings, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases (i.e., the entire lease is classified as an operating lease).

#### How we see it

An entity that leases an entire building (i.e., 100% of the building) is inherently leasing the land underneath the building and would potentially account for the land and the building as separate lease components. However, this would not necessarily be the case when an entity only leases part of the building (e.g., one floor of a multi-storey building).

#### 2.2.2 Identifying and separating lease from non-lease components of a contract

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). The non-lease components are identified and accounted for separately from the lease component in accordance with other standards (except when a lessee applies the practical expedient as discussed in section 2.2.2.2 *Practical expedient - lessees*). For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers).

Some contracts contain items that do not relate to the transfer of goods or services by the lessor to the lessee (e.g., fees or other administrative costs a lessor charges a lessee). These items are not considered separate lease or non-lease components, and lessees and lessors do not allocate consideration in the contract to these items. Refer to section 2.2.3.2 *Allocating the consideration in the contract - lessees* on lessee allocation of consideration in the contract and 2.2.4.2 *Allocating the consideration in the contract - lessors* on lessor allocation of consideration in the contract.

However, if the lessor provides services (e.g., maintenance, supply of utilities) or operates the underlying asset (e.g., vessel charter, aircraft wet lease), the contract would generally contain non-lease components.

##### 2.2.2.1 Lessee reimbursements

Under IFRS 16, payments for maintenance activities, including common area maintenance (e.g., cleaning the common areas of a building, removing snow from a car park for employees and customers) and other goods or services transferred

to the tenant (e.g., providing utilities or rubbish removal) are considered non-lease components because they provide the lessee with a service.

In some leases, a lessee also may reimburse (or make certain payments on behalf of) the lessor that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee (e.g., payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is, payments made for insurance that protects the lessor's investment in the asset and the landlord will receive the proceeds from any claim). Under IFRS 16, such costs are not separate components of the contract because they do not represent payments for goods or services and are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components). Entities also need to evaluate whether such payments are fixed (or in-substance fixed) lease payments or variable lease payments. Refer to section 3.5 *Lease Payments*.

#### **Illustration 8 – Activities that are not components of a lease contract**

##### **Scenario A**

A lessee enters into a three-year lease of equipment, with fixed annual payments of CU12,000. The contract itemises the fixed annual payments as follows: CU9,000 for rent, CU2,500 for maintenance and CU500 of administrative tasks.

*Analysis:* The contract contains two components - a lease component (lease of equipment) and a non-lease component (maintenance). The amount paid for administrative tasks does not transfer a good or service to the lessee. Therefore, the total consideration in the contract of CU36,000 will be allocated to the lease component (equipment) and the non-lease component (maintenance).

##### **Scenario B**

Assume the fact pattern as in scenario A except that, in addition, the contract requires the lessee to pay for the restoration of the equipment to its original condition.

*Analysis:* The contract still contains two components - a lease component (lease of equipment) and a non-lease component (maintenance). Similar to the amount paid for administrative tasks, the restoration does not transfer a good or service to the lessee as it is only performed at the end of the lease term. Therefore, the total consideration in the contract will be allocated to the lease component (equipment) and the non-lease component (maintenance). See 4.2.1 for further discussion on the inclusion of restoration costs to the initial measurement of the right-of-use asset.

#### **2.2.2.2 Practical expedient – lessees**

##### **Extract from IFRS 16**

15 As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component. A lessee shall not apply this practical expedient to embedded derivatives that meet the criteria in paragraph 4.3.3 of IFRS 9 *Financial Instruments*.

Lessees can make a policy election to not separate non-lease components from lease components.

IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. IFRS 16 provides this expedient to alleviate concerns that the costs and administrative burden of allocating consideration to separate lease and non-lease components may not be justified by the benefit of more precisely reflecting the right-of-use asset and the lease liability. Furthermore, the Board expects the practical expedient to most often be used when the non-lease components of a contract are not significant when compared with the lease components of a contract. The practical expedient does not allow lessees to account for multiple lease components of a contract (refer to section 2.2.1 *Identifying and separating lease components of a contract*) as a single lease component. Refer to section 4 *Lessee accounting* for a discussion of measurement of right-of-use assets and lease liabilities.

Although it is not explicitly stated, we believe that non-lease components relate to services contained within the lease contract. Paragraphs BC133 and BC135 of the Basis for Conclusions to IFRS 16 refer to non-lease components being service components. Therefore, when a lease includes a component related to the purchase of inventory or another asset such as property, plant and equipment or an intangible asset, we believe an entity should separate these asset components from other lease and non-lease components, even if it has elected to apply the practical expedient to the class of underlying asset to which the lease relates. For example, if a contract contains a lease as well as non-lease components related to a service and the purchase of sheet metal to be used in the construction of inventory, we believe the purchase of the sheet metal should be accounted for as a component of inventory rather than together with the lease component as the purchase of a physical good is not a 'non-lease component associated with that lease component'.

Lessees that make the policy election to account for each separate lease component of a contract and any associated non-lease components as a single lease component allocate all of the contract consideration to the lease component. Therefore, the initial and subsequent measurement of the lease liability and right-of-use asset is higher than if the policy election was not applied.

### **2.2.3 Determining and allocating the consideration in the contract - lessees**

#### **2.2.3.1 Determining the consideration in the contract**

IFRS 16 does not define 'consideration' in a lease contract, nor is 'consideration' defined in the IFRS Glossary. However, we believe that the consideration in a lease contract for a lessee would include all the payments described in section 3.5 *Lease payments* as well as any fixed payments (e.g., monthly service charges) or in substance fixed payments, variable payments that depend on an index or a rate, initially measured using the index or rate at the commencement date, less any incentives paid or payable to the lessee, other than those included in lease payments.



### 2.2.3.2 Allocating the consideration in the contract - lessees

#### Extract from IFRS 16

13 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

14 The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximising the use of observable information.

Lessees that do not make an accounting policy election (by class of underlying asset) to use the practical expedient (discussed in section 2.2.2.2 *Practical expedient – lessees*) to account for each separate lease component of a contract and any associated non-lease components as a single lease component are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees estimate stand-alone prices, maximising the use of observable information. Although a contractually stated price may be the stand-alone price for a good or service, it is not presumed to be for accounting purposes.

#### Illustration 9 – Allocating contract consideration to lease and non-lease components - lessees

A lessee enters into a lease of equipment. The contract stipulates the lessor will perform maintenance of the leased equipment and receive consideration for that maintenance service. The contract includes the following fixed prices for the lease and non-lease component:

Lease	CU80,000
Maintenance	<u>CU10,000</u>
Total	CU90,000

Assume the stand-alone prices cannot be readily observed, so the lessee makes estimates, maximising the use of observable information, of the lease and non-lease components, as follows:

Lease	CU85,000
Maintenance	<u>CU15,000</u>
Total	CU100,000

*Analysis:* The stand-alone price for the lease component represents 85% of total estimated stand-alone prices. The lessee allocates the consideration in the contract (CU90,000), as follows:

#### Illustration 9 – Allocating contract consideration to lease and non-lease components - lessees (cont'd)

Lease	CU76,500 <sup>(1)</sup>
Maintenance	<u>CU13,500<sup>(2)</sup></u>
Total	CU90,000

(1) 85% x CU90,000

(2) 15% x CU90,000

## 2.2.4 Determining and allocating the consideration in the contract - lessors

### 2.2.4.1 Determining the consideration in the contract - lessors

As discussed in section 2.2.3.1 *Determining the consideration in the contract*, IFRS 16 does not define 'consideration' in a lease contract, nor is 'consideration' defined in the IFRS Glossary. However, we believe that the consideration in a lease contract for a lessor would include the following:

- ▶ Lease payments in section 3.5 *Lease payments*
- ▶ Any other fixed payments (e.g., monthly service charges, non-lease components such as maintenance) or in-substance fixed payments made during the lease term, less any incentives paid or payable to the lessee
- ▶ Any other variable payments that depend on an index or a rate made during the lease term and initially measured using the index or rate at the commencement date (refer to section 3.2 *Commencement date of the lease*)
- ▶ Any other variable payment amounts that would be included in the transaction price in accordance with the requirements on variable consideration in IFRS 15 that specifically relate to either of the following:
  - ▶ The lessor's efforts to transfer one or more goods or services that are not leases
  - ▶ An outcome from transferring one or more goods or services that are not leases

Variable consideration is described broadly in IFRS 15 and can take many forms. Consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. It is important for lessors to appropriately identify the different types of variable consideration included in the contract because estimating variable consideration requires lessors to apply a constraint to each type of variable consideration.

Refer to our publication [Applying IFRS: A closer look at IFRS 15, the revenue recognition standard](#) (updated October 2020)<sup>1</sup> for an in-depth discussion of the forms of variable consideration, estimating variable consideration and constraining estimates of variable consideration.

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<sup>1</sup> The publication is available on <http://www.ey.com/ifrs>.

## 2.2.4.2 Allocating the consideration in the contract - lessors

### Extracts from IFRS 16

17 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessor shall allocate the consideration in the contract applying paragraphs 73-90 of IFRS 15.

Lessors allocate the consideration in the contract between the lease and non-lease components of the contract on a relative stand-alone selling price basis.

When applying IFRS 16, lessors are required to apply paragraphs 73 - 86 of IFRS 15 to allocate the consideration in the contract between the lease and non-lease components on a relative stand-alone selling price basis. In addition, lessors are required to apply paragraphs 87-90 of IFRS 15 to allocate any subsequent changes in the consideration of the contract between the lease and non-lease components. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate the stand-alone selling price. Paragraph 79 of IFRS 15 provides suitable methods for estimating the stand-alone selling price.

Refer to our publication [Applying IFRS: A closer look at IFRS 15, the revenue recognition standard](#) (updated October 2020), for an in-depth discussion on determining standalone selling prices under IFRS 15.

### How we see it

We anticipate that personnel responsible for an entity's revenue recognition policies (including revenue recognition policies associated with arrangements that include a lease) will need to obtain information from personnel beyond those in the accounting or finance departments to estimate stand-alone selling prices. That is, we expect them to need to gain information and an understanding of an entity's pricing decisions in order to determine estimated stand-alone selling prices, especially when there are limited or no observable inputs. This may be a change for some entities that do not today estimate stand-alone selling prices.

## 2.2.5 Examples - Identifying and separating components of a contract and determining and allocating the consideration in the contract

IFRS 16 provides the following example to illustrate how lessees identify and separate lease and non-lease components of a contract and determine and allocate the consideration in the contract.

### Extract from IFRS 16 Illustrative Examples

#### Example 12—Lessee allocation of consideration to lease and non-lease components of a contract

*Lessor leases a bulldozer, a truck and a long-reach excavator to Lessee to be used in Lessee's mining operations for four years. Lessor also agrees to maintain each item of equipment throughout the lease term. The total consideration in the contract is CU600,000<sup>(a)</sup>, payable in annual instalments of CU150,000, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. The variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. The consideration includes the cost of maintenance services for each item of equipment.*

### Extract from IFRS 16 Illustrative Examples (cont'd)

Lessee accounts for the non-lease components (maintenance services) separately from each lease of equipment applying paragraph 12 of IFRS 16. Lessee does not elect the practical expedient in paragraph 15 of IFRS 16. Lessee considers the requirements in paragraph B32 of IFRS 16 and concludes that the lease of the bulldozer, the lease of the truck and the lease of the long-reach excavator are each separate lease components. This is because:

- (a) Lessee can benefit from use of each of the three items of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or excavator to use in its operations); and
- (b) Although Lessee is leasing all three items of equipment for one purpose (ie to engage in mining operations), the machines are neither highly dependent on, nor highly interrelated with, each other. Lessee's ability to derive benefit from the lease of each item of equipment is not significantly affected by its decision to lease, or not lease, the other equipment from Lessor.

Consequently, Lessee concludes that there are three lease components and three non-lease components (maintenance services) in the contract. Lessee applies the guidance in paragraphs 13-14 of IFRS 16 to allocate the consideration in the contract to the three lease components and the non-lease components.

*Several suppliers provide maintenance services for a similar bulldozer and a similar truck. Accordingly, there are observable standalone prices for the maintenance services for those two items of leased equipment. Lessee is able to establish observable stand-alone prices for the maintenance of the bulldozer and the truck of CU32,000 and CU16,000, respectively, assuming similar payment terms to those in the contract with Lessor. The long-reach excavator is highly specialised and, accordingly, other suppliers do not lease or provide maintenance services for similar excavators. Nonetheless, Lessor provides four-year maintenance service contracts to customers that purchase similar long-reach excavators from Lessor. The observable consideration for those four-year maintenance service contracts is a fixed amount of CU56,000, payable over four years, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. That variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. Consequently, Lessee estimates the stand-alone price of the maintenance services for the long-reach excavator to be CU56,000 plus any variable amounts. Lessee is able to establish observable stand-alone prices for the leases of the bulldozer, the truck and the long-reach excavator of CU170,000, CU102,000 and CU224,000, respectively.*

Lessee allocates the fixed consideration in the contract (CU600,000) to the lease and non-lease components as follows:

### Extract from IFRS 16 Illustrative Examples (cont'd)

CU	Bulldozer	Truck	Long-reach excavator	Total
Lease	170,000	102,000	224,000	496,000
Non-lease				104,000
Total fixed consideration				600,000

Lessee allocates all of the variable consideration to the maintenance of the long-reach excavator, and, thus, to the non-lease components of the contract. Lessee then accounts for each lease component applying the guidance in IFRS 16, treating the allocated consideration as the lease payments for each lease component.

(a) In these Illustrative Examples, currency amounts are denominated in 'currency units' (CU).

## 2.3 Contract combinations

### Extract from IFRS 16

B2 In applying this Standard, an entity shall combine two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if one or more of the following criteria are met:

- (a) the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together;
- (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
- (c) the rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component as described in paragraph B32.

IFRS 16 requires that two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty) be considered a single contract if any one of the following criteria is met:

- ▶ The contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together
- ▶ The amount of consideration to be paid in one contract depends on the price or performance of the other contract
- ▶ The rights to use the underlying assets conveyed in the contracts (or some of the rights to use underlying assets conveyed in each of the contracts) are a single lease component (refer to section 2.2.1 *Identifying and separating lease components of a contract*)

The IASB indicated in the Basis for Conclusions (BC130-132) that it developed these criteria to address concerns that separately accounting for multiple contracts may not result in a faithful representation of the combined transaction.

## 3. Key concepts

Lessees and lessors generally apply the same key concepts for the purposes of identifying, recognising and measuring lease contracts.

### 3.1 Inception of a contract

#### Extract from IFRS 16

9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

#### Appendix A

##### Defined terms

##### **Inception date of the lease (inception date)**

The earlier of the date of a **lease** agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

Entities determine whether a contract is or contains a lease at the inception of the contract.

IFRS 16 requires customers and suppliers to determine whether a contract is or contains a lease at the inception of the contract. The inception date of a lease is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

As indicated in the Basis for Conclusions (BC72), after the inception of the lease, but before the commencement date (refer to section 3.2 *Commencement date of the lease*), the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* apply to any contract (and, hence, any lease contract) that becomes onerous as defined in that standard.

### 3.2 Commencement date of the lease

#### Extract from IFRS 16

#### Appendix A

##### Defined terms

##### **Commencement date of the lease (commencement date)**

The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.

##### **Underlying asset**

An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

The commencement date is the date on which the lessor makes an underlying asset (i.e., the asset that is subject to the lease) available for use by the lessee. In some cases, the commencement date of the lease may be before the date stipulated in the lease agreement (e.g., the date on which rents become due and payable). This often occurs when the leased space is modified by the lessee prior to commencing operations in the leased space (e.g., during the period a lessee uses the leased space to construct its own leasehold improvements). If a lessee

takes possession of, or is given control over, the use of the underlying asset before it begins operations or making lease payments under the terms of the lease, the lease term has commenced even if the lessee is not required to pay rent or the lease arrangement states the lease commencement date is a later date. The timing of when lease payments begin under the contract does not affect the commencement date of the lease. For example, a lessee (except for a lessee applying the short-term lease or low-value asset exemption discussed in sections 4.1.1 *Short-term leases* and 4.1.2 *Leases of low-value assets*) initially recognises a lease liability and related right-of-use asset on the commencement date and a lessor (for finance leases) initially recognises its net investment in the lease on the commencement date.

### **3.3 Lessee involvement with the underlying asset before the commencement date**

An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

If the lessee incurs costs relating to the construction or design of an underlying asset, the lessee accounts for those costs applying other IFRS, such as IAS 16 *Property, Plant and Equipment*. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments.

The lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction.

If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for as described at section 7 below.

However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset, but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but as a lease.

## 3.4 Lease term and purchase options

### 3.4.1 Lease term

#### Extract from IFRS 16

18 An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

- (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

19 In assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease, as described in paragraphs B37-B40.

B36 The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

B37 At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the option. Examples of factors to consider include, but are not limited to:

- (a) contractual terms and conditions for the optional periods compared with market rates, such as:
  - (i) the amount of payments for the lease in any optional period;
  - (ii) the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and
  - (iii) the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).
- (b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- (c) costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;



### Excerpt from IFRS 16 (cont'd)

- (d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset, the location of the underlying asset and the availability of suitable alternatives; and
- (e) conditionality associated with exercising the option (ie when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

B38 An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments in paragraph B42, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

B39 The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

B40 A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if the lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

The lease term begins at the lease commencement date and is determined on that date based on the non-cancellable term of the lease, together with both of the following:

- ▶ The periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option
- ▶ The periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option

The phrase 'reasonably certain' which was also used in IAS 17 is generally interpreted as a high threshold. Therefore, the IASB does not anticipate a change in practice.

Purchase options should be assessed in the same way as options to extend the lease term or terminate the lease. The IASB indicated in the Basis for Conclusions (BC173) that an option to purchase an underlying asset is economically similar to an option to extend the lease term for the remaining economic life of the underlying asset.

### 3.4.1.1 Evaluating lease term and purchase options

When evaluating whether a lessee is reasonably certain to exercise an option to renew the lease, not terminate the lease or to purchase the underlying asset, lessees and lessors are required to assess all relevant factors that create an economic incentive for the lessee to exercise lease renewal, termination or purchase options.

The longer the period from commencement of the lease (refer to section 3.1 *Inception of a contract*) to the exercise date of an option, the more difficult it will be, in certain cases, to determine whether the exercise of the option is reasonably certain. The difficulty arises from several factors. For example, a lessee's estimates of its future needs for the leased asset become less precise the further into the future the forecast goes. Also, the future fair value of certain assets such as those involving technology is more difficult to predict than the future fair value of a relatively stable asset, such as a fully leased commercial office building located in a prime area.

The further into the future that the option date is, the lower the option price must be in relation to the estimated future fair value to conclude that the lessee is reasonably certain to exercise the option. The difference between the option price and the estimated future fair value of an asset that is subject to significant changes in value also should be greater than would be the case for an asset with a relatively stable value.

An artificially short lease term (e.g., a lease of a corporate headquarters, distribution facility, manufacturing plant or other key property with a four-year lease term), may effectively create a significant economic incentive for the lessee to exercise a purchase or renewal option. This may be evidenced by the significance of the underlying asset to the lessee's continuing operations and whether, absent the option, the lessee would have entered into such a lease.

Similarly, the significance of the underlying asset to the lessee's operations may affect a lessee's decisions about whether it is reasonably certain to exercise a purchase or renewal option. For example, a company that leases a specialised facility (e.g., manufacturing plant, distribution facility, corporate headquarters) and does not exercise a purchase or renewal option would face a significant economic penalty if an alternative facility is not readily available. This would potentially have an adverse effect on the company while it searched for a replacement asset.

A lessee may enter into a lease contract for non-consecutive periods. This is seen in the retail industry when retailers enter into contracts with shopping centres to lease the same retail space for certain non-consecutive months of the year (e.g., during an annual holiday period). Similar arrangements also exist when sports teams lease a sports stadium for particular non-consecutive days of the year. These arrangements will usually meet the definition of a lease because during the agreed period of use, the customer controls the right to use the underlying asset. In these arrangements, the lease term is the aggregate of the non-consecutive periods, as shown in Illustration 10, Scenario C.

### Illustration 10 – Determining the lease term

#### Scenario A

Entity P enters into a lease for equipment that includes a non-cancellable term of four years and a two-year fixed-priced renewal option with future lease payments that are intended to approximate market rates at lease inception. There are no termination penalties or other factors indicating that Entity P is reasonably certain to exercise the renewal option.

*Analysis:* At the lease commencement date, the lease term is four years.

#### Scenario B

Entity Q enters into a lease for a building that includes a non-cancellable term of four years and a two-year, market-priced renewal option. Before it takes possession of the building, Entity Q pays for leasehold improvements. The leasehold improvements are expected to have significant value at the end of four years, and that value can only be realised through continued occupancy of the leased property.

*Analysis:* At lease commencement, Entity Q determines that it is reasonably certain to exercise the renewal option because it would suffer a significant economic penalty if it abandoned the leasehold improvements at the end of the initial non-cancellable period. At lease commencement, Entity Q concludes that the lease term is six years.

#### Scenario C

Entity R enters into a lease for an identified retail space in a shopping centre. The retail space will be available to Entity R for only the months of October, November and December during a non-cancellable term of five years. The lessor agrees to provide the same retail space for each of the five years.

*Analysis:* At the lease commencement date, the lease term is 15 months (three months per year over the five annual periods specified in the contract).

### 3.4.1.2 Cancellable leases

#### Extract from IFRS 16

B34 In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

B35 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

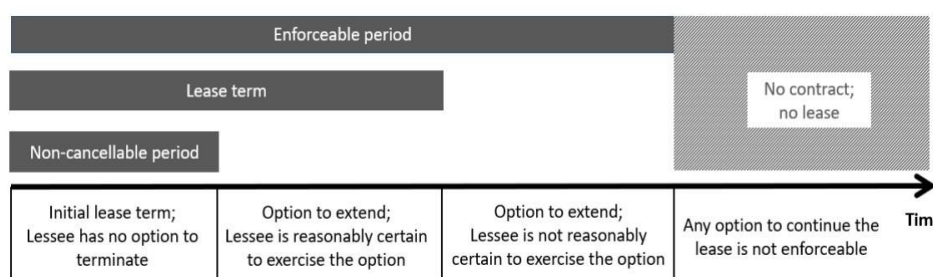
Any non-cancellable periods (by the lessee and the lessor) in contracts that meet the definition of a lease are considered part of the lease term. If only the lessor has the right to terminate a lease, the period covered by the option to terminate the lease is included in the non-cancellable period of the lease. If only the lessee has the right to terminate a lease, that right is a termination option that is

considered when determining the lease term. Refer to section 3.4.1.1 *Evaluating lease term and purchase options*.

An arrangement is not enforceable if both the lessor and lessee each have the right to terminate the lease without permission from the other party and with no more than an insignificant penalty. The question arises as to whether penalty should be interpreted to include only the contractual amount payable by one party to the other if the termination option is exercised (i.e., the narrow interpretation) or whether significant economic disincentives should also be considered a penalty (i.e., the wide interpretation). With respect to the determination of the lease term, IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option and thus suggests that all aspects of termination penalties, whether contractual or financial in nature, should be considered. Although the guidance may not directly apply in this situation as the lessee is unable to exercise the option to renew the lease without the approval of the lessor, we believe, by analogy, it is appropriate to evaluate the existence of any significant economic disincentives taking into account all facts and circumstances.

The IFRS Interpretations Committee issued an agenda decision in November 2019 related to this issue. The Committee was asked how to determine the lease term of a cancellable lease or a renewable lease. Specifically, when applying paragraph B34 of IFRS 16 and assessing ‘no more than an insignificant penalty’ whether an entity considers the broader economics of the contract or only contractual termination payments. Such broader economic considerations might include the cost of abandoning or dismantling leasehold improvements. Another example may be the importance of the asset to the lessee’s operations.

To determine the lease term, an entity determines the non-cancellable period and the enforceable period. It then determines where the lease term falls, depending on the likelihood of exercising the options to extend or terminate using the reasonably certain threshold. The impact of extension options is shown in the diagram below, taken from the Committee’s agenda paper.



We believe the impact of termination options on the determination of the lease term would be similar. That is, the lease term includes the non-cancellable period, the periods covered by the options to extend if the lessee is reasonably certain to exercise that option and the periods covered by the option to terminate, if the lessee is reasonably certain not to exercise that option.

The Committee noted that in applying paragraph B34 and determining the enforceable period of the lease, an entity considers:

- ▶ The broader economics of the contract (i.e., not only the contractual termination payments). For example, if either party has an economic incentive not to terminate the lease such that it would incur a more than

insignificant penalty on termination, the contract is enforceable beyond the date on which the contract can be terminated

- ▶ Whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Applying paragraph B34, a lease is no longer enforceable only when both parties have such a right. Consequently, if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that party

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease, it then applies paragraphs 19 and B37-B40 of IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

The Committee noted that in assessing whether a lessee is reasonably certain to extend (or not to terminate) a lease, paragraph B37 of IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee. This includes significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when an option to extend or terminate the lease becomes exercisable (paragraph B37(b) of IFRS 16). In addition, an entity considers the broader economics of the contract when determining the enforceable period of a lease. This includes, for example, the costs of abandoning or dismantling non-removable leasehold improvements. If an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur a more than insignificant penalty if it terminates the lease. Consequently, applying paragraph B34 of IFRS 16, an entity considers whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine the lease term of cancellable and renewable leases and, therefore, decided not to add this item to its agenda.

In many jurisdictions, property leases are subject to local property laws in addition to the contractual terms of the lease arrangement. That is, local laws and regulations may give the lessee legal renewal options not stated in the lease contract. Examples of where the local law may provide lessees such rights include airport terminal and retail shopping space. When assessing the lease term, entities need to consider whether local laws and regulations create enforceable rights and obligations that need to be included in the evaluation of the lease term.

IFRS 16 applies to contracts that are referred to as 'cancellable', 'month-to-month', 'at will', 'evergreen', 'perpetual' or 'rolling' if they create enforceable rights and obligations. These types of lease generally allow for the contract to continue beyond a non-cancellable period until one party gives notice to terminate the contract (e.g., the contract will roll monthly until the lessee or the lessor elect to terminate the contract). If both the lessee and the lessor can terminate the contract without more than an insignificant penalty at any time at or after the end of the non-cancellable term, then there are no enforceable rights and obligations beyond the non-cancellable term (i.e., the lease term is limited to the non-cancellable term). However, if only the lessee holds a renewal

option, there may be other factors to consider in order to determine whether the lessee is reasonably certain to extend the lease, including economic disincentives discussed above.

#### **Illustration 11 – Cancellable leases**

A lease contract has an initial non-cancellable period of one year and an extension for an additional year if both the lessee and the lessor agree. There is no penalty if the lessee and the lessor do not agree to extend for the additional year. The initial one-year non-cancellable period meets the definition of a contract because it creates enforceable rights and obligations. However, the one-year extension period does not meet the definition of a contract because both the lessee and the lessor could unilaterally elect to not extend the arrangement without a more than insignificant penalty. That is, at lease commencement, neither party has enforceable rights and obligations beyond the initial non-cancellable period.

### **3.4.2 Reassessment of the lease term and purchase options**

#### **Extract from IFRS 16**

20 A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:

- (a) is within the control of the lessee; and
- (b) affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term (as described in paragraph B41).

21 An entity shall revise the lease term if there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:

- (a) the lessee exercises an option not previously included in the entity's determination of the lease term;
- (b) the lessee does not exercise an option previously included in the entity's determination of the lease term;
- (c) an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term; or
- (d) an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term.

B41 Paragraph 20 specifies that, after the commencement date, a lessee reassesses the lease term upon the occurrence of a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term. Examples of significant events or changes in circumstances include:

- (a) significant leasehold improvements not anticipated at the commencement date that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;

- (b) a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
- (c) the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- (d) a business decision of the lessee that is directly relevant to exercising, or not exercising, an option (for example, a decision to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use asset is employed).

#### **3.4.2.1 Reassessment of the lease term and purchase options- lessees**

After lease commencement (refer to section 3.2 *Commencement date of the lease*), IFRS 16 requires lessees to monitor leases for significant changes that could trigger a change in the lease term. Lessees are required to reassess the lease term upon the occurrence of either a significant event or a significant change in circumstances that:

- ▶ Is within the control of the lessee
- ▶ Affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term

Examples of significant events or significant changes in circumstances within the lessee's control include:

- ▶ Constructing significant leasehold improvements that are expected to have significant economic value for the lessee when the option becomes exercisable
- ▶ Making significant modifications or customisations to the underlying asset
- ▶ Making a business decision that is directly relevant to the lessee's ability to exercise, or not to exercise, an option (e.g., extending the lease of a complementary asset or disposing of an alternative asset)
- ▶ Subleasing the underlying asset for a period beyond the exercise date of the option

Changes in market-based factors (e.g., a change in market rates to lease or purchase a comparable asset) are not within the lessee's control, and they therefore do not trigger a reassessment by themselves.

IFRS 16 also requires lessees to revise the lease term when the lessee either exercises an option that it previously deemed it was not reasonably certain to exercise or does not exercise an option that it previously deemed it was reasonably certain to exercise. Furthermore, the lease term is revised if an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term or an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term.

As the lessee is required to reassess the lease term upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee, the revision of the lease term often happens before the actual exercise of the option in these circumstances. Additionally, if the

reassessment of lease term or the exercise of a purchase option results in a change, the lessee would remeasure the lease liability, using revised inputs (e.g., discount rate,) at the reassessment date, and would adjust the right-of-use asset. However, if the right-of-use asset is reduced to zero, the lessee would recognise any remaining amount in profit or loss. Refer to section 3.5.9 *Reassessment of the lease liability*.

Refer to Appendix D for a summary of lessee reassessment and remeasurement requirements.

#### **3.4.2.2 Reassessment of the lease term and purchase options - lessors**

IFRS 16 requires the lessor to revise the lease term to account for the lessee's exercise of an option to extend or terminate the lease or purchase the underlying asset, when exercise of such options was not already included in the lease term.

Refer to Appendix D for a summary of lessor reassessment and remeasurement requirements.

### **3.5 Lease payments**

#### **Extract from IFRS 16**

##### **Appendix A**

##### **Defined terms**

##### **Lease payments**

Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, comprising the following:

- (a) **fixed payments** (including in-substance fixed payments), less any **lease incentives**;
- (b) **variable lease payments** that depend on an index or a rate;
- (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- (d) payments of penalties for terminating the **lease**, if the lease term reflects the lessee exercising an option to terminate the lease.

For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.



Variable lease payments that depend on an index or a rate are included in lease payments, but other variable lease payments are not.

Lease payments are payments, made by a lessee to a lessor, relating to the right to use an underlying asset during the lease term and include the following amounts:

- ▶ Fixed (including in-substance fixed) payments, less any lease incentives receivable from the lessor (refer to section 3.5.1 *In-substance fixed lease payments* and section 3.5.2 *Lease incentives*)
- ▶ Variable lease payments that depend on an index or a rate (refer to section 3.5.3 *Variable payments that depend on an index or rate*)
- ▶ The exercise price of a purchase option if the lessee is reasonably certain to exercise that purchase option (refer to section 3.5.4 *The exercise price of a purchase option*)
- ▶ Payments for penalties for terminating a lease, if the lease term reflects the lessee exercising an option to terminate the lease (refer to section 3.5.5 *Payments for penalties for terminating a lease*)
- ▶ Amounts expected to be payable by the lessee under residual value guarantees (lessee only) (refer to section 3.5.6 *Amounts expected to be payable under residual value guarantees - lessees only*)
- ▶ Residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee (lessor only) (refer to section 3.5.7 *Residual value guarantees - lessors only*)

Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

### 3.5.1 In-substance fixed lease payments

#### Extract from IFRS 16

B42 Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, if:

- (a) payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance. Examples of those types of payments include:
  - (i) payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; or
  - (ii) payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.
- (b) there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case, an entity shall consider the realistic set of payments to be lease payments.
- (c) there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In this case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

Some lease agreements include payments that are described as variable, or may appear to contain variability, but are in-substance fixed payments because the contract terms ensure that the payment of a fixed amount is unavoidable. Such payments are included in the lease payments at lease commencement and thus used to measure entities' lease assets and lease liabilities.

### 3.5.2 Lease incentives

#### Extract from IFRS 16

##### Appendix A

##### Defined terms

##### Lease incentives

Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.

A lease agreement with a lessor might include incentives for the lessee to sign the lease, such as an upfront cash payment to the lessee, payment of costs for the lessee (such as moving expenses) or the assumption by the lessor of the lessee's pre-existing lease with a third party.

For lessees, lease incentives that are received by the lessee at or before the lease commencement date reduce the initial measurement of a lessee's right-of-use asset. Lease incentives that are receivable by the lessee at lease commencement date reduce a lessee's lease liability (and therefore, the right-of-use asset as well).

For lessors, lease incentives that are paid or payable to the lessee are also deducted from lease payments and affect the lease classification test. For finance leases, lease incentives that are payable to the lessee reduce the expected lease receivables at the commencement date and, thereby, the initial measurement of the lessor's net investment in the lease. For operating leases, lessors should defer the cost of any lease incentives paid or payable to the lessee and recognise that cost as a reduction to lease income over the lease term. Refer to sections 4 *Lessee accounting* and 5 *Lessor accounting*, respectively.

In May 2020, the IASB issued *Annual Improvements to IFRS Standards 2018 - 2020*, which includes an amendment to Illustrative Example 13 to remove the illustration of the reimbursement of leasehold improvements by the lessor. This was removed because of concerns that the example did not explain clearly enough the conclusion as to whether the reimbursement would meet the definition of a lease incentive in IFRS 16.

### 3.5.3 Variable lease payments that depend on an index or rate

#### Extract from IFRS 16

42 A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:

- (a) there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee.
- (b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

43 In applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

Variable lease payments that depend on an index or a rate include, for example, payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates. The payments are included in the lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). The IASB indicated in the Basis for Conclusions (BC165) that, despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of an asset (lessor) and a liability (lessee) because they are unavoidable and do not depend on any future activity of the lessee. Lessees subsequently remeasure the lease liability if there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect) for future payments resulting from a change in index or rate used to determine lease payments. Refer to section 4.4 *Remeasurement of lease liabilities*.

#### Illustration 12 – Variable lease payment that depends on an index or rate

Entity A enters into a 10-year lease of property. The lease payment for the first year is CU1,000. The lease payments are linked to the consumer price index (CPI), i.e., not a floating interest rate. The CPI at the beginning of the first year is 100. Lease payments are updated at the end of every second year. At the end of year one, the CPI is 105. At the end of year two, the CPI is 108.

*Analysis:* At the lease commencement date, the lease payments are CU1,000 per year for 10 years. Entity A does not take into consideration the potential future changes in the index. At the end of year one the payments have not changed, so the liability is not updated. At the end of year two, when the lease payments change, Entity A updates the remaining eight lease payments to CU1,080 per year ( $CU1,000/100 \times 108$ ) and does not change its discount rate to remeasure the lease liability (and right-of-use asset).

Lease contracts, particularly those relating to property, may include market rent reviews at future dates. The following example shows how these clauses may be treated.

#### **Illustration 13 – Property leases with market rent reviews**

Entity A enters into a 5-year lease of property. The lease payment for the first year is CU1,000. In years 2 and 3, there is a fixed escalation of 4%. At the beginning of year 4, there is a market rent review that will determine the lease payment in years 4 and 5.

*Analysis:* The lease payments included in the lease liability and right-of-use asset at the lease commencement date are determined, as follows:

Year 1 - CU1,000

Year 2 - CU1,000 + 4% fixed escalation = CU1,040

Year 3 - CU1,040 + 4% fixed escalation = CU1,082

The market rent review applicable to years 4 and 5 is a variable lease payment that depends on an index or a rate (as described in IFRS 16 paragraph 28). Entity A assesses the market rent at commencement date for the lease of the property for a period of two years, which is the length of the remaining lease term. This is determined to be CU1,035 per annum for years 4 and 5.

#### **3.5.4 The exercise price of a purchase option**

If the lessee is reasonably certain to exercise a purchase option, the exercise price is included as a lease payment. That is, entities consider the exercise price of asset purchase options included in lease contracts consistently with the evaluation of lease renewal and termination options (refer to section 3.4 *Lease term and purchase options*).

#### **3.5.5 Payments for penalties for terminating a lease**

If it is reasonably certain that the lessee will not terminate a lease, the lease term is determined assuming that the termination option would not be exercised, and any termination penalty is excluded from the lease payments. Otherwise, the lease termination penalty is included as a lease payment. The determination of whether to include lease termination penalties as lease payments is similar to the evaluation of lease renewal options.

#### **3.5.6 Amounts expected to be payable under residual value guarantees - lessees only**

IFRS 16 requires lessees to include amounts expected to be payable to the lessor under residual value guarantees as lease payments.

A lessee may provide a guarantee to the lessor that the value of the underlying asset it returns to the lessor at the end of the lease will be at least a specified amount. Such guarantees are enforceable obligations that the lessee has assumed by entering into the lease. Uncertainty related to a lessee's guarantee of a lessor's residual value affects the measurement of the obligation rather than the existence of an obligation.

A lessee is required to remeasure the lease liability if there is a change in the amounts expected to be payable under a residual value guarantee. Refer to section 3.5.9 *Reassessment of the lease liability*.

#### **Illustration 14 – Residual value guarantee included in lease payments**

Entity R (lessee) enters into a lease and guarantees that the lessor will realise CU15,000 from selling the asset to another party at the end of the lease. At lease commencement, based on Entity R's estimate of the residual value of the underlying asset, Entity R determines that it expects that it will owe CU6,000 at the end of the lease.

*Analysis:* Because it is expected that it will owe the lessor CU6,000 under the residual value guarantee, Entity R includes that amount as a lease payment.

### **How we see it**

IFRS 16 does not state how frequently reassessment should occur for expected changes under residual value guarantees. We would expect entities to apply judgement to determine the frequency of reassessment based on the relevant facts and circumstances.

#### **3.5.7 Residual value guarantees – lessors only**

IFRS 16 requires lessors to include in the lease payments, any residual value guarantees provided to the lessor by the lessee, a party related to the lessee, or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. This amount included in the lease payments is different from that for a lessee which only includes the amount expected to be payable (refer to section 3.5.6 *Amounts expected to be payable under residual value guarantees – lessees only*.)

#### **3.5.8 Variable lease payments which do not depend on an index or rate**

Variable lease payments that do not depend on an index or rate and are not, in substance, fixed (refer to section 3.5.1 *In-substance fixed lease payments*), such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset (e.g., the number of hours flown, the number of units produced), are not included as lease payments. Instead, they are recognised in profit or loss (unless they are included in the carrying amount of another asset in accordance with other IFRS) in the period in which the event that triggers the payment occurs.

In some cases, the variability may be resolved during the lease term, so that payments become fixed for the remainder of the lease term. The new fixed payments are then used to remeasure the lease liability (with an offset to the right-of-use asset). In some cases, the contract specifies that when the contingency is resolved, the lessee is required to make an immediate catch-up payment. The catch-up payment relates specifically to the lessee's prior use of the asset. In this case, we believe, when the contingency is resolved, the catch-up obligation is recognised as part of the lease liability and is expensed immediately (rather than adjusting the right-of-use asset).

#### **Illustration 15 – Variable lease payments that do not depend on an index or rate**

Entity A is a medical equipment manufacturer and a supplier of the related consumables. Customer B operates a medical centre. Under the agreement entered into by both parties, Entity A grants Customer B the right to use a medical laboratory machine at no cost and Customer B purchases consumables for use in the equipment from Entity A at CU100 each. The consumables can only be used for that equipment and Customer B cannot use other consumables as substitutes. There is no minimum purchase amount required in the contract.

Based on its historical experience, Customer B estimates that it is highly likely to purchase at least 8,000 units of consumables annually. Customer B has appropriately assessed that the arrangement contains a lease of medical equipment. There are no residual value guarantees or other forms of consideration included in the contract.

Analysis: There are two components in the arrangement, a lease of equipment and the purchase of consumables.

Even though Customer B may believe that it is highly unlikely to purchase fewer than 8,000 units of consumables every year, in this example, there are no lease payments for purposes of initial measurement (Entity A and Customer B) and lease classification (Entity A).

Entity A and Customer B would allocate the payments associated with the future payments to the lease and consumables component of the contract.

Lease payments do not include payments allocated to the non-lease components of a contract. However, lease payments include amounts that would otherwise be allocable to the non-lease components of a contract when the lessee makes an accounting policy election to account for the lease and non-lease components as a single lease component. Refer to section 2.2.2 *Identifying and separating lease from non-lease components of a contract*.

#### **3.5.9 Security deposits**

At the commencement of a lease, a lessee may be required to pay a security deposit to the lessor. As long as the deposit is a true deposit and not a prepaid lease payment, the deposit gives the lessee a right to receive the money back in cash from the lessor and is, therefore, a financial asset for the lessee and a financial liability for the lessor and is within the scope of IFRS 9 *Financial Instruments*. The deposit must initially be accounted for at fair value. The fair value of the deposit is determined based on the prevailing market rate of interest for a similar loan to the lessor, considering the lessor's credit-worthiness and, depending on facts and circumstances, any additional security available to the lessee.

When the deposit earns interest below the market rate, the excess of the principal amount of the deposit over its fair value is accounted for by both the lessee and lessor as a prepaid lease payment. It is therefore considered by the lessor in determining whether the lease is an operating or finance lease. The lessee includes this amount in the cost of its right-of-use asset at the lease commencement date. For the lessor, if the lease is classified as an operating lease, the prepaid lease payment is included in the total lease payments that are recognised as income on either a straight-line basis or another systematic basis, if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. If the lease is classified as a finance lease, the lessor includes the prepaid lease payment in the consideration for the lease

(i.e., lease payments) and, therefore, in the determination of the gain or loss on derecognition of the underlying asset, if any.

Interest on the deposit is accounted for using the effective interest method by both the lessee and the lessor.

### **3.5.10 Value added tax and property taxes**

When a lessee enters into a lease contract the lessor may be required to charge the lessee VAT in accordance with the local tax regulations. In many jurisdictions, the lessor charges VAT on behalf of the tax authority and payment is remitted to the tax authority. In circumstances when the VAT is the obligation of the lessee (i.e., not the lessor's obligation) the VAT charged is not a lease payment from the perspective of the lessor. From a lessee's perspective, typically the lessee only incurs a liability for the VAT when the lessor invoices the lease payment. In some cases, VAT is not fully recoverable by the lessee, usually because either the activities of the lessee prohibit the recovery of VAT or recovery is prohibited due to the nature of the leased asset. Generally, we expect that lessees will not include VAT in lease payments in these situations. Non-recoverable VAT payments are in the scope of IFRS 21 *Levies*.

In some circumstances, a lessee may enter into a contract to lease property and the lessor is required to pay property taxes levied by a local government authority. The lease contract may specify that the lessee pays an additional amount to cover the lessor's tax costs. Property tax that is reimbursable by the lessee to the lessor as the owner of the office building, according to the contract, does not transfer any goods or services to the lessee and, as such, it is not a separate component of the contract. Rather, it is part of the total consideration and should be allocated to the separately identified components of the contract. Unlike the non-recoverable VAT payments discussed above, the property tax reimbursable by the lessee to the lessor is not a collection of tax by the lessor on behalf of the tax authority. The obligation to pay the property tax rests with the lessor as the owner (regardless of whether the lessee ends up making any payments to the lessor). That is, the property tax is a cost of ownership and the lessee's payment to the lessor simply compensates the lessor for the use of the office building.

### **3.5.11 Co-tenancy clauses**

A co-tenancy clause is a clause in a lease contract that could result in changes in a lessee's lease payments if certain events involving other tenants occur (e.g., if key tenants, or a certain number of tenants, leave a retail shopping centre). A co-tenancy clause, if triggered, may temporarily reduce a lessee's lease payments or contractually change the lease payments from fixed lease payments to variable lease payments (e.g., payments that were previously fixed are changed to a percentage of sales). Generally, when the co-tenancy clause is resolved (e.g., the anchor tenant is replaced or occupancy levels return to a stated percentage), the lease payments will revert back to the previous amounts.

If after lease commencement, a co-tenancy clause is triggered, we believe a lessee generally would not remeasure the lease payments. IFRS 16 requires a lessee to remeasure lease payments when a contingency, upon which some or all of the variable lease payments that will be paid over the remainder of the lease term are based, is resolved and those payments now meet the definition of lease payments. A co-tenancy clause would typically result in the inverse scenario because it would temporarily lower the lease payment or temporarily cause fixed payments to become variable. Therefore, we believe any temporary

change in lease payments that results from a co-tenancy clause being triggered should be recognised in profit or loss similar to variable lease payments.

However, in certain circumstances, when it is likely the co-tenancy clause will not be resolved (e.g., the lease space is an aging shopping centre with a low likelihood of locating replacement tenants that comply with the clause), we believe a lessee may reasonably conclude it should remeasure the lease payments. In this example, the lease payments would be remeasured resulting in a reduction to the existing lease liability. The effect of a co-tenancy clause when reassessing lease payments will depend on facts and circumstances.

### 3.5.12 Reassessment of the lease liability

IFRS 16 contains specific requirements about how to remeasure the lease liability to reflect changes to the lease payments (see 4.4). A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee recognises any remaining amount of the remeasurement in profit or loss. Refer to Appendix D for a summary of lessee reassessment and remeasurement requirements.

### 3.5.13 Remeasurement by lessors

Lessors remeasure the lease payments upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease that was not part of its original terms and conditions) that is not accounted for as a separate contract. Refer to section 5.5 *Lease modifications*.

## 3.6 Discount rates

### Extract from IFRS 16

#### Appendix A

#### Defined terms

#### Interest rate implicit in the lease

The rate of interest that causes the present value of (a) the **lease payments** and (b) the **unguaranteed residual value** to equal the sum of (i) the **fair value** of the **underlying asset** and (ii) any **initial direct costs** of the lessor.

#### Lessee's incremental borrowing rate

The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.

Discount rates are used to determine the present value of the lease payments, which are used to determine lease classification (refer to section 5.1 *Lease classification*) and to measure a lessor's net investment in the lease and a lessee's lease liability.



For a lessor, the discount rate for the lease is the interest rate implicit in the lease, which is the rate that causes the following:

$$\begin{array}{|c|} \hline \text{The present value of lease payments made by the lessee for the right to use the underlying asset} \\ \hline \end{array} + \begin{array}{|c|} \hline \text{The unguaranteed residual value} \\ \hline \end{array} = \begin{array}{|c|} \hline \text{The fair value of the underlying asset} \\ \hline \end{array} + \begin{array}{|c|} \hline \text{Any initial direct costs of the lessor} \\ \hline \end{array}$$

Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. Refer to section 5 *Lessor accounting*. Also refer to section 3.7 *Initial direct costs*.

For lessees, lease payments are discounted using the interest rate implicit in the lease as described above if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses the incremental borrowing rate.

The term readily determinable is not equivalent to estimable. Therefore, when the interest rate implicit in the lease can only be determined by using estimates and/or assumptions, then the interest rate implicit in the lease is not readily determinable.

The lessee's incremental borrowing rate is the rate of interest that the lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

In determining the incremental borrowing rate, the lessee considers borrowings with a similar term and security to the right-of-use asset, not the underlying asset. For example, in the case of a five-year property lease, the lessee considers borrowings with a similar term to the five year right-of-use asset, not the property itself, which may have a significantly longer life. Observable rates, such as a property yield can be used as a starting point to determine the incremental borrowing rate, but adjustments need to be considered for an asset with a value similar to the right-of-use asset. Other potential sources of adjustment may include the credit profile of the lessee, the borrowing currency, or the length of the lease term. It is likely that in some cases significant judgement will be needed to determine the incremental borrowing rate.

Market interest rates, particularly risk-free rates, can be negative. IFRS 16 does not contain a floor of zero for the discount rate and therefore it is possible that a lessee's incremental borrowing rate could be below zero. However, as stated above, observable borrowings with negative nominal interest rates may be a starting point and entities will need to consider all potential sources of adjustment (e.g., its own credit rating, lease term, currency) to determine its own incremental borrowing rate.

In certain cases, particularly for high value assets, the incremental borrowing rate may be lower than the lessee would expect the lessor's interest rate implicit in the lease to be, because the lessor is exposed to the residual value risk of the

asset at the end of the lease term. This asset risk premium is not adjusted for as it does not meet the definition of the incremental borrowing rate in IFRS 16.

As explained above, the lessee's incremental borrowing rate reflects the rate of interest that a lessee would have to pay, among others, in a similar economic environment. This is generally a nominal discount rate. If the contract requires lease payments to be made in a currency other than the functional currency of the lessee, the incremental borrowing rate of the lessee should be determined based on a borrowing of a similar amount in that foreign currency. Leases denominated in a foreign currency are discussed further at 4.6.2 below.

In June and September 2019, the IFRS Interpretations Committee discussed whether a lessee's incremental borrowing rate is required to reflect the interest rate on a loan with both a similar maturity to the lease and a similar payment profile to the lease. Specifically, whether an entity should use the interest rate for an amortising loan (whereby the principal and interest are paid down over time) or the interest rate for a bullet repayment loan, (whereby the interest is paid over time with a single bullet payment of the principal at the end of the loan). Interest rates for bullet repayment loans are often higher than those for amortising loans.

The Committee noted that the lessee's incremental borrowing rate is a lease-specific rate that the Board defined 'to take into account the terms and conditions of the lease.'<sup>2</sup> The definition of a lessee's incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate on a loan with a similar payment profile to the lease payments. Nonetheless, the Committee observed that it would be consistent with the Board's objective (when developing the definition of incremental borrowing rate) for a lessee to refer, as a starting point, to a readily observable rate for a loan with a similar payment profile to that of the lease. The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for a lessee to determine its incremental borrowing rate and decided not to add the matter to its standard-setting agenda.

Given the lack of prescriptive guidance, we believe that the use of an amortising loan rate that has a similar payment profile to the lease is always acceptable. The use of other rates (e.g., bullet loan rates) may also be acceptable depending on the facts and circumstances (e.g., when the use of such rates aligns with the lessee's normal borrowing practices).

### How we see it

The interest rate implicit in the lease is not necessarily the rate stated in the contract and reflects, among other things, the lessor's initial direct costs and estimates of residual value. Therefore, lessees may find it difficult to determine the interest rate implicit in the lease, in which case, they will need to determine the incremental borrowing rate.

#### ***3.6.1 Determination of the incremental borrowing rate by a subsidiary with centralised treasury functions***

Some groups maintain centralised treasury functions and all funding requirements for the group are managed by the parent entity. Under IFRS 16, subsidiaries participating in a centralised treasury function cannot default to their parent's incremental borrowing rate. Rather, all facts and circumstances should be considered to determine the subsidiary/lessee's incremental borrowing rate. The existence of guarantees of the subsidiary's obligations

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<sup>2</sup> IFRS 16 Basis for Conclusions paragraph BC162.

may result in a rate that is similar to the parent's rate as if the parent had entered into the lease directly.

### 3.6.2 Reassessment of the discount rate

Refer to sections 3.5.9 *Reassessment of the lease liability* and 4.5 *Lease modifications*.

## 3.7 Initial direct costs

### Extract from IFRS 16

69 Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

#### Appendix A

#### Defined terms

#### Initial direct costs

Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.

Initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained.

Under IFRS 16, initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained (e.g., commissions, certain payments made to an existing lessee to incentivise that lessee to terminate its lease). Lessees and lessors apply the same definition of initial direct costs. The requirements under IFRS 16 for initial direct costs are consistent with the concept of incremental costs in IFRS 15. Under IAS 17, initial direct costs are incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors.

### How we see it

The revised definition of initial direct costs could result in some changes in practice for lessors. In addition to excluding allocated costs (e.g., salaries), which are excluded under IAS 17, lessors' initial direct costs also exclude costs that are incurred regardless of whether the lease is obtained (e.g., certain legal advice).

#### **3.7.1 Lessor accounting for initial direct costs**

IFRS 16 requires lessors, other than manufacturer or dealer lessors, to include initial direct costs in the initial measurement of their net investments in finance leases and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease and they are not added separately. Initial direct costs related to finance leases incurred by manufacturer or dealer lessors are expensed at lease commencement.

IFRS 16 requires lessors to include initial direct costs in the carrying amount of the underlying asset in an operating lease. These initial direct costs are recognised as an expense over the lease term on the same basis as lease income.

#### **3.7.2 Lessee accounting for initial direct costs**

IFRS 16 requires lessees to include their initial direct costs in their initial measurement of the right-of-use asset.

### How we see it

Certain costs associated with acquiring an asset within the scope of IAS 16 are required to be capitalised upon initial recognition. However, IFRS 16 does not address the accounting for lessees' costs incurred directly attributable to bringing a right-of-use asset to the location and condition necessary for it to be capable of operating in the manner intended by management. To the extent that costs related to acquiring a right-of-use asset are not subject to capitalisation under other IFRS (e.g. IAS 16), it remains to be seen in practice whether they are charged to profit or loss when incurred or capitalised by analogy to IAS 16. For example, a lessee may incur costs when leasing an asset, by paying a third party to ship the asset, prepare the site and install the underlying asset. We believe lessees may analogise to IAS 16 to determine if such costs can be capitalised.

### 3.8 Economic life

#### Extract from IFRS 16

##### Appendix A

##### Defined terms

##### Economic life

Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

### 3.9 Fair value

#### Extract from IFRS 16

##### Appendix A

##### Defined terms

##### Fair value

For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The definition of fair value for lessors is the same as the definition of fair value in IAS 17. This is a result of the IASB's decision to substantially carry forward the lessor accounting model in IAS 17.

## 4. Lessee accounting

### 4.1 Initial recognition

#### Extract from IFRS 16

##### Appendix A

##### Defined terms

##### Short term lease

A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.

5 A lessee may elect not to apply the requirements in paragraphs 22-49 to:

- (a) *short-term leases*; and
- (b) leases for which the *underlying asset* is of low value (as described in paragraphs B3-B8).

6 If a lessee elects not to apply the requirements in paragraphs 22-49 to either short-term leases or leases for which the underlying asset is of low value, the lessee shall recognise the *lease payments* associated with those leases as an expense on either a straight-line basis over the *lease term* or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

7 If a lessee accounts for short-term leases applying paragraph 6, the lessee shall consider the lease to be a new lease for the purposes of this Standard if:

- (a) there is a *lease modification*; or
- (b) there is any change in the lease term (for example, the lessee exercises an option not previously included in its determination of the lease term).

8 The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The election for leases for which the underlying asset is of low-value can be made on a lease-by-lease basis.

**22 At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability.**

IFRS 16 requires lessees to recognise a liability to make lease payments and an asset representing the right to use the underlying asset (i.e., the right-of-use asset) during the lease term for all leases, except for short-term leases (refer to section 4.1.1 *Short-term leases*) and leases of low-value assets (refer to section 4.1.2 *Leases of low-value assets*) if they choose to apply such exemptions. The short-term lease and leases of low-value assets accounting policy elections are intended to reduce the cost and complexity of applying IFRS 16. However, a lessee that makes such elections must make certain quantitative and qualitative disclosures about short-term leases and leases of low-value assets. Refer to section 4.8 *Disclosure*.

Lessees can make an accounting policy election (by class of underlying asset) not to recognise right-of-use assets and lease liabilities for short-term leases.

#### 4.1.1 Short-term leases

A short-term lease is defined as a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset.

The short-term lease exemption can be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations.

A lessee that makes this accounting policy election does not recognise a lease liability or right-of-use asset on its balance sheet. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis. The lessee is required to apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

When determining whether a lease qualifies as a short-term lease, a lessee evaluates the lease term in the same manner as all other leases. Refer to section 3.4 *Lease term and purchase options*. That is, the lease term includes the non-cancellable term of the lease, periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. As the determination is made at commencement date, a lease cannot be classified as short-term if the lease term is subsequently reduced to less than 12 months. In addition, to qualify as a short-term lease, the lease cannot include an option to purchase the underlying asset.

A lease that qualifies as a short-term lease at the commencement is a new lease if there is a lease modification or a change in a lessee's assessment of the lease term (e.g., the lessee exercises an option not previously included in the determination of the lease term). The new lease is evaluated to determine whether it qualifies for the short-term exemption, similar to any other new lease.

The short-term lease accounting policy election is intended to reduce the cost and complexity of applying IFRS 16. However, a lessee that makes the election must make certain quantitative and qualitative disclosures about short-term leases. Refer to section 4.8 *Disclosure*.

Once a lessee establishes a policy for a class of underlying assets, all future short-term leases for that class are required to be accounted for in accordance with the lessee's policy. A lessee evaluates any potential change in its accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

#### Illustration 16: Short-term lease

##### Scenario A

A lessee enters into a lease with a nine-month non-cancellable term with an option to extend the lease for four months. The lease does not have a purchase option. At the lease commencement date, the lessee concludes that it is reasonably certain to exercise the extension option because the monthly lease payments during the extension period are significantly below market rates.

*Analysis:* The lease term is greater than 12 months (i.e., 13 months). Therefore, the lessee may not account for the lease as a short-term lease.

#### Illustration 16: Short-term lease (cont'd)

##### Scenario B

Assume the same facts as Scenario A except, at the lease commencement date, the lessee concludes that it is not reasonably certain to exercise the extension option because the monthly lease payments during the optional extension period are at what the lessee expects to be market rates and there are no other factors that would make exercise of the renewal option reasonably certain.

*Analysis:* The lease term is 12 months or less, i.e., nine months. Therefore, the lessee may (subject to its accounting policy, by class of underlying asset) account for the lease under the short-term lease exemption, i.e., it recognises lease payments as an expense on either a straight-line basis over the lease term or another systematic basis and does not recognise a lease liability or right-of-use asset on its balance sheet, similar to an operating lease under IAS 17.

#### 4.1.2 Leases of low-value assets

##### Extract from IFRS 16

B3 Except as specified in paragraph B7, this Standard permits a lessee to apply paragraph 6 to account for leases for which the underlying asset is of low value. A lessee shall assess the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased.

B4 The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the accounting treatment in paragraph 6 regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value.

B5 An underlying asset can be of low value only if:

- (a) the lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and
- (b) the underlying asset is not highly dependent on, or highly interrelated with, other assets.

B6 A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

B7 If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

B8 Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones.



Lessees can also make an election for leases for which the underlying asset is of low value (i.e., low-value assets). This election can be made on a lease-by-lease basis. A lessee that makes this election does not recognise a lease liability or right-of-use asset on its statement of financial position. Instead, the lessee recognises the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

A lessee assesses the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased. The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the exemption regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusion about whether a particular underlying asset is of low-value. At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, of US\$5,000 or less. Examples of low-value assets include desktop and laptop computers, small items of office furniture, telephones and other low-value equipment and excludes cars because a new car would typically not be of low value.

An underlying asset can only be of low-value if both:

- ▶ The lessee can benefit from use of the assets on their own, or together with, other resources that are readily available to the lessee
- ▶ The underlying asset is not dependent on, or highly interrelated with, other assets

For example, an entity may lease a truck for use in its business and the lease includes the use of the tyres attached to the truck. To use the tyres for their intended purpose, they can only be used with the truck and as such, they are dependent on, or highly interrelated with the truck. Therefore, the tyres would not qualify for the low-value asset exemption.

An intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset. Refer to section 6.2 *Intermediate lessor accounting*.

## 4.2 Initial measurement

### 4.2.1 Right-of-use assets

#### Extract from IFRS 16

##### Initial measurement

##### *Initial measurement of the right-of-use asset*

**23 At the commencement date, a lessee shall measure the right-of-use asset at cost.**

24 The cost of the right-of-use asset shall comprise:

- (a) the amount of the initial measurement of the lease liability, as described in paragraph 26;
- (b) any lease payments made at or before the commencement date, less any *lease incentives* received;
- (c) any *initial direct costs* incurred by the lessee; and

### Extract from IFRS 16 (cont'd)

(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

25 A lessee shall recognise the costs described in paragraph 24(d) as part of the cost of the right-of-use asset when it incurs an obligation for those costs. A lessee applies IAS 2 *Inventories* to costs that are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories during that period. The obligations for such costs accounted for applying this Standard or IAS 2 are recognised and measured by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

A lessee initially measures the right-of-use asset at cost, which consists of all of the following:

- ▶ The amount of the initial measurement of the lease liability (refer to section 4.2.2 *Lease liabilities*)
- ▶ Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor (refer to section 3.5.2 *Lease incentives*)
- ▶ Any initial direct costs incurred by the lessee (refer to section 3.7 *Initial direct costs*)
- ▶ An estimate of the costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which the underlying asset is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories

On initial measurement, a lessee is required to recognise dismantling, removal and restoration costs as part of the right-of-use asset. Costs may be incurred at lease commencement or during a particular period as a consequence of having used an underlying asset. Costs that are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories are accounted for under IAS 2 *Inventories*. The liability associated with dismantling, removal and restoration costs is recognised and measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

In certain retail property leases, a lessee may sign a lease contract with a lessor and also make a payment to the existing lessee in return for vacating the property. This is sometimes referred to as key money. The existing lessee is released from all obligations under the lease contract with the lessor (i.e., this is not a sublease arrangement). The new lessee also has the right to transfer its rights and obligations in the lease contract to another party in exchange for payment, which would also release the new lessee from all obligations with the lessor. On initial recognition of the lease contract, the payment to the previous lessee is accounted for as an initial direct cost and is included in the measurement of the ROU asset. The payment is not in the scope of IAS 38 *Intangible Assets*. The new lessee applies the requirements described in section 4.3.1 below to the subsequent measurement of the right-of-use asset.

## 4.2.2 Lease liabilities

### Extract from IFRS 16

#### *Initial measurement of the lease liability*

**26** At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. 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*.

**27** At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- (a) *fixed payments* (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;
- (b) *variable lease payments* that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);
- (c) amounts expected to be payable by the lessee under *residual value guarantees*;
- (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs B37-B40); and
- (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease

At the commencement date, a lessee initially measures the lease liability at the present value of the lease payments to be made over the lease term. Lessees apply the concepts previously described in sections 2 and 3 to identify the lease components and to determine the lease term, lease payments and discount rate as of the commencement date of the lease.

## 4.3 Subsequent measurement

### 4.3.1 Right-of-use assets

#### Extract from IFRS 16

#### *Subsequent measurement of the right-of-use asset*

**29** After the commencement date, a lessee shall measure the right-of-use asset applying a cost model, unless it applies either of the measurement models described in paragraphs 34 and 35.

#### **Cost model**

**30** To apply a cost model, a lessee shall measure the right-of-use asset at cost:

- (a) less any accumulated depreciation and any accumulated impairment losses; and
- (b) adjusted for any remeasurement of the lease liability specified in paragraph 36(c).

### Extract from IFRS 16 (cont'd)

31 A lessee shall apply the depreciation requirements in IAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset, subject to the requirements in paragraph 32.

32 If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the *useful life* of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the *useful life* of the right-of-use asset or the end of the lease term.

33 A lessee shall apply IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

#### Other measurement models

34 If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in IAS 40.

35 If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

A lessee subsequently measures the right-of-use asset using a cost model, unless it applies one of the other measurement models discussed below.

#### Cost model

When a lessee applies the cost model, the right-of-use asset is subsequently measured at cost less accumulated depreciation and accumulated impairment losses.

A lessee applies the depreciation requirements in IAS 16 in depreciating the right-of-use asset, subject to the following requirements:

If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term, or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee depreciates the right-of-use asset from the commencement date to the end of the useful life of the underlying asset. Otherwise, the lessee depreciates the right-of-use asset from the commencement date to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. The leased asset is depreciated from the commencement date of the lease even if the lessee chooses not to use the asset from the commencement date, for example, because leasehold improvements are being constructed.

Depreciation of the right-of-use asset is recognised in a manner consistent with existing standards for property, plant and equipment. IAS 16 is not prescriptive about the methods of depreciation, mentioning straight line, diminishing balance and units of production as possibilities. The overriding requirement of IAS 16 is that the depreciation charge reflects the pattern of consumption of the benefits the asset brings over its useful life and is applied consistently from period to period.

IAS 16 also requires that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. An entity allocates the amount initially recognised with respect to an item of property, plant and equipment to its significant parts and separately depreciates each such part. For example, as noted in IAS 16, it may be appropriate to depreciate separately the airframe and engines of an aircraft. In many cases, the right-of-use asset will relate to one underlying asset or significant part and so a component approach may not be necessary. However, entities will need to assess whether it should be applied for right-of-use assets that have significant parts with different useful economic lives.

A lessee applies IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

#### **Other measurement models**

If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee also applies the fair value model to right-of-use assets that meet the definition of investment property in IAS 40.

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, the lessee may elect to apply that revaluation model to all the right-of-use assets that relate to that class of property, plant and equipment.

#### **4.3.2 Lease liabilities**

##### **Extract from IFRS 16**

###### *Subsequent measurement of the lease liability*

**36** After the commencement date, a lessee shall measure the lease liability by:

- (a) increasing the carrying amount to reflect interest on the lease liability;
- (b) reducing the carrying amount to reflect the lease payments made; and
- (c) remeasuring the carrying amount to reflect any reassessment or lease modifications specified in paragraphs 39-46, or to reflect revised in-substance fixed lease payments (see paragraph B42).

37 Interest on the lease liability in each period during the lease term shall be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The periodic rate of interest is the discount rate described in paragraph 26, or if applicable the revised discount rate described in paragraph 41, paragraph 43 or paragraph 45(c).

38 After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:

- (a) interest on the lease liability; and
- (b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

The IASB indicated in the Basis for Conclusions (BC182) that a lease liability should be accounted for in a manner similar to other financial liabilities (i.e., on an amortised cost basis). Consequently, the lease liability is accreted using an amount that produces a constant periodic discount rate on the remaining balance of the liability (i.e., the discount rate determined at commencement, as long as

a reassessment requiring a change in the discount rate has not been triggered). Lease payments reduce the lease liability when paid. Refer to sections 3.5.9 *Remeasurement of the lease liability* and 4.5 *Lease modifications*, respectively.

### 4.3.3 Expense recognition

Lessees recognise the following items in expense for leases:

- ▶ Depreciation of the right-of-use asset
- ▶ Interest on the lease liability
- ▶ Variable lease payments that are not included in the lease liability (e.g., variable lease payments that do not depend on an index or rate)
- ▶ Impairment of the right-of-use asset

#### Depreciation of the right-of-use asset and interest on the lease liability

After the commencement date, a lessee recognises depreciation of the right-of-use asset and separately recognises interest on the lease liability.

When a lessee depreciates the right-of-use asset on a straight-line basis, the total periodic expense (i.e., the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the lease liability, interest expense decreases as cash payments are made during the lease term and the lease liability decreases. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the right-of-use asset, results in a front-loaded expense recognition pattern.

#### Variable lease payments

After the commencement date, lessees recognise in profit or loss, any variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occur.

#### Impairment of the right-of-use asset

Lessees' right-of-use assets are subject to existing impairment requirements in IAS 36 *Impairment of Assets*.

If a lessee determines that a right-of-use asset is impaired, it recognises an impairment loss and measures the right-of-use asset at its carrying amount immediately after the impairment. A lessee subsequently depreciates, generally on a straight-line basis, the right-of-use asset from the date of the impairment to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term. However, the depreciation period is the remaining useful life of the underlying asset if the lessee is reasonably certain to exercise an option to purchase the underlying asset or if the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. Refer to section 4.6.1 *Impairment of right-of-use assets*, for additional discussion of impairment of right-of-use assets.

Lessees will generally have a front-loaded expense recognition pattern.

#### 4.3.4 Example – lessee accounting

##### Illustration 17 – Lessee accounting

Entity H (lessee) enters into a three-year lease of equipment. Entity H agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no other elements to the lease payments (e.g., purchase options, lease incentives from the lessor or initial direct costs). The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of approximately 4.235%). Entity H uses its incremental borrowing rate because the interest rate implicit in the lease cannot be readily determined. Entity H depreciates the right-of-use asset on a straight-line basis over the lease term.

*Analysis:* At lease commencement, Entity H would recognise the lease-related asset and liability:

Right-of-use asset	CU33,000	
Lease liability		CU33,000

*To initially recognise the lease-related asset and liability*

The following journal entries would be recorded in the first year:

Interest expense	CU1,398	
Lease liability		CU1,398

*To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)*

Depreciation expense	CU11,000	
Right-of-use asset		CU11,000

*To record depreciation expense on the right-of-use asset (CU33,000 ÷ 3 years)*

Lease liability	CU10,000	
Cash		CU10,000

*To record lease payment*

A summary of the lease contract's accounting (assuming no changes due to reassessment) is, as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		CU10,000	CU12,000	CU14,000
<i>Lease expense recognised</i>				
Interest expense		CU1,398	CU1,033	CU569
Depreciation expense		<u>11,000</u>	<u>11,000</u>	<u>11,000</u>
Total periodic expense		<u>CU12,398</u>	<u>CU12,033</u>	<u>CU11,569</u>
<i>Balance sheet</i>				
Right-of-use asset	CU33,000	CU22,000	CU11,000	–
Lease liability	CU(33,000)	CU(24,398)	CU(13,431)	–

## 4.4 Remeasurement of lease liabilities

### Extract from IFRS 16

39 After the commencement date, a lessee shall apply paragraphs 40-43 to remeasure the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.

40 A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

- (a) there is a change in the lease term, as described in paragraphs 20-21. A lessee shall determine the revised lease payments on the basis of the revised lease term; or
- (b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20-21 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

41 In applying paragraph 40, a lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the date of reassessment, if the interest rate implicit in the lease cannot be readily determined.

42 A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:

- (a) there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee.
- (b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

43 In applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

IFRS 16 requires lessees to remeasure lease liabilities when there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease that was not part of the original terms and conditions of the lease) that is not accounted for as a separate contract. Refer to the section 4.5 *Lease modifications*. Lessees are also required to remeasure lease payments upon a change in any of the following:



- ▶ The lease term (refer to section 3.4.1 *Lease term*)
- ▶ The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset (refer to section 3.4.1.1 *Evaluating lease term and purchase options*)
- ▶ The amounts expected to be payable under residual value guarantees (refer to section 3.5.6 *Amounts expected to be payable under residual value guarantees - lessees only*)
- ▶ Future lease payments resulting from a change in an index or rate (refer to section 3.5.3 *Variable lease payments that depend on an index or rate*)
- ▶ In-substance fixed lease payments (refer to section 3.5.1 *In-substance fixed lease payments*)

Lessees use a revised discount rate when lease payments are updated for a change in the lease term or a revised assessment of a purchase option. The revised discount rate is based on the interest rate implicit in the lease for the remainder of the lease term. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate. Lessees use the original discount rate when lease payments are updated for a change in expected amounts for residual value guarantees and payments dependent on an index or rate, unless the rate is a floating interest rate.

When a lease includes a market rate adjustment (a market rent review), the negotiations between the lessee and the lessor may take some time to complete (the negotiation period). For example, consider a 10-year lease that has a market rate adjustment that applies from the end of year 5. The market rent review negotiations begin during year 5, but are not completed until later in year 6. During year 6, while the negotiation is ongoing, the lessee is required to pay the original contractual lease payments. At the conclusion of the negotiation period (i.e., upon a final determination of the lease payments for year 6 until year 10), the new lease payments apply retrospectively from the beginning of year 6.

In this example, the lessee does not adjust the lease payments at the beginning of year 6 for the expected increase in rent. Rather, any adjustment is recognised as an adjustment to lease payments when the market rent review is finalised and the change in contractual cash flows takes effect.

The accounting for changes in lease payments arising from rent concessions when the lessee applies *Covid-19-Related Rent Concessions - Amendment to IFRS 16 Leases* is dealt with in a separate publication [Applying IFRS: Accounting for covid-19 related rent concessions](#) (updated July 2020).

## 4.5 Lease modifications

### Extract from IFRS 16

#### Appendix A

#### Defined terms

#### Lease modification

A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease.

If a lease is modified (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease), the modified contract is evaluated to determine whether it is or contains a lease. Refer to section 2.1.7 *Reassessment of the contract*. If a lease continues to exist, lease modification can result in:

- ▶ A separate lease. Refer to section 4.5.1 *Determining whether a lease modification results in a separate lease*.
- ▶ A change in the accounting for the existing lease (i.e., not a separate lease). Refer to section 4.5.2, *Lessee accounting for a modification that does not result in a separate lease*.

The exercise of an existing purchase or renewal option or a change in the assessment of whether such options are reasonably certain to be exercised are not lease modifications but can result in the remeasurement of lease liabilities and right-of-use assets. Refer to section 3.5.9 *Remeasurement of the lease liability*.

In April 2020, the IASB issued an educational document explaining how an entity evaluates whether a rent concession constitutes a lease modification. On 28 May 2020, the IASB issued *Covid-19-Related Rent Concessions - Amendment to IFRS 16 Leases* (the amendment). The Board amended the standard to provide a temporary optional relief to lessees from applying IFRS 16 guidance on lease modification accounting for rent concessions arising as a direct consequence of the coronavirus pandemic. Application of the amendment and the accounting consequences that arise from covid-19-related rent concessions are dealt with in a separate publication [Applying IFRS: Accounting for covid-19 related rent concessions \(updated July 2020\)](#).

#### 4.5.1 Determining whether a lease modification results in a separate lease

### Extract from IFRS 16

44 A lessee shall account for a lease modification as a separate lease if both:

- (a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- (b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

A lessee accounts for a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease) as a separate lease (i.e., separate from the original lease) when both of the following conditions are met:

- ▶ The modification increases the scope of the lease by adding the right to use one or more underlying assets.
- ▶ The consideration for the lease increases commensurate with the standalone price for the increase in scope and any adjustments to that stand-alone price reflect the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original lease and a separate new lease. Lessees account for the separate contract that contains a lease in the same manner as other new leases. Refer to IFRS 16's Example 15 that illustrates this concept in section 4.5.3 *Examples – lessees' accounting for lease modifications*.

If either of the conditions are not met, the modified lease is not accounted for as a separate lease. Refer to section 3.5.9 *Remeasurement of the lease liability*.

#### **4.5.2 Lessee accounting for a modification that does not result in a separate lease**

##### **Extract from IFRS 16**

45 For a lease modification that is not accounted for as a separate lease, at the *effective date of the lease modification* the lessee shall:

- (a) allocate the consideration in the modified contract applying paragraphs 13-16;
- (b) determine the lease term of the modified lease applying paragraphs 18-19; and
- (c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

46 For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

- (a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.
- (b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.

For those lease modifications that do not result in a separate lease, lessees allocate the consideration in the contract (refer to section 2.2.3.2 *Allocating the consideration in the contract – lessees*) and remeasure the lease liability (using the lease term of the modified lease and the discount rate (i.e., the interest rate implicit in the lease for the remainder of the lease term if that rate can be readily determined or if not the lessee's incremental borrowing rate) as determined at the effective date of the modification).

For a modification that fully or partially decreases the scope of the lease (e.g., reduces the square footage of leased space), IFRS 16 requires a lessee to decrease the carrying amount of the right-of-use asset to reflect partial or full termination of the lease. Any difference between those adjustments is recognised in profit or loss at the effective date of the modification. Refer to IFRS 16's Examples 17 and 18 in section 4.5.3, *Examples – lessees' accounting for lease modifications*.

For all other lease modifications which are not accounted for as a separate lease, IFRS 16 requires the lessee to recognise the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss. Refer to IFRS 16's Examples 16, 18 and 19 that illustrate this concept in section 4.5.3, *Examples – lessees' accounting for lease modifications*.

In the IASB's view as illustrated in the Basis for Conclusions (BC204), this approach results in accounting outcomes that faithfully represent the substance of a lease modification and closely aligns gain or loss recognition with a corresponding change in the lessee's rights and obligations under the lease. This is because a lease gives rise to both a right-of-use asset and a lease liability. Accordingly, a lease modification can result in a change to the lessee's rights (i.e., a change to the right-of-use asset), a change to the lease liability, or both.

In some cases, the lessee and lessor may agree to a modification to the lease contract that starts at a later date (i.e., the terms of the modification take effect at a date later than the date when both parties agreed to the modification). For example, a lessee enters into a lease arrangement with a lessor to lease an asset for 10 years. At the beginning of year 8, the lessee and lessor agree to a modification to the contract that will take effect from the beginning of year 9.

- ▶ If the modification is an increase in the scope that does not result in a separate lease, the lessee will re-allocate the consideration in the modified contract to each of the existing lease and non-lease components and remeasure the lease liability at the date both parties agreed to the modification (the beginning of year 8).
- ▶ If the modification results in a separate lease component, the lessee will allocate the consideration in the modified contract to each of the existing and new lease and non-lease components at the date both parties agreed to the modification (the beginning of year 8). The lessee will remeasure the lease liability for the existing lease components at that date as well. However, recognition of the lease liability and right-of-use asset for any new lease component occurs at the commencement date of the new lease component (the beginning of year 9).
- ▶ If the modification is a decrease in the scope, the lessee will re-allocate the consideration in the modified contract to each existing lease and non-lease component and remeasure the lease liability and right-of-use asset at the effective date of the modification (the beginning of year 8).

Refer to Appendix D for a summary of lessee reassessment and remeasurement requirements.

#### 4.5.3 Examples - lessees' accounting for lease modifications

##### Extract from IFRS 16 Illustrative Examples

###### **Example 15—Modification that is a separate lease**

*Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease is commensurate with the current market rate for the new 3,000 square metres of office space, adjusted for the discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).*

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

###### **Example 16—Modification that increases the scope of the lease by extending the contractual lease term**

*Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (ie CU100,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7 per cent per annum.*

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on: (a) an eight-year remaining lease term, (b) annual payments of CU100,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified lease liability equals CU597,130. The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is CU346,511. Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (CU250,619) as an adjustment to the right-of-use asset.

## Extract from IFRS 16 Illustrative Examples (cont'd)

### Example 17—Modification that decreases the scope of the lease

*Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are CU50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are CU30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5 per cent per annum.*

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU30,000 and (c) Lessee's incremental borrowing rate of 5 per cent per annum. This equals CU129,884.

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset (ie 2,500 square metres corresponding to 50 per cent of the original right-of-use asset).

50 per cent of the pre-modification right-of-use asset (CU184,002) is CU92,001. Fifty per cent of the pre-modification lease liability (CU210,618) is CU105,309. Consequently, Lessee reduces the carrying amount of the right-of-use asset by CU92,001 and the carrying amount of the lease liability by CU105,309. Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (CU105,309 - CU92,001 = CU13,308) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of CU105,309 and the modified lease liability of CU129,884 (which equals CU24,575) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

### Example 18—Modification that both increases and decreases the scope of the lease

*Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to (a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and (b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is CU150,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum.*

*The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.*

### Extract from IFRS 16 Illustrative Examples (cont'd)

The pre-modification right-of-use asset and the pre-modification lease liability in relation to the lease are as follows.

Year	Lease liability				Right-of-use asset		
	Beginning balance	6% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
1	736,009	44,160	(100,000)	680,169	736,009	(73,601)	662,408
2	680,169	40,810	(100,000)	620,979	662,408	(73,601)	588,807
3	620,979	37,259	(100,000)	558,238	588,807	(73,601)	515,206
4	558,238	33,494	(100,000)	491,732	515,206	(73,601)	441,605
5	491,732	29,504	(100,000)	421,236	441,605	(73,601)	368,004
6	421,236				368,004		

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of: (a) a three-year remaining lease term, (b) annual payments of CU150,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified liability equals CU393,647, of which (a) CU131,216 relates to the increase of CU50,000 in the annual lease payments from Year 6 to Year 8 and (b) CU262,431 relates to the remaining three annual lease payments of CU100,000 from Year 6 to Year 8.

#### Decrease in the lease term

At the effective date of the modification (at the beginning of Year 6), the pre-modification right-of-use asset is CU368,004. Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset for the original 2,000 square metres of office space (ie a remaining three-year lease term rather than the original five-year lease term). The remaining right-of-use asset for the original 2,000 square metres of office space is CU220,802 (ie  $CU368,004 \div 5 \times 3$  years).

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is CU421,236. The remaining lease liability for the original 2,000 square metres of office space is CU267,301 (ie present value of three annual lease payments of CU100,000, discounted at the original discount rate of 6 per cent per annum).

Consequently, Lessee reduces the carrying amount of the right-of-use asset by CU147,202 (CU368,004 - CU220,802), and the carrying amount of the lease liability by CU153,935 (CU421,236 - CU267,301). Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (CU153,935 - CU147,202 = CU6,733) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease liability	CU153,935	
Right-of-use asset		CU147,202
Gain		CU6,733

### Extract from IFRS 16 Illustrative Examples (cont'd)

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7 per cent per annum, which is CU4,870 (CU267,301 - CU262,431), as an adjustment to the right-of-use asset.

Lease liability	CU4,870	
Right-of-use asset		CU4,870

#### Increase in the leased space

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in scope of CU131,216 (i.e., present value of three annual lease payments of CU50,000, discounted at the revised interest rate of 7 per cent per annum) as an adjustment to the right-of-use asset.

Lease liability	CU131,216	
Right-of-use asset		CU131,216

The modified right-of-use asset and the modified lease liability in relation to the modified lease are as follows.

Year	Lease liability				Right-of-use asset		
	Beginning balance	7% interest expense	Lease payment	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
6	393,647	27,556	(150,000)	271,203	347,148	(115,716)	231,432
7	271,203	18,984	(150,000)	140,187	231,432	(115,716)	115,716
8	140,187	9,813	(150,000)	-	115,716	(115,716)	-

### Example 19—Modification that is a change in consideration only

*Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from CU100,000 per year to CU95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum. The annual lease payments are payable at the end of each year.*

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU95,000, and (c) Lessee's incremental borrowing rate of 7 per cent per annum. Lessee recognises the difference between the carrying amount of the modified liability (CU389,519) and the lease liability immediately before the modification (CU421,236) of CU31,717 as an adjustment to the right-of-use asset.



## 4.6 Other lessee matters

### 4.6.1 Impairment of right-of-use assets

#### Extract from IFRS 16

33 A lessee shall apply IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

Lessees' right-of-use assets are subject to existing impairment requirements in IAS 36 *Impairment of Assets*.

IAS 36 requires an impairment indicator analysis at each reporting period. If any indicators are present, the entity is required to estimate the recoverable amount of the asset (or the cash-generating unit (CGU) of which the asset is a part). The entity has to recognise an impairment loss if the recoverable amount of the CGU is less than the carrying amount of the CGU. After an impairment loss is recognised, the adjusted carrying amount of the right-of-use asset would be its new basis for depreciation.

Subsequent reversal of a previously recognised impairment loss needs to be assessed if there is any indication that an impairment loss recognised in prior periods may no longer exist or may have decreased. In recognising any reversal, the increased carrying amount of the asset must not exceed the carrying amount that would have been determined after depreciation, had there been no impairment.

Lessees currently apply the same impairment analysis to assets held under finance leases. This analysis would be new for leases currently accounted for as operating leases and could significantly affect the timing of expense recognition.

#### How we see it

For leases that are not currently on the balance sheet (i.e., leases that are operating leases under IAS 17), the requirement to test right-of-use assets for impairment could accelerate expense recognition (i.e., if an impairment occurs).

### 4.6.2 Leases denominated in a foreign currency

Lessees apply IAS 21 *The Effects of Changes in Foreign Exchange Rates*, to leases denominated in a foreign currency. As they do for other monetary liabilities, lessees remeasure the foreign currency-denominated lease liability using the exchange rate at each reporting date. Any changes to the lease liability due to exchange rate changes are recognised in profit or loss. Because the right-of-use asset is a non-monetary asset measured at historical cost, it is not affected by changes in the exchange rate.

The IASB acknowledged in the Basis for Conclusions (BC199) that this approach could result in volatility in profit or loss from the recognition of foreign currency exchange gains or losses, but it will be clear to users of financial statements that the gains or losses result solely from changes in exchange rates.

### 4.6.3 Portfolio application

#### Extract from IFRS 16

B1 This Standard specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply this Standard to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

IFRS 16 applies to individual leases. However, entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar rolling stock) may face practical challenges in applying the leases model on a lease-by-lease basis. The IASB in the Basis for Conclusions (BC83) acknowledged the concerns and included a practical expedient that allows entities to use a portfolio approach for leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio.

#### How we see it

The IASB decided to include the portfolio approach to be consistent with IFRS 15. A decision to use the portfolio approach would be similar to a decision some entities make today to expense, rather capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

### 4.6.4 Income tax accounting

IFRS 16 could affect lessees' accounting for income taxes. For lessees, IFRS 16 requires recognition of lease-related assets and liabilities and could change the measurement of other lease-related assets and liabilities. These changes affect certain aspects of accounting for income taxes such as the following:

- ▶ Recognition and measurement of deferred tax assets and liabilities
- ▶ Assessment of the recoverability of deferred tax assets

## 4.7 Presentation

#### Extract from IFRS 16

47 A lessee shall either present in the statement of financial position, or disclose in the notes:

- (a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:
  - (i) include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
  - (ii) disclose which line items in the statement of financial position include those right-of-use asset

### Extract from IFRS 16 (cont'd)

(b) lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

48 The requirement in paragraph 47(a) does not apply to right-of-use assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.

49 In the statement of profit or loss and other comprehensive income, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of IAS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss and other comprehensive income.

50 In the statement of cash flows, a lessee shall classify:

- (a) cash payments for the principal portion of the lease liability within financing activities;
- (b) cash payments for the interest portion of the lease liability applying the requirements in IAS 7 *Statement of Cash Flows* for interest paid;
- (c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

Right-of-use assets and lease liabilities are subject to the same considerations as other assets and liabilities in classifying them as current and non-current in the statement of financial position.

The following table summarises how lease-related amounts and activities are presented in lessees' financial statements:

Financial statement	Lessee presentation
<b>Balance sheet</b>	<ul style="list-style-type: none"> <li>▶ Right-of-use assets presented either:                             <ul style="list-style-type: none"> <li>▶ Separately from other assets (e.g., owned assets)</li> <li>▶ Together with other assets as if they were owned, with disclosures of the balance sheet line items that include right-of-use assets and their amounts</li> </ul> </li> <li>▶ Right-of-use assets that meet the definition of investment property are presented as investment property</li> <li>▶ Lease liabilities presented either:                             <ul style="list-style-type: none"> <li>▶ Separately from other liabilities</li> <li>▶ Together with other liabilities with disclosure of the balance sheet line items that include lease liabilities and their amounts</li> </ul> </li> </ul>
<b>Statement of profit or loss</b>	Lease-related depreciation and lease-related interest expense are presented separately (i.e., lease-related depreciation and lease-related interest expense cannot be combined). Interest expense on the lease liability is a component of finance costs.

Financial statement	Lessee presentation
Statement of cash flows	<ul style="list-style-type: none"> <li>▶ Cash payments for the principal portion of the lease liability are presented within financing activities</li> <li>▶ Cash payments for the interest portion of the lease liability are presented based on an accounting policy election in accordance with IAS 7 <i>Statement of Cash Flows</i></li> <li>▶ Lease payments for short-term leases and leases of low-value assets not recognised on the balance sheet and variable lease payments not included in the lease liability are presented within operating activities</li> <li>▶ Non-cash activity (e.g., the initial recognition of the lease at commencement) is disclosed as a supplemental non-cash item</li> </ul>

## 4.8 Disclosure

### 4.8.1 Disclosure objective

#### Extract from IFRS 16

##### Disclosure

51 The objective of the disclosures is for lessees to 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. Paragraphs 52–60 specify requirements on how to meet this objective.

The objective of lessee disclosures is to enable financial statement users to assess the effect that leases have on a lessee's financial statements (e.g., the amount, timing and uncertainty of cash flows arising from leases). In accordance with the Basis for Conclusions (BC215), the IASB believes that if a lessee is required to assess whether the overall quality and informational value of its lease disclosures are sufficient to meet the stated objective, the lessees' interpretation and implementation of the disclosure requirements will be improved.

IFRS 16 requires lessees to present all disclosures in a single note or separate section in the financial statements. In accordance with the Basis for Conclusions (BC228), the IASB believes this will often be the most effective way to present information about leases in the manner required by paragraph 113 of IAS 1 *Presentation of Financial Statements*.

#### 4.8.2 Disclosures of assets, liabilities, expenses and cash flows

IFRS 16 includes the following disclosure requirements for lessees:

##### Extract from IFRS 16

53 A lessee shall disclose the following amounts for the reporting period:

- (a) depreciation charge for right-of-use assets by class of underlying asset;
- (b) interest expense on lease liabilities;
- (c) the expense relating to short-term leases accounted for applying paragraph 6. This expense need not include the expense relating to leases with a lease term of one month or less;
- (d) the expense relating to leases of low-value assets accounted for applying paragraph 6. This expense shall not include the expense relating to short-term leases of low-value assets included in paragraph 53(c);
- (e) the expense relating to variable lease payments not included in the measurement of lease liabilities;
- (f) income from subleasing right-of-use assets;
- (g) total cash outflow for leases;
- (h) additions to right-of-use assets;
- (i) gains or losses arising from sale and leaseback transactions; and
- (j) the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

54 A lessee shall provide the disclosures specified in paragraph 53 in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.

55 A lessee shall disclose the amount of its lease commitments for short-term leases accounted for applying paragraph 6 if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed applying paragraph 53(c) relates.

56 If right-of-use assets meet the definition of investment property, a lessee shall apply the disclosure requirements in IAS 40. In that case, a lessee is not required to provide the disclosures in paragraph 53(a), (f), (h) or (j) for those right-of-use assets.

57 If a lessee measures right-of-use assets at revalued amounts applying IAS 16, the lessee shall disclose the information required by paragraph 77 of IAS 16 for those right-of-use assets.

58 A lessee shall disclose a maturity analysis of lease liabilities applying paragraphs 39 and B11 of IFRS 7 *Financial Instruments: Disclosures* separately from the maturity analyses of other financial liabilities.

Lessees are required to disclose the following information, which users of financial statements identified as being most useful to their analyses:

- ▶ Carrying amount of right-of-use assets and depreciation charge for those assets, split by class of underlying asset

- ▶ Interest expense on lease liabilities
- ▶ Short-term lease expense for such leases with a lease term greater than one month
- ▶ Low-value asset lease expense (except for portions related to short-term leases)
- ▶ Variable lease expense (i.e., for variable lease payments not included in the lease liability)
- ▶ Income from subleasing right-of-use assets
- ▶ Total cash outflow for leases
- ▶ Additions to right-of-use assets
- ▶ Gains and losses arising from sale and leaseback transactions
- ▶ Carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset

All of the above disclosures are required to be presented in tabular format, unless another format is more appropriate. The amounts disclosed include costs that a lessee has included in the carrying amount of another asset during the reporting period.

Lessees also are required to disclose a maturity analysis of lease liabilities in accordance with paragraphs 39 and B11 of IFRS 7 *Financial Instruments: Disclosures*. Lessees are required to disclose this maturity analysis separately from the maturity analyses of other financial liabilities. In accordance with the Basis for Conclusions (BC222), the IASB believes that because the lessee accounting model is based on the premise that a lease liability is a financial liability, it is appropriate for lessees to apply the same maturity analysis disclosure requirements to lease liabilities as to those applied to other financial liabilities.

A lessee is required to disclose the amount of its lease commitments for short-term leases when short-term lease commitments at the end of the reporting period are dissimilar to same period's short-term lease expense (that is otherwise required to be disclosed).

A lessee is not required to provide the disclosures required in IFRS 16.53(a), (f), (h) or (j) for right-of-use assets that meet the definition of investment property. Instead, a lessee applies the disclosure requirements in IAS 40.

If a lessee measures right-of-use assets at revalued amounts when applying IAS 16, the lessee is required to disclose the information required by IAS 16.77 for those right-of-use assets.

### How we see it

IFRS 16 requires disclosure of the total cash outflow for leases. It does not explicitly state that leases of low-value assets and short-term leases are excluded. Therefore, we believe the cash outflows related to those leases should be included in the disclosure.

### 4.8.3 Additional disclosures

#### Extract from IFRS 16

59 In addition to the disclosures required in paragraphs 53–58, a lessee shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 51 (as described in paragraph B48). This additional information may include, but is not limited to, information that helps users of financial statements to assess:

- (a) the nature of the lessee's leasing activities;
- (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 (as described in paragraph B49);
  - (ii) extension options and termination options (as described in paragraph B50);
  - (iii) residual value guarantees (as described in paragraph B51); and
  - (iv) leases not yet commenced to which the lessee is committed.
- (c) restrictions or covenants imposed by leases; and
- (d) sale and leaseback transactions (as described in paragraph B52).

60 A lessee that accounts for short-term leases or leases of low-value assets applying paragraph 6 shall disclose that fact.

In providing additional information, lessees are required to consider:

- (a) Whether that information is relevant to users of financial statements. The additional information specified above is included only if that information is expected to be relevant to users of financial statements. In this context, this is likely to be the case if it helps those users to understand:
  - (i) The flexibility provided by leases. Leases may provide flexibility if, for example, a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions
  - (ii) Restrictions imposed by leases. Leases may impose restrictions, for example, by requiring the lessee to maintain particular financial ratios
  - (iii) Sensitivity of reported information to key variables. Reported information may be sensitive to, for example, future variable lease payments
  - (iv) Exposure to other risks arising from leases
  - (v) Deviations from industry practice. Such deviations may include, for example, unusual or unique lease terms and conditions that affect a lessee's lease portfolio
- (b) Whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements

Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective 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
- (d) Other operational and financial effects of variable lease payments

Additional information relating to extension options or termination options that, depending on the circumstances, may be needed to satisfy the disclosure objective could include information that helps users of financial statements to assess, for example:

- (a) The lessee's reasons for using extension options or termination options and the prevalence of those options
- (b) The relative magnitude of optional lease payments to lease payments
- (c) The prevalence of the exercise of options that were not included in the measurement of lease liabilities
- (d) Other operational and financial effects of those options

Optional lease payments are payments made by a lessee to a lessor for the right to use an underlying asset during periods covered by an option to extend or terminate a lease that are not included in the lease term.

Additional information relating to residual value guarantees that, depending on the circumstances, may be needed to satisfy the disclosure objective could include information that helps users of financial statements to assess, for example:

- (a) The lessee's reasons for providing residual value guarantees and the prevalence of those guarantees
- (b) The magnitude of a lessee's exposure to residual value risk
- (c) The nature of underlying assets for which those guarantees are provided
- (d) Other operational and financial effects of those guarantees

#### **4.8.4 Disclosures required by IAS 1**

In addition to the disclosure requirements under IFRS 16 described above, an entity is required to make disclosures in accordance with IAS 1 *Presentation of Financial Statements*.

An entity is required to disclose its significant accounting policies comprising:

- (a) the measurement basis (or bases) used in preparing the financial statements; and
- (b) the other accounting policies used that are relevant to an understanding of the financial statements.

An entity discloses, along with its significant accounting policies or other notes, the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. An entity also discloses information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes include details of:



- (a) their nature, and
- (b) their carrying amount as at the end of the reporting period.

There are a number of judgements and estimates that entities may make in applying IFRS 16, which may require disclosure in accordance with IAS 1. These include, but are not limited to, application of the definition of a lease, determination of the lease term and determination of the incremental borrowing rate.

IFRS 16 substantially carries forward the lessor accounting model in IAS 17.

## 5. Lessor accounting

IFRS 16 substantially carries forward the lessor accounting model in IAS 17. The significant differences between the lessor accounting requirements in IFRS 16 and those in IAS 17 are primarily a consequence of decisions reached about the lessee accounting model in IFRS 16. IFRS 16 does change certain aspects of the lessor accounting model, including changes to the accounting for subleases, initial direct costs and lessor disclosures.

### 5.1 Lease classification

#### Extract from IFRS 16

**61** A lessor shall classify each of its leases as either an *operating lease* or a *finance lease*.

**62** A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

**B53** The classification of leases for lessors in this Standard is based on the extent to which the lease transfers the risks and rewards incidental to ownership of an underlying asset. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. Rewards may be represented by the expectation of profitable operation over the underlying asset's economic life and of gain from appreciation in value or realisation of a residual value.

**B54** A lease contract may include terms and conditions to adjust the lease payments for particular changes that occur between the inception date and the commencement date (such as a change in the lessor's cost of the underlying asset or a change in the lessor's cost of financing the lease). In that case, for the purposes of classifying the lease, the effect of any such changes shall be deemed to have taken place at the inception date.

At inception, lessors classify all leases as finance leases or operating leases. Lease classification determines how and when a lessor recognises lease income and what assets are recorded. The criteria used for lease classification is the same as in IAS 17 and are discussed in detail below.

#### 5.1.1 Criteria for lease classification

The classification of leases in IFRS 16 has not changed from IAS 17. Classification is based on the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee. It depends on the substance of the transaction rather than the form of the contract. IFRS 16 lists a number of examples that individually, or in combination, would normally lead to a lease being classified as a finance lease:

- ▶ The lease transfers ownership of the asset to the lessee by the end of the lease term
- ▶ The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised

- ▶ The lease term is for the major part of the economic life of the asset even if title is not transferred
- ▶ At the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the asset
- ▶ The asset is of such a specialised nature that only the lessee can use it without major modifications

IFRS 16 does not provide quantitative indicators or thresholds for the assessment of the terms “major part” and “substantially all” to determine that a lease should be classified as a finance lease rather than as an operating lease. Under IFRS 16, entities apply qualitative, rather than quantitative, assessments to determine whether the risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Accordingly, assessing whether a lease term is for the major part of the economic life of an asset or whether the present value of the lease payments amounts to at least substantially all of the fair value of a leased asset is a matter of judgement.

In addition, IFRS 16 lists the following indicators of situations that, individually or in combination, could also lead to a lease being classified as a finance lease:

- ▶ If the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee
- ▶ Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (e.g., in the form of a rent rebate that is equal to most of the sale proceeds at the end of the lease)
- ▶ The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent

In our view, other considerations that could be made in determining the economic substance of the lease arrangement include the following:

- ▶ Are the lease rentals based on a market rate for use of the asset (which would indicate an operating lease) or a financing rate for use of the funds, which would be indicative of a finance lease?
- ▶ Is the existence of put and call options a feature of the lease? If so, are they exercisable at a predetermined price or formula (indicating a finance lease) or are they exercisable at the market price at the time the option is exercised (indicating an operating lease)?

### **5.1.2 Lease classification test for land and buildings**

For a lease that includes both land and buildings elements, the lessor separately assesses the classification of each element as a finance lease or an operating lease, noting that land normally has an indefinite economic life. The lessor allocates lease payments between the land and the buildings elements in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case, the entire lease is classified as an operating lease.

For a lease of land and buildings in which the amount for the land element is immaterial to the lease, the lessor may treat the land and buildings as a single unit for the purpose of lease classification and classify it as a finance lease or an operating lease. In such a case, the lessor regards the economic life of the buildings as the economic life of the entire underlying asset.

### 5.1.3 Residual value guarantees included in the lease classification test

In evaluating IFRS 16's lease classification criteria, lessors are required to include in the 'substantially all' test any (i.e., the maximum obligation) residual value guarantees provided by both lessees and any other third party unrelated to the lessor.

### 5.1.4 Reassessment of lease classification

#### Extract from IFRS 16

66 Lease classification is made at the inception date and is reassessed only if there is a lease modification. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the underlying asset), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

Lessors are required to reassess the lease classification only if there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease). Lessors reassess lease classification as at the effective date of the modification using the modified conditions at that date. If a lease modification results in a separate new lease, that new lease would be classified in the same manner as any new lease.

Refer to section 5.5 *Lease modifications*. Also refer to Appendix D for a summary of lessor reassessment and remeasurement requirements.

## 5.2 Key concepts applied by lessor

#### Extract from IFRS 16

##### Appendix A

##### Defined terms

##### Gross investment in the lease

The sum of:

- (a) the **lease payments** receivable by a **lessor** under a **finance lease**; and
- (b) any **unguaranteed residual value** accruing to the lessor.

##### Net investment in the lease

The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.

##### Unguaranteed residual value

That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.

At lease commencement, lessors apply the key concepts described in section 3 such as determining the initial direct costs, lease term, lease payments, fair value of the underlying asset and the interest rate implicit in the lease. Lessors also apply the following lessor accounting concepts to recognise and measure their leases.

### Gross investment in the lease

The lessor's gross investment in the lease consists of the following undiscounted amounts:

- ▶ Lease payments receivable by the lessor under a finance lease. Refer to section 3.5 *Lease payments*.
- ▶ Any unguaranteed residual value accruing to the lessor - the unguaranteed residual value is the portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.

### Net investment in the lease

A lessor's net investment in a finance lease consists of the gross investment in the lease discounted at the interest rate implicit in the lease.

## 5.3 Finance leases

### 5.3.1 Initial recognition and measurement

#### Extract from IFRS 16

#### Recognition and measurement

**67** At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the *net investment in the lease*.

#### *Initial measurement*

**68** The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. In the case of a sublease, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease.

**69** Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

#### Initial measurement of the lease payments included in the net investment in the lease

**70** At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:

- (a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives payable;

### Extract from IFRS 16 (cont'd)

- (b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;
- (c) any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee;
- (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraph B37); and
- (e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

### Illustration 18 - The lessor's gross and net investment in the lease

Details of a non-cancellable lease are, as follows:

- ▶ The asset has a fair value of CU10,000
- ▶ The lessee is required to make five annual rentals payable in advance of CU2,100
- ▶ The unguaranteed estimated residual value at the end of five years is CU1,000.

The lessor's direct costs have been excluded for simplicity.

The interest rate implicit in the lease is that which gives a present value of CU10,000 for

the five rentals plus the total estimated residual value at the end of year 5. This rate is 6.62%.

Year	Net investment in the lease		Finance income (6.62% per annum)	Gross investment at end of period	Gross earnings allocated to future periods		Receivable at end of period
	at start of period	Rental received			CU	CU	
1	10,000	2,100	523	9,400	977	8,423	
2	8,423	2,100	419	7,300	558	6,742	
3	6,742	2,100	307	5,200	251	4,949	
4	4,949	2,100	189	3,100	62	3,038	
5	3,038	2,100	62	1,000	-	1,000	
		<u>10,500</u>	<u>1,500</u>				

The lessor's gross investment in the lease is the total rents receivable of CU10,500 and the unguaranteed residual value of CU1,000. The gross earnings are therefore CU1,500.

The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value, e.g., at the end of year 2, the gross investment of CU7,300 is three years' rental of CU2,100 plus the unguaranteed residual of CU1,000. The net investment, which is the amount at which the debtor will be recorded in the statement of financial position, is CU7,300 less the earnings allocated to future periods of CU558 = CU6,742.

At lease commencement, a lessor accounts for a finance lease, as follows:

- ▶ Derecognises the carrying amount of the underlying asset
- ▶ Recognises the net investment in the lease
- ▶ Recognises, in profit or loss, any selling profit or selling loss

For finance leases (other than those involving manufacturer and dealer lessors), initial direct costs are included in the initial measurement of the finance lease receivable. Initial direct costs are included in the interest rate implicit in the lease and are not added separately.

The net investment in the lease is initially measured as the sum of: (1) the present value of both the lease payments (section 3.5 *Lease payments*); and (2) the present value of the unguaranteed residual asset, both discounted using the interest rate implicit in the lease (section 3.6 *Discount rates*). Any selling profit or loss is measured as the difference between the fair value of the underlying asset or the lease receivable, if lower, and the carrying amount of the underlying asset, net of any unguaranteed residual asset.

### 5.3.2 Manufacturer or dealer lessors

#### Extract from IFRS 16

71 At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:

- (a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;
- (b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the *unguaranteed residual value*; and
- (c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which IFRS 15 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15.

72 Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts.

73 Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged.

74 A manufacturer or dealer lessor shall recognise as an expense costs incurred in connection with obtaining a finance lease at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit. Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

If a manufacturer or dealer lessor quotes artificially low rates of interest, the selling profit is restricted to that which would apply if a market rate of interest were charged.

At the commencement date, a manufacturer or dealer lessor recognises selling profit or loss in accordance with its policy for outright sales to which IFRS 15 applies.

Therefore, at lease commencement, a manufacturer or dealer lessor recognises the following:

- ▶ The fair value of the underlying asset as revenue (or if lower, the present value of the lease payments discounted using a market rate of interest)
- ▶ The cost (or carrying amount) of the asset less the present value of the unguaranteed residual value, as cost of sale
- ▶ The selling profit or loss in accordance with the policy for outright sales. A manufacturer or dealer lessor recognises selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15

Costs incurred by a manufacturer or dealer lessor in connection with obtaining a finance lease are recognised as an expense at the commencement date and are excluded from the net investment in the lease because they are mainly related to earning the manufacturer or dealer's selling profit.

#### Illustration 19 - Manufacturer or dealer lessors

A company manufactures specialised machinery. The company offers customers the choice of either buying or leasing the machinery. A customer chooses to lease the machinery. Details of the arrangement are, as follows:

- (i) The lease commences on 1 January 20X1 and lasts for three years.
- (ii) The lessee is required to make three annual rentals payable in arrears of CU57,500.
- (iii) The leased machinery is returned to the lessor at the end of the lease.
- (iv) The fair value of the machinery is CU150,000, which is equivalent to the selling price of the machinery.
- (v) The machinery cost CU100,000 to manufacture. The lessor incurred costs of CU2,500 to negotiate and arrange the lease.
- (vi) The expected useful life of the machinery is 3 years. The machinery has an expected residual value of CU10,000 at the end of year three.
- (vii) The interest rate implicit in the lease is 10.19%.

The lessor classifies the lease as a finance lease.

The cost to the lessor of providing the machinery for lease consists of the book value of the machinery (CU100,000), plus the initial direct costs associated with entering into the lease (CU2,500), less the future income expected from disposing of the machinery at the end of the lease (the present value of the unguaranteed residual value of CU10,000, being CU7,475). This gives a cost of sale of CU95,025.

The lessor records the following entries at the commencement of the lease:

	Debit	Credit
	CU	CU
Net investment in the lease	150,000	
Cost of sales	95,025	
Inventory		100,000
Revenue		142,525
Creditors / cash (initial direct costs)		2,500



**Illustration 19 - Manufacturer or dealer lessors (cont'd)**

The sales profit recognised by the lessor at the commencement of the lease is therefore CU47,500 (CU142,525 - CU95,025). This is equal to the fair value of the machinery of CU150,000, less the book value of the machinery (CU100,000) and the initial direct costs of entering into the lease (CU2,500). Revenue is equal to the lease receivable (CU150,000), less the present value of the unguaranteed residual value (CU7,475).

Lease payments received from the lessee will then be allocated over the lease term, as follows:

Year	Lease receivable at the start of the year (CU)	Lease payments (CU)	Interest income (10.19% per annum) (CU)	Decrease in lease receivable (CU)	Lease receivable at the end of the year (CU)
	(a)	(b)	(c)	(d)=(b)-(c)	(e)=(a)-(d)
1	150,000	57,500	15,280	42,220	107,780
2	107,780	57,500	10,979	46,521	61,260
3	61,260	57,500	6,240	51,260	10,000

The lessor will record the following entries:

		Debit CU	Credit CU
Year 1	Cash	57,500	
	Lease receivable		42,220
	Interest income		15,280
Year 2	Cash	57,500	
	Lease receivable		46,521
	Interest income		10,979
Year 3	Cash	57,500	
	Lease receivable		51,260
	Interest income		6,240

At the end of the three-year lease term, the leased machinery will be returned to the lessor, who will record the following entries:

Inventory	10,000	
Lease receivable		10,000

### 5.3.3 Subsequent measurement

#### Extract from IFRS 16

##### *Subsequent measurement*

**75 A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.**

76 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the *gross investment in the lease* to reduce both the principal and the *unearned finance income*.

After lease commencement, a lessor accounts for a finance lease, as follows:

- ▶ Recognises finance income (in profit or loss) over the lease term in an amount that produces a constant periodic rate of return on the remaining balance of the net investment in the lease (i.e., using the interest rate implicit in the lease). Income is recognised on the components of the net investment in the lease, including:
  - ▶ Interest on the lease receivable
  - ▶ Interest via accretion of the unguaranteed residual asset to its expected value at the end of the lease
- ▶ Reduces the net investment in the lease for lease payments received (net of finance income calculated above)
- ▶ Separately recognises income from variable lease payments that are not included in the net investment in the lease (e.g., performance- or usage-based variable payments) in the period in which that income is earned
- ▶ Recognises any impairment of the net investment in the lease

The question arises as to whether the finance income should be calculated based on the gross lease receivable or the net amount of the lease receivable less any expected credit loss? We believe the staging approach<sup>3</sup> in IFRS 9 *Financial Instruments* can be applied to determine how finance income recognised over the lease term is calculated:

- ▶ On a gross basis (excluding the effect of expected credit losses) for lease receivables in stages 1 or 2 of the expected credit loss model in IFRS 9; and
- ▶ On a net basis (based on the net investment in the lease less expected credit losses) for lease receivables in stage 3 of the expected credit loss model in IFRS 9.

The election (or non-election) of the simplified approach allowed by IFRS 9 does not affect this conclusion.

In the absence of prescriptive guidance in IFRS, entities may apply the above accounting as an accounting policy choice. Alternative approaches may also be acceptable.

Credit losses should be presented separately in the income statement in accordance with paragraph 82 of IAS 1 *Presentation of Financial Statements*.

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<sup>3</sup> IFRS 9, paragraph 5.4.1.

The net investment in the lease should generally be presented net of the loss allowance. However, a separate presentation of the net investment in the lease, gross of the lease allowance and the loss allowance itself may be appropriate when the presentation is relevant to understanding the entity's financial position. For example, where the loss allowance has significantly reduced an otherwise material net investment in the lease.

The following illustration shows how a lessor accounts for a finance lease that gives rise to selling profit;

**Illustration 20 - Lessor accounting for a finance lease (dealer-lessor case)**

Assume Lessor enters into a 10-year lease of equipment with Lessee. The equipment is not specialised in nature and is expected to have alternative use to Lessor at the end of the 10-year lease term. Under the lease:

- ▶ Lessor receives annual lease payments of CU15,000, payable at the end of the year
- ▶ Lessor expects the residual value of the equipment to be CU50,000 at the end of the 10-year lease term
- ▶ Lessee provides a residual value guarantee that protects Lessor from the first CU30,000 of loss for a sale at a price below the estimated residual value at the end of the lease term (i.e., CU50,000)
- ▶ The equipment has an estimated remaining economic life of 15 years, a carrying amount of CU100,000 and a fair value of CU111,000
- ▶ The lease does not transfer ownership of the underlying asset to Lessee at the end of the lease term or contain an option to purchase the underlying asset
- ▶ The interest rate implicit in the lease is 10.078%.

Lessor classifies the lease as a finance lease because the sum of the present value of lease payments amounts to substantially all of the fair value of the underlying asset.

At lease commencement, Lessor accounts for the finance lease, as follows:

*To record the net investment in the finance lease and derecognise the underlying asset:*

Net investment in the lease	CU111,000 <sup>(a)</sup>	
Cost of goods sold	CU92,344 <sup>(b)</sup>	
Revenue		CU103,344 <sup>(c)</sup>
Property held for lease		CU100,000 <sup>(d)</sup>

### Illustration 20 - Lessor accounting for a finance lease (cont'd)

- (a) The net investment in the lease consists of (1) the present value of the 10 annual payments of CU15,000 plus the guaranteed residual value of CU30,000, both discounted at the interest rate implicit in the lease, which equals CU103,344 (i.e., the lease payment) and (2) the present value of unguaranteed residual asset of CU20,000, which equals CU7,656. Note that the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet (refer to section 5.7 *Presentation*)
- (b) Cost of goods sold is the carrying amount of the equipment of CU100,000 less the present value of the unguaranteed residual asset of CU7,656
- (c) Revenue equals the lease receivable
- (d) The carrying amount of the underlying asset

At lease commencement, Lessor recognises selling profit of CU11,000 which is calculated as the lease payment of CU103,344 less the carrying amount of the asset (CU100,000), net of any unguaranteed residual asset (CU7,656), which equals CU92,344.

*Year 1 journal entries for a finance lease:*

Cash	CU15,000 <sup>(e)</sup>	
Net investment in the lease		CU3,813 <sup>(f)</sup>
Interest income		CU11,187 <sup>(g)</sup>

- (e) Receipt of annual lease payments at the end of the year
- (f) Reduction of the net investment in the lease for lease payments received of (CU15,000), net of interest income of CU11,187
- (g) Interest income is the amount that produces a constant periodic discount rate on the remaining balance of the net investment in the lease. See computation below

The following table summarises the interest income from this lease and the related amortisation of the net investment over the lease term:

Year	Annual rental payment	Annual interest income <sup>(h)</sup>	Net investment at end of year
Initial net investment	CU –	CU –	CU111,000
1	15,000	11,187	107,187
2	15,000	10,803	102,990
3	15,000	10,380	98,370
4	15,000	9,914	93,284
5	15,000	9,401	87,685
6	15,000	8,837	81,522
7	15,000	8,216	74,738
8	15,000	7,532	67,270
9	15,000	6,780	59,050
10	15,000	5,950	50,000 <sup>(i)</sup>

- (h) Interest income equals 10.078% of the net investment in the lease at the beginning of each year. For example, Year 1 annual interest income is calculated as CU111,000 (initial net investment) x 10.078%.
- (i) The estimated residual value of the equipment at the end of the lease term.

### 5.3.4 Unguaranteed residual values

Income recognition by lessors can be extremely sensitive to the amount recognised as the asset's residual value. This is because the amount of the residual value directly affects the computation of the amount of finance income earned over the lease term - this is shown in Illustration 21 below. The standard gives no guidance regarding the estimation of unguaranteed residual values, but it does require them to be reviewed regularly. If there has been a reduction in the estimated value, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognised immediately.

#### Illustration 21 - Reduction in residual value

At lease commencement, the lessor accounts for the finance lease, as follows:

Details of a non-cancellable lease are:

- ▶ The asset has a fair value of CU10,00
- ▶ The lessee is required to make five annual rentals payable in advance of CU2,100
- ▶ The unguaranteed estimated residual value at the end of five years is CU1,000.

The lessor's direct costs have been excluded for simplicity.

Year	Receivable at start of period CU	Rental received CU	Finance income (6.62% per annum) CU	Gross investment at end of period CU	Gross earnings allocated to future periods CU	Receivable at end of period CU
1	10,000	2,100	523	9,400	977	8,423
2	8,423	2,100	419	7,300	558	6,742
3	6,742	2,100	307	5,200	251	4,949
4	4,949	2,100	189	3,100	62	3,038
5	3,038	2,100	62	1,000	-	1,000
		<u>10,500</u>	<u>1,500</u>			

The gross investment in the lease at any point in time comprises the aggregate of the rentals receivable in future periods and the unguaranteed residual value, e.g., at the end of year 2, the gross investment of CU7,300 is three years' rental of CU2,100 plus the unguaranteed residual of CU1,000. The net investment, which is the amount that will be recorded in the statement of financial position, is CU7,300 less the earnings allocated to future periods of CU558 = CU6,742. The gross earnings allocated to future periods is the total finance income of CU1,500 less the finance income already recognised.

### Illustration 21 - Reduction in residual value (cont'd)

The lessor concludes at the end of year 2 that the residual value of the asset is only CU500 and revises the income allocation over the lease term accordingly.

Year	Receivable at start of period CU	Rental received CU	Finance income (6.62% per annum) CU	Gross investment at end of period* CU	Gross earnings allocated to future periods CU	Receivable at end of period CU
2	8,423	2,100	419	6,800	471	6,329
3	6,329	2,100	280	4,700	191	4,509
4	4,509	2,100	160	2,600	31	2,569
5	2,569	2,100	31	500	-	500

\* The gross investment in the lease now takes account of the revised unguaranteed residual of CU500, rather than the original CU1,000.

The lessor will have to write off CU413, being the difference between the carrying amount of the receivable and the revised balance above (CU6,742 - CU6,329). This is the present value as at the end of year 2 of CU500 and represents the part of the unguaranteed residual written off.

#### 5.3.5 Remeasurement of the net investment in the lease

After lease commencement, the net investment in a lease is remeasured when the following occurs:

- ▶ The lease is modified (i.e., a change in the scope of the lease, or the consideration for the lease, that was not part of its original terms and conditions) and the modified lease is not accounted for as a separate contract. Refer to section 5.5 *Lease modifications*.
- ▶ The lease term is revised when there is a change in the non-cancellable period of the lease. Refer to section 3.4.2.2 *Reassessment of the lease term and purchase options - lessors*.
- ▶ There is a change in the estimated unguaranteed residual value. Refer to section 5.3.4 *Unguaranteed residual values*.

A lessor includes in its initial measurement of the net investment in the lease, variable lease payments that depend on an index or rate. IFRS 16 is silent on the accounting for any subsequent changes in future cash flows resulting from a change in an index or rate or variable lease payments becoming in-substance fixed. In the absence of further guidance, we believe lessors have an accounting policy choice regarding whether variable lease payments that do not depend on an index or rate are remeasured.

## 5.4 Operating leases

### Extract from IFRS 16

#### Recognition and measurement

81 A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit derived from the use of the underlying asset is diminished.

82 A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense.

83 A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

Under IFRS 16, lessors account for operating leases in a manner similar to the requirements under IAS 17. That is, they continue to recognise the underlying asset and do not recognise a net investment in the lease on the balance sheet or initial profit (if any) on the income statement. The underlying asset continues to be accounted for in accordance with applicable accounting standards (e.g., IAS 16).

Lessors subsequently recognise lease payments over the lease term on either a straight-line basis or another systematic and rational basis if that basis better represents the pattern in which benefit is expected to be derived from the use of the underlying asset. If the lessor pays the lessee an incentive to enter the lease, this is accounted for as described in 3.5.2 *Lease incentives* above. After lease commencement, lessors recognise variable lease payments that do not depend on an index or rate (e.g., performance- or usage- based payments) as they are earned.

IFRS 16 also requires lessors of operating leases to defer initial direct costs at lease commencement and recognise them over the lease term on the same basis as lease income.

Refer to section 3.4.2.2 *Reassessment of the lease term and purchase options-lessors*.

### 5.4.1 Operating lease income

Unlike other standards such as IFRS 15, IFRS 16 does not refer to collectability to determine whether (and when) lease income should be recognised. Therefore, we believe that a lessor may continue to recognise operating lease income even when collectability is not probable. However, other approaches may also be appropriate when there is significant doubt about collectability. Therefore, there could be diversity in practice, and it is important to consider the views of local regulators. Regardless of the approach followed, IFRS 9's guidance on credit losses continues to be applicable to recognised lease receivables.

### Illustration 22 - Operating lease income not expected to be fully collectible

Restaurant A leases space in a shopping mall from Lessor B. Lessor B classifies the lease as an operating lease.

Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2022. The contract does not include any non-lease components, extension, termination or purchase options.

Due to significant financial difficulties, at the end of June, Restaurant A has indicated that it will only pay 25% of the lease receivable due for the month of July 2020. Up to 31 July 2020, CU25 has been collected and Lessor B does not expect the remaining amount of CU75 due in respect of July to be recovered considering Restaurant A's financial condition.

#### *Analysis*

##### *Approach 1 - Recognising the full operating lease income*

Lessor B recognises the full operating lease income on a straight-line basis of CU100 per month in accordance with paragraph 81 of IFRS 16.

Lessor B recognises a lease receivable and an impairment loss of CU75 reflecting the remote likelihood of collection in accordance with IFRS 9.

Under this approach, Lessor B records the following entries

Dr Lease receivable	CU100	
Cr Operating lease income		CU100
To record the operating lease income and lease receivable for July 2020		
Dr Impairment loss on lease receivable	CU75	
Cr Impairment allowance on lease receivable		CU75
To record an impairment loss against the lease receivable		
Dr Cash	CU25	
Cr Lease receivable		CU25
To record receipt of CU25 from the lessee		

##### *Approach 2 - Recognition of operating lease income to the extent collectable*

Under this approach, Lessor B accounts for the monthly lease income to the extent collectable. This approach reflects the high uncertainty related to the collectability of the full lease payments and Lessor B's concerns about the appropriateness of reporting income when the likelihood of collecting the full amount is considered to be remote.

Under this approach, Lessor B records the following entries:

Dr Lease receivable	CU25	
Cr Operating lease income		CU25
To record the operating lease income for July 2020		
Dr Cash	CU25	
Cr Lease receivable		CU25
To record receipt of CU25 from the lessee		



## 5.5 Lease modifications

### Extract from IFRS 16

#### Appendix A

#### Defined terms

#### Lease modification

A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).

If a finance lease is modified (i.e., there is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and condition of the lease), the modified lease is evaluated to determine whether it is or contains a lease. Refer to section 2.1 *Determining whether an arrangement contains a lease*. If a lease continues to exist, a modification to a finance lease may result in:

- ▶ A separate lease (refer to section 5.5.1.1 *Determining whether a lease modification results in a separate lease*)
- ▶ A change in the accounting for the existing lease (i.e., not a separate lease) (refer to section 5.5.1.2 *Lessor accounting for a modification that does not result in a separate lease*)

If an operating lease is modified, it is treated as a new lease from the effective date of the modification. Refer to section 5.5.2 *Modification to an operating lease*.

### 5.5.1 Modifications to a finance lease

#### 5.5.1.1 Determining whether a lease modification results in a separate lease

### Extract from IFRS 16

79 A lessor shall account for a modification to a finance lease as a separate lease if both:

- (a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- (b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

Lessors account for a lease modification to a finance lease as a separate lease (i.e., separate from the original lease) when both of the following conditions are met:

- ▶ The modification increases the scope of the lease by adding the right to use one or more underlying assets.
- ▶ The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

If both of these conditions are met, the lease modification results in two separate leases, the unmodified original finance lease and a separate lease. Lessors account for the separate lease in the same manner as other new leases. If either of the conditions is not met, the lease modification does not result in a separate lease. The accounting for a modification that does not result in a separate lease is discussed further in section 5.5.1.2 *Lessor accounting for a modification that does not result in a separate lease*.

#### **5.5.1.2 Lessor accounting for a modification that does not result in a separate lease**

##### **Extract from IFRS 16**

80 For a modification to a finance lease that is not accounted for as a separate lease, a lessor shall account for the modification as follows:

- (a) if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor shall:
  - (i) account for the lease modification as a new lease from the effective date of the modification; and
  - (ii) measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
- (b) otherwise, the lessor shall apply the requirements of IFRS 9.

Lessors reassess the lease classification at the effective date of a finance lease modification that is not accounted for as a separate contract.

If a finance lease is modified and does not result in a separate lease, lessors account for the modification depending on the classification of the modified lease. If the lease would have been classified as an operating lease had the modification been in effect at the inception date, lessors account for such modifications as the creation of a new lease that commences on the effective date of the modification. The carrying amount of the underlying asset is measured as the net investment in the original lease immediately before the effective date of the modification. Otherwise, the net investment in the lease is accounted for in accordance with IFRS 9 *Financial Instruments*.

Refer to Appendix D for a summary of lease reassessment and remeasurement requirements.

#### **5.5.2 Modification to an operating lease**

##### **Extract from IFRS 16**

87 A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

If an operating lease is modified and the arrangement continues to be or contains a lease, it is treated as a new lease from the effective date of the modification. Accounting for the new lease includes identifying and separating the lease and non-lease components of the contract as discussed in section 2.2 *Identifying and separating lease and non-lease components of a contract and allocating contract consideration*.

Upon modification, the classification criteria is reassessed (refer to 5.1 *Lease classification*). As a result, the new lease may be an operating lease or a finance lease. Any remaining prepaid or accrued lease payments relating to the original lease are included as part of the lease payments for the new lease.

Illustration 23 shows how the modification guidance is applied for a concession that involves the forgiveness of future lease payments.

**Illustration 23 - Forgiveness of future lease payments on an operating lease**

Restaurant A leases space in a shopping mall from Lessor B. Lessor B classifies the lease as an operating lease.

Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2022. The contract does not include any non-lease components, extension, termination or purchase options.

All lease payments due up to 30 June 2020 have been received in a timely manner. On 30 June 2020, in compensation for the closure of the shopping mall, Lessor B agrees to forgive Restaurant A's future lease payments for the months of July, August and September 2020.

*Analysis:*

The rent concession results in a decrease in the total lease payments. Thus, there has been a change in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, the rent concession constitutes a lease modification. The modification does not change the classification of the lease as an operating lease.

- ▶ On the effective date of the modification (i.e., 30 June 2020), Lessor B accounts for the modification as a new lease, as follows:
  - ▶ The remaining lease payments under the modified lease comprise CU1,700 (lease payments of CU100 per month from October 2020 to February 2022).
  - ▶ The remaining lease term is 20 months.

The monthly operating lease income to be recognised over the remaining lease term is therefore  $CU1,700 / 20 \text{ months} = CU85$ .

In some cases, a lessor may forgive past lease payments that are recognised as a lease receivable in an operating lease. The rent concession results in a change in the consideration for the lease that was not part of the original terms of the lease and, therefore, may be viewed as a lease modification. An alternative view may be to consider that the forgiveness of the past lease payments is an extinguishment of the operating lease receivable and the derecognition requirements of IFRS 9 apply. Paragraph 2.1(b)(i) of IFRS 9 clarifies that operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of IFRS 9. When IFRS 9 is applied in these situations, we believe the lessor has an accounting policy choice, to be applied consistently, to either include or exclude the expected forgiveness of lease payments in the ECL assessment of operating lease receivables. The approaches applying IFRS 9 and IFRS 16 are illustrated below.

#### Illustration 24 - Waiver of a lease receivable in an operating lease

Restaurant A leases space in a shopping mall from Lessor B. Lessor B classifies the lease as an operating lease.

Under the terms of the lease, Restaurant A makes fixed lease payments of CU100 to Lessor B at the beginning of each month. The non-cancellable lease term ends on 28 February 2022. The contract does not include any non-lease components, extension, termination or purchase options.

Due to financial difficulties, Restaurant A did not pay the lease payment for June 2020. Consequently, Lessor B recognised, in accordance with IFRS 9, an impairment loss of CU20 on 30 June 2020, which takes into consideration the collateral in the contract.

On 1 July 2020, Lessor B grants a rent concession that waives CU60 of the outstanding amount for June 2020. The remaining amount (CU40) is paid shortly after.

#### *Analysis*

##### *Approach 1- Lease modification under IFRS 16*

The rent concession results in a decrease in the total lease payments and, thus, there has been a change in the consideration for a lease that was not part of the original terms and conditions of the contract. Therefore, the rent concession constitutes a lease modification. Assume the modification does not change the classification of the lease as an operating lease.

Lessor B records the following entries for June 2020:

Dr Lease receivable	CU100
Cr Operating lease income	CU100

To record the operating lease income and lease receivable for June 2020

Dr Impairment loss on lease receivable	CU20
Cr Impairment allowance on lease receivable	CU20

To record an impairment loss against the lease receivable

Paragraph 87 of IFRS 16 requires that a lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

Therefore, at the effective date of the modification (i.e., 1 July 2020), Lessor B accounts for the new lease with a lease term that ends in February 2022. The remaining lease payments after taking into account the partial forgiveness of the June lease payment amount to CU1,940 (CU2,000 - CU60).

Lessor B records the following entries for July 2020:

Dr Lease receivable	CU60
Cr Lease receivable	CU60
Dr Impairment allowance on lease receivable	CU20
Cr Profit/loss	CU20

**Illustration 24 - Waiver of a lease receivable in an operating lease (cont'd)**

To recognise the lease incentive (forgiveness of CU60) to enter into the modified lease and reverse the IFRS 9 allowance recognised in June 2020

Dr Cash	CU40
Cr Lease receivable	CU40

To record receipt of partial payment

Dr Lease receivable	CU100
Cr Operating lease income	CU100
Dr Operating lease income	CU3
Cr Lease incentive	CU3

To recognise July 2020 lease income of CU100 (based on the monthly CU100 payments) less amortisation of the lease incentive of CU3 (CU60 divided by 20 months).

Therefore, operating lease income of CU97 will be recognised each month for the remainder of the new lease term. The IFRS 9 impairment loss of CU20 is written back to profit or loss when the CU60 of the receivable is forgiven.

Under this approach, since the remaining CU40 recognised receivable of the pre-modified lease has already been recognised in income and will be received, it is not carried forward to the new lease.

*Approach 2 - Derecognition of past lease receivable under IFRS 9*

Lessor B records the following entries for June 2020:

Dr Lease receivable	CU100
Cr Operating lease income	CU100

To record the operating lease income and lease receivable for June 2020

Dr Impairment loss on lease receivable	CU20
Cr Impairment allowance on lease receivable	CU20

To record an impairment loss against the lease receivable

Lessor B records the following entries for July 2020:

Dr Impairment allowance on lease receivable	CU20
Dr Derecognition loss on lease receivable	CU40
Cr Lease receivable	CU60

To derecognise the past lease receivable that is forgiven

Under this approach, the forgiveness of the lease receivables that were previously impaired under IFRS 9 does not impact the lease modification accounting. Therefore, the lessor in this illustration would continue to recognise CU100 of lease income over the new lease term (i.e., based on the regular payments of CU100 over the new lease term).

## 5.6 Other lessor matters

### 5.6.1 Impairment of the net investment in the lease

#### Extract from IFRS 16

77 A lessor shall apply the derecognition and impairment requirements in IFRS 9 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

Lessors evaluate their net investment in the lease for impairment by applying the derecognition and impairment requirements in IFRS 9 *Financial Instruments*.

### 5.6.2 Portfolio application

#### Extract from IFRS 16

B1 This Standard specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply this Standard to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

IFRS 16 applies to individual leases. However, entities that have a large number of leases of similar assets (e.g., leases of a fleet of similar rolling stock may face practical challenges in applying the leases model on a lease-by-lease basis). The IASB in the Basis for Conclusions (BC83) acknowledged the concerns and included a practical expedient that allows entities to use a portfolio approach to leases with similar characteristics if the entity reasonably expects that the effects on the financial statements would not differ materially from the application of the standard to the individual leases in that portfolio.

A decision to use the portfolio approach would be similar to a decision some entities already make to expense, rather than capitalise, certain assets when the accounting difference is, and would continue to be, immaterial to the financial statements.

## 5.7 Presentation

#### Extract from IFRS 16

67 At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the *net investment in the lease*.

88 A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

Lessors recognise assets held under a finance lease in the statements of financial position and present them as a receivable at an amount equal to the net investment in the lease under IFRS 16. In addition, lessors are required under

IFRS 16 to present underlying assets subject to operating leases according to the nature of that asset in the statement of financial position.

In addition, the net investment in the lease is subject to the same considerations as other assets in classification as current or non-current assets in a classified balance sheet.

## 5.8 Disclosure

### Extract from IFRS 16

#### Disclosure

**89** The objective of the disclosures is for lessors to 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 lessor. Paragraphs 90–97 specify requirements on how to meet this objective.

90 A lessor shall disclose the following amounts for the reporting period:

(a) for finance leases:

- (i) selling profit or loss;
- (ii) finance income on the net investment in the lease; and
- (iii) income relating to variable lease payments not included in the measurement of the net investment in the lease.

(b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.

91 A lessor shall provide the disclosures specified in paragraph 90 in a tabular format, unless another format is more appropriate.

92 A lessor shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 89. This additional information includes, but is not limited to, information that helps users of financial statements to assess:

- (a) the nature of the lessor's leasing activities; and
- (b) how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor shall disclose its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk. Such means may include, for example, buy-back agreements, residual value guarantees or variable lease payments for use in excess of specified limits.

#### Finance leases

93 A lessor shall provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.

94 A lessor shall disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value.

## Extract from IFRS 16 (cont'd)

### Operating leases

95 For items of property, plant and equipment subject to an operating lease, a lessor shall apply the disclosure requirements of IAS 16. In applying the disclosure requirements in IAS 16, a lessor shall disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases. Accordingly, a lessor shall provide the disclosures required by IAS 16 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor.

96 A lessor shall apply the disclosure requirements in IAS 36, IAS 38, IAS 40 and IAS 41 for assets subject to operating leases.

97 A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

Lessors are required to disclose more information about how they manage the risks related to residual values of assets under lease.

The objective of the disclosures is for lessors to disclose information that 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 lessor. IFRS 16 requires a lessor to disclose quantitative and qualitative information about its leases, the significant judgements made in applying IFRS 16 and the amounts recognised in the financial statements related to the leases.

Lessors may need to exercise judgement to determine the appropriate level at which to aggregate, or disaggregate, disclosures so that meaningful information is not obscured by insignificant details or by grouping items with different characteristics.



## 6. Subleases

### 6.1 Definition

#### Extract from IFRS 16

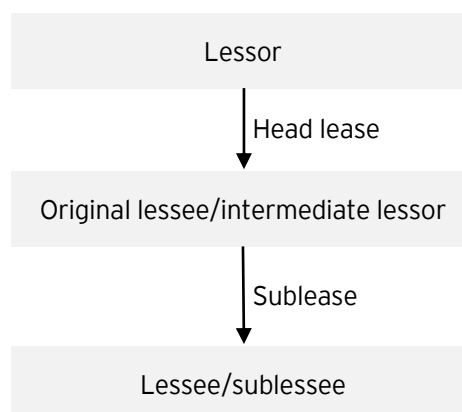
##### Appendix A

##### Defined terms

##### Sublease

A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.

Lessees often enter into arrangements to sublease a leased asset to a third party while the original lease contract is in effect. In these arrangements, one party acts as both the lessee and lessor of the same underlying asset. The original lease is often referred to as a head lease, the original lessee is often referred to as an intermediate lessor or sub-lessor and the ultimate lessee is often referred to as the sub-lessee.



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.

### 6.2 Intermediate lessor accounting

#### Extract from IFRS 16

B7 If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

B58 In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

- (a) if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying paragraph 6, the sublease shall be classified as an operating lease.
- (b) otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease).

If an underlying asset is re-leased by a lessee to a third party and the original lessee retains the primary obligation under the original lease, the transaction is a sublease. That is, the original lessee generally continues to account for the original lease (the head lease) as a lessee and accounts for the sublease as the lessor (intermediate lessor).

When the head lease is a short-term lease, the sublease is classified as an operating lease. Otherwise, the sublease is classified using the classification criteria in section 5 *Lessor Accounting* by reference to the right-of-use asset in the head lease (and not the underlying asset of the head lease).

#### Illustration 25 – Classification of a sublease

Entity F (original lessee/intermediate lessor) leases a building for five years. The building has an economic life of 30 years. Entity F subleases the building for four years. The sublease is classified with reference to the right-of-use asset in the head lease (and not the underlying building). For example, when assessing the useful life criterion, the sublease term of four years is compared with five year right-of-use asset in the head lease and not with 30-year economic life of the building which may result in the sublease being classified as a finance lease.

The intermediate lessor accounts for the sublease as follows:

- ▶ If the sublease is classified as an operating lease, the original lessee continues to account for the lease liability and right-of-use asset on the head lease like any other lease. Refer to section 4 *Lessee Accounting*. If the total remaining carrying amount of the right-of-use asset on the head lease exceeds the anticipated sublease income, this may indicate that the right-of-use asset associated with the head lease is impaired. A right-of-use asset is assessed for impairment under IAS 36.
- ▶ If the sublease is classified as a finance lease, the original lessee derecognises the right-of-use asset on the head lease at the sublease commencement date and continues to account for the original lease liability in accordance with the lessee accounting model. Refer to section 4 *Lessee Accounting*. The original lessee, as the sublessor, recognises a net investment in the sublease and evaluates it for impairment. Refer to section 5.6.1 *Impairment of the net investment in the lease*.

In a sublease, an intermediate lessor may use the discount rate for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease, if the interest rate implicit in the lease cannot be readily determined.

When contracts are entered into at or near the same time, an intermediate lessor is required to consider the criteria for combining contracts (e.g., when the contracts are negotiated as a package with a single commercial objective, or when the consideration to be paid in one contract depends on the price or performance of the other contract). If the contracts are required to be combined, the intermediate lessor accounts for the head lease and sublease as a single combined transaction. Refer to section 2.3 *Contract combinations*.

An intermediate lessor who subleases, or expects to sublease an asset, cannot account for the head lease as a lease of a low-value asset even when the criteria, as discussed in section 4.1.2 *Leases of low-value assets*, are satisfied.

IFRS 16 gives the following two examples of applying the requirements to an intermediate lessor that enters into a head lease and a sublease of the same underlying asset.

#### **Extract from IFRS 16 Illustrative Examples**

##### **Example 20- Sublease classified as a finance lease**

*Head lease – An intermediate lessor enters into a five-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).*

*Sublease – At the beginning of Year 3, the intermediate lessor subleases the 5,000 square metres of office space for the remaining three years of the head lease to a sublessee.*

The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease. The intermediate lessor classifies the sublease as a finance lease, having considered the requirements in paragraphs 61-66 of IFRS 16.

When the intermediate lessor enters into the sublease, the intermediate lessor:

- (a) derecognises the right-of-use asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;
- (b) recognises any difference between the right-of-use asset and the net investment in the sublease in profit or loss; and
- (c) retains the lease liability relating to the head lease in its statement of financial position, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both finance income on the sublease and interest expense on the head lease.

##### **Example 21- Sublease classified as an operating lease**

*Head lease—An intermediate lessor enters into a five-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).*

*Sublease—At commencement of the head lease, the intermediate lessor subleases the 5,000 square metres of office space for two years to a sublessee.*

The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease. The intermediate lessor classifies the sublease as an operating lease, having considered the requirements in paragraphs 61-66 of IFRS 16.

When the intermediate lessor enters into the sublease, the intermediate lessor retains the lease liability and the right-of-use asset relating to the head lease in its statement of financial position.

During the term of the sublease, the intermediate lessor:

- (a) recognises a depreciation charge for the right-of-use asset and interest on the lease liability; and
- (b) recognises lease income from the sublease.

### 6.3 Sub-lessee accounting

A sub-lessee accounts for its lease in the same manner as any other lease (i.e., as a new lease subject to IFRS 16's recognition and measurement provisions). Refer to section 4 *Lessee Accounting*.

### 6.4 Presentation

According to paragraph 32 of IAS 1, an entity cannot offset assets and liabilities or income and expenses, unless required or permitted by an IFRS. Therefore, intermediate lessors are not permitted to offset lease liabilities and lease assets that arise from a head lease and a sublease, respectively, unless those liabilities and assets meet the requirements in IAS 1 for offsetting. Similarly, intermediate lessors are not permitted to offset depreciation and interest expenses and lease income relating to a head lease and a sublease of the same underlying asset, respectively, unless the requirements for offsetting in IAS 1 are met. For example, intermediate lessors apply the principal-versus-agent application guidance in IFRS 15 to determine whether sublease revenue needs to be presented on a gross or net basis (i.e., reduced for head lease expenses). We believe that intermediate lessors generally will not meet the principal-versus-agent application guidance in IFRS 15 to present sublease income on a net basis and therefore, will generally present sublease revenue on a gross basis. Refer to our publication, [Applying IFRS: A closer look at IFRS 15, the revenue recognition standard](#) (updated October 2020) for analysis on the principal-versus-agent application guidance.

### 6.5 Disclosure

Under IFRS 16, entities including intermediate lessors are required to disclose qualitative and quantitative information which 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 lessor. Refer to sections 4.8 *Disclosure* for lessees and 5.7 *Disclosure* for lessors, respectively.

## 7. Sale and leaseback transactions

### Extract from IFRS 16

#### Sale and leaseback transactions

98 If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease applying paragraphs 99-103.

Sale and leaseback transactions no longer provide lessees with a source of off-balance sheet financing.

A sale and leaseback transaction involves the transfer of an asset by an entity (the seller-lessee) to another entity (the buyer-lessor) and the leaseback of the same asset by the seller-lessee. Because IFRS 16 requires lessees to recognise most leases on the balance sheet, sale and leaseback transactions may no longer provide lessees with a source of off-balance sheet financing. Both the seller-lessee and the buyer-lessor are required to apply IFRS 15 to determine whether to account for a sale and leaseback transaction as a sale and purchase of an asset.

### 7.1 Determining whether the transfer of an asset is a sale

#### Extract from IFRS 16

#### Assessing whether the transfer of the asset is a sale

99 An entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

When determining whether the transfer of an asset should be accounted for as a sale or purchase, both the seller-lessee and the buyer-lessor apply the requirements in IFRS 15 on when an entity satisfies a performance obligation by transferring control of an asset. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale or purchase of the asset and a lease. If not, both the seller-lessee and the buyer-lessor account for the transaction as a financing transaction.

IFRS 15 includes the following to help entities determine whether control of the asset has been transferred.

#### Extract from IFRS 15

**31 An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.**

32 For each performance obligation identified in accordance with paragraphs 22-30, an entity shall determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 35-37) or satisfies the performance obligation at a point in time (in accordance with paragraph 38). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

### Extract from IFRS 15 (cont'd)

33 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by:

- (a) using the asset to produce goods or provide services (including public services);
- (b) using the asset to enhance the value of other assets;
- (c) using the asset to settle liabilities or reduce expenses;
- (d) selling or exchanging the asset;
- (e) pledging the asset to secure a loan; and
- (f) holding the asset.

34 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see paragraphs B64-B76).

38 If a performance obligation is not satisfied over time in accordance with paragraphs 35-37, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the requirements for control in paragraphs 31-34. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

- (a) The entity has a present right to payment for the asset—if a customer is presently obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.
- (b) The customer has legal title to the asset—legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.
- (c) The entity has transferred physical possession of the asset – the customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs B64-B76, B77-B78 and B79-B82 provide guidance on accounting for repurchase agreements, consignment arrangements and bill-and-hold arrangements, respectively.

#### Extract from IFRS 15 (cont'd)

- (d) The customer has the significant risks and rewards of ownership of the asset—the transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity shall exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.
- (e) The customer has accepted the asset—the customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. To evaluate the effect of a contractual customer acceptance clause on when control of an asset is transferred, an entity shall consider the guidance in paragraphs B83-B86.

Unlike other buyers of assets, a buyer in a sale and leaseback transaction will determine whether it has purchased an asset by applying the new revenue standard.

None of the indicators above individually determine whether the buyer-lessor has obtained control of the underlying asset. Both the seller-lessee and the buyer-lessor must consider all relevant facts and circumstances to determine whether control has transferred. Furthermore, not all of the indicators must be present to determine that the buyer-lessor has gained control. Rather, the indicators are factors that are often present when a customer has obtained control of an asset and the list is meant to help entities apply the principle of control. Refer to our publication [Applying IFRS: A closer look at IFRS 15, the revenue recognition standard](#) (updated October 2020) for in-depth analysis on determining whether the control of the asset has been transferred.

The IASB noted, in the Basis for Conclusions (BC262), that the existence of a leaseback, in isolation, does not preclude a sale. This is because a lease is different from the sale or purchase of an underlying asset, as a lease does not transfer control of the underlying asset. Instead, it transfers the right to control the use of the underlying asset for the period of the lease. However, if the seller-lessee has a substantive repurchase option for the underlying asset (i.e., a right to repurchase the asset), no sale has occurred because the buyer-lessor has not obtained control of the asset.

## How we see it

- ▶ The new requirements are a significant change from current practice for seller-lessees. Under IFRS 16, seller-lessees must apply the requirements in IFRS 15 to determine whether a sale has occurred. Also, even if the criteria for a sale have been met, sale and leaseback transactions generally would no longer lead to an off-balance sheet financing.
- ▶ IFRS 16 does not address whether a lessee's renewal options (e.g., fixed price, fair value at the date of exercise) permitting the seller-lessee to extend the lease for substantially all of the remaining economic life of the underlying asset precludes sale accounting. We believe that a lessee that has an option to extend a lease for substantially all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Therefore, when the renewal price is not fair value at the time the renewal option is exercised, the renewal option would prohibit sale accounting under IFRS 15 and IFRS 16.

## 7.2 Transactions in which the transfer of an asset is a sale

### Extract from IFRS 16

#### Transfer of the asset is a sale

100 If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset:

- (a) the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
- (b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard.

101 If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

- (a) any below-market terms shall be accounted for as a prepayment of lease payments; and
- (b) any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

102 The entity shall measure any potential adjustment required by paragraph 101 on the basis of the more readily determinable of:

- (a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and
- (b) the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.



### 7.2.1 Accounting for the sale

If the transfer of the asset is a sale, the seller-lessee will:

- ▶ Derecognise the underlying asset
- ▶ Recognise the gain or loss, if any, that relates to the rights transferred to the buyer-lessor and adjusted for off-market terms

A buyer-lessor accounts for the purchase of the asset in accordance with other standards based on the nature of the asset (e.g., IAS 16 for property, plant and equipment).

Entities that have sale and leaseback transactions will need to determine the gain or loss that relates to the rights transferred to the buyer-lessor in accordance with paragraph 100(a) of IFRS 16. IFRS 16 Illustrative Example 24 (shown below) shows a methodology for determining the gain on sale. The example assumes that the lease payments are fixed. This methodology seems to suggest that the gain or loss recognised up front may be based on the proportion of fixed payments. However, there is no further guidance available in IFRS 16.

The IFRS Interpretations Committee issued an agenda decision in June 2020 related to a sale and leaseback transaction with variable payments. In the transaction described in the request, an entity (seller-lessee) enters into a sale and leaseback transaction whereby it transfers an item of property to another entity (buyer-lessor) and leases the asset back for five years. The transfer of the property satisfies the requirements in IFRS 15 to be accounted for as a sale of the property. The amount paid by the buyer-lessor to the seller-lessee in exchange for the property equals the property's fair value at the date of the transaction. Payments for the lease (which are at market rates) include variable payments (not based on an index or rate), calculated as a percentage of the seller-lessee's revenue generated using the property during the five-year lease term. The seller-lessee has determined that the variable payments are not in-substance fixed payments as described in IFRS 16. The request asked how, in the transaction described, the seller-lessee measures the right-of-use asset arising from the leaseback and determines the amount of any gain or loss recognised at the date of the transaction.

The Committee observed that the requirements applicable to the transaction described in the request are in paragraph 100 of IFRS 16. Paragraph 100 states that, '... if the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset: (a) the seller-lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.'

Consequently, to measure the right-of-use asset arising from the leaseback, the seller-lessee determines the proportion of the property transferred to the buyer-lessor that relates to the right of use retained. It does so by comparing, at the date of the transaction, the right of use it retains via the leaseback to the rights comprising the entire property. IFRS 16 does not prescribe a method for determining that proportion. In the transaction described in the request, the seller-lessee could determine the proportion by comparing, for example: (a) the present value of expected lease payments (including those that are variable and not based on an index or rate); with (b) the fair value of the property at the date of the transaction.

The gain or loss the seller-lessee recognises at the date of the transaction is a consequence of its measurement of the right-of-use asset arising from the leaseback. Because the right of use the seller-lessee retains is not remeasured as a result of the transaction (it is measured as a proportion of the property's previous carrying amount), the amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor. Applying paragraph 53(i) of IFRS 16, the seller-lessee discloses gains or losses arising from sale and leaseback transactions.

The seller-lessee also recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate. The initial measurement of the liability is a consequence of how the right-of-use asset is measured – and the gain or loss on the sale and leaseback transaction determined – applying paragraph 100(a) of IFRS 16.

#### Extract from June 2020 IFRIC Update

Seller-lessee enters into a sale and leaseback transaction whereby it transfers an asset (PPE) to Buyer-lessor, and leases that PPE back for five years. The transfer of the PPE satisfies the requirements in IFRS 15 to be accounted for as a sale of the PPE.

The carrying amount of the PPE in Seller-lessee's financial statements at the date of the transaction is CU1,000,000, and the amount paid by Buyer-lessor for the PPE is CU1,800,000 (the fair value of the PPE at that date). All the payments for the lease (which are at market rates) are variable, calculated as a percentage of Seller-lessee's revenue generated using the PPE during the five-year lease term. At the date of the transaction, the present value of the expected payments for the lease is CU450,000. There are no initial direct costs.

Seller-lessee determines that it is appropriate to calculate the proportion of the PPE that relates to the right of use retained using the present value of expected payments for the lease. On this basis, the proportion of the PPE that relates to the right of use retained is 25%, calculated as CU450,000 (present value of expected payments for the lease) ÷ CU1,800,000 (fair value of the PPE). Consequently, the proportion of the PPE that relates to the rights transferred to Buyer-lessor is 75%, calculated as (CU1,800,000 – CU450,000) ÷ CU1,800,000.

Applying paragraph 100(a), Seller-lessee:

- (a) measures the right-of-use asset at CU250,000, calculated as CU1,000,000 (previous carrying amount of the PPE) × 25% (proportion of the PPE that relates to the right of use it retains).
- (b) recognises a gain of CU600,000 at the date of the transaction, which is the gain that relates to the rights transferred to Buyer-lessor. This gain is calculated as CU800,000 (total gain on sale of the PPE (CU1,800,000 – CU1,000,000)) × 75% (proportion of the PPE that relates to rights transferred to Buyer-lessor).

Applying paragraph 100(a), the right-of-use asset would not be measured at zero at the date of the transaction because zero would not reflect the proportion of the previous carrying amount of the PPE (CU1,000,000) that relates to the right of use retained by Seller-lessee.

### Extract from June 2020 IFRIC Update (cont'd)

At the date of the transaction, Seller-lessee accounts for the transaction as follows:

Dr cash	CU 1,800,000	
Dr right-of-use asset	CU 250,000	
Cr PPE		CU 1,000,000
Cr liability		CU 450,000
Cr gain on rights transferred		CU 600,000

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine, at the date of the transaction, the accounting for the sale and leaseback transaction described in the request and, therefore, decided not to add the matter to its standard-setting agenda.

The Committee's discussions above highlighted that IFRS 16 does not specify the measurement of the liability that arises in such a sale and leaseback transaction. To address this, the IASB issued an Exposure Draft *Lease Liability in a Sale and Leaseback (Proposed amendment to IFRS 16)* (the ED) in November 2020. The Board is proposing an amendment to IFRS 16 to specify the method a seller-lessee uses in initially measuring the right-of-use asset and lease liability arising in a sale and leaseback transaction and how the seller-lessee subsequently measures that liability.

The proposal in the ED is intended to improve the requirements for sale and leaseback transactions in IFRS 16. It does not change the principles for the sale and leaseback requirements in IFRS 16 and does not result in any change to the accounting for leases unrelated to sale and leaseback transactions.

#### *Initial measurement*

For sale and leaseback transactions in which a transfer of the asset satisfies the requirements in IFRS 15 to be accounted for as a sale, paragraph 100 (a) of IFRS 16 requires the seller-lessee to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

The proposed amendment clarifies that the seller-lessee determines the proportion described above by comparing the present value of the expected lease payments to the fair value of the asset sold.

The expected lease payments comprise the following relating to the right to use the asset during the lease term at market rates:

- ▶ Fixed payments (including in-substance fixed payments), less any lease incentives
- ▶ Variable lease payments (regardless of whether they depend on an index or rate). This represents a departure from the general leases model under IFRS 16
- ▶ Amounts expected to be payable by the seller-lessee under residual value guarantees

- ▶ Payments of penalties for terminating the lease, if the lease term reflects the seller-lessee exercising an option to terminate the lease

The present value of the expected lease payments would be determined by discounting the expected lease payments using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate.

The proposed amendment also clarifies that the seller-lessee recognises a lease liability arising from the leaseback. The seller-lessee initially measures the lease liability at the present value of the expected lease payments (as described above) that are not paid at the commencement date as determined above.

#### *Subsequent measurement*

The proposed amendment clarifies that the seller-lessee subsequently measures the right-of-use asset arising from the leaseback in accordance with the existing requirements in IFRS 16. Applying the proposed amendment, the seller-lessee will subsequently measure the lease liability arising from the leaseback by:

- ▶ Increasing the carrying amount to reflect interest on the lease liability
- ▶ Reducing the carrying amount to reflect the expected lease payments for the reporting period as determined at the commencement date (or the revised expected lease payments for the reporting period if applicable)
- ▶ Remeasuring the carrying amount to reflect any reassessments or lease modifications as specified in IFRS 16, or to reflect revised in-substance fixed lease payments, other than a change in future lease payments resulting from a change in an index or a rate (including a change to reflect changes in market rental rates following a market rent review). Where there is a lease modification or a change in the lease term, the revised lease payments are the revised expected lease payments at the date of remeasurement. Except for a change in the lease term or a lease modification, the seller-lessee will not remeasure the lease liability to reflect a change in future variable lease payments
- ▶ Recognising any excess of the actual payments made for the lease (excluding any above-market terms) over the expected lease payments for the reporting period in profit or loss. If there are shortfalls in the actual payments made or recoveries of shortfalls, the seller-lessee also adjusts the carrying amount of the lease liability and makes a corresponding adjustment through profit or loss

The ED is open for public comment until 29 March 2021. Further information on the proposals can be found in the publication *IFRS Developments (December 2020) IASB issues ED on measuring the lease liability arising in a sale and leaseback transaction*.<sup>4</sup>

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<sup>4</sup> Available on [www.ey.com/ifrs](http://www.ey.com/ifrs)

## How we see it

Although not explicitly stated in IFRS 16, we believe that if the sale and leaseback transaction is expected to result in a loss to the seller-lessee, that loss will not be deferred. In addition, the seller-lessee may also need to consider whether the underlying asset may have been impaired prior to the sale and leaseback and the transaction would require the asset to have been classified as held-for-sale under IFRS 5 and, hence, subject to potential impairment prior to the transaction.

### 7.2.2 Accounting for the leaseback

When a sale occurs, both the seller-lessee and the buyer-lessor account for the leaseback in the same manner as any other lease (refer to sections 4 *Lessee accounting* and 5 *Lessor accounting*, respectively), with adjustments for any off-market terms. Specifically, a seller-lessee recognises a lease liability and right-of-use asset for the leaseback.

### 7.2.3 Adjustment for off-market terms

The sale transaction and the ensuing lease are generally interdependent and negotiated as a package. Consequently, some transactions could be structured with a negotiated sales price that is above or below the asset's fair value and with lease payments for the ensuing lease that are above or below the market rates. These off-market terms could distort the gain or loss on the sale and the recognition of lease expense and lease income for the lease. To ensure that the gain or loss on the sale and the lease-related assets and liabilities associated with such transactions are neither understated nor overstated, IFRS 16 requires adjustments for any off-market terms of sale and leaseback transactions, on the more readily determinable basis of the difference between the fair value of the consideration for the sale and the fair value of the asset and the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

When the sale price is less than the underlying asset's fair value or the present value of the lease payments is less than the present value of the market lease payments, using the more readily determinable basis, a seller-lessee recognises the difference as an increase to the sales price and the initial measurement of the right-of-use asset as a lease prepayment. When the sale price is greater than the underlying asset's fair value or the present value of the lease payments is greater than the present value of the market lease payments, using the more readily determinable basis, a seller-lessee recognises the difference as a reduction in the sales price and an additional financing received from the buyer-lessor.

Buyer-lessors are also required to adjust the purchase price of the underlying asset for any off-market terms. Such adjustments are recognised as lease prepayments made by the seller-lessee or as additional financing provided to the seller-lessee.

### 7.2.4 Example

IFRS 16 provides the following example of the accounting for a sale and leaseback transaction:

#### Extract from IFRS 16 Illustrative Examples

##### Example 24 – Sale and leaseback transaction

*An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15 Revenue from Contracts with Customers.*

*Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback. This example ignores any initial direct costs.*

*The fair value of the building at the date of sale is CU1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. The amount of the excess sale price of CU200,000 (CU2,000,000 – CU1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.*

*The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of CU120,000, discounted at 4.5 per cent per annum) amounts to CU1,459,200, of which CU200,000 relates to the additional financing and CU1,259,200 relates to the lease—corresponding to 18 annual payments of CU16,447 and CU103,553, respectively.*

*Buyer-lessor classifies the lease of the building as an operating lease.*

##### Seller-lessee

At the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right-of-use retained by Seller-lessee, which is CU699,555. This is calculated as: CU1,000,000 (the carrying amount of the building) ÷ CU1,800,000 (the fair value of the building) x CU1,259,200 (the discounted lease payments for the 18-year right-of-use asset).

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of CU240,355 calculated as follows. The gain on sale of building amounts to CU800,000 (CU1,800,000 - CU1,000,000), of which:

- (a) CU559,645 (CU800,000 ÷ CU1,800,000 x CU1,259,200) relates to the right to use the building retained by Seller-lessee; and
- (b) CU240,355 (CU800,000 ÷ CU1,800,000 x (CU1,800,000 - CU1,259,200)) relates to the rights transferred to Buyer-lessor.

### Extract from IFRS 16 Illustrative Examples (cont'd)

At the commencement date, Seller-lessee accounts for the transaction, as follows:

Cash	CU2,000,000	
Right-of-use asset	CU699,555	
Building		CU1,000,000
Financial liability		CU1,459,200
Gain on rights transferred		CU240,355

#### Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction, as follows:

Building	CU1,800,000	
Financial asset	CU200,000	(18 payments of CU16,447, discounted at 4.5 per cent per annum)
Cash		CU2,000,000

After the commencement date, Buyer-lessor accounts for the lease by treating CU103,553 of the annual payments of CU120,000 as lease payments. The remaining CU16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of CU200,000 and (b) interest revenue.

## 7.3 Transactions in which the transfer of an asset is not a sale

### Extract from IFRS 16

#### Transfer of the asset is not a sale

103 If the transfer of an asset by the seller-lessee does not satisfy the requirements of IFRS 15 to be accounted for as a sale of the asset:

- (a) the seller-lessee shall continue to recognise the transferred asset and shall recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying IFRS 9.
- (b) the buyer-lessor shall not recognise the transferred asset and shall recognise a financial asset equal to the transfer proceeds. It shall account for the financial asset applying IFRS 9.

If the transfer of an asset is not a sale, the seller-lessee accounts for the transaction as a financing transaction. The seller-lessee keeps the transferred asset subject to the sale and leaseback transaction on its balance sheet and accounts for amounts received as a financial liability in accordance with IFRS 9. The seller-lessee decreases the financial liability by the payments made less the portion considered interest expense.

If the transfer of an asset is not a sale, the buyer-lessor does not recognise the transferred asset and accounts for the amounts paid as a receivable in accordance with IFRS 9.

## 7.4 Disclosure

### Extract from IFRS 16

B52 Additional information relating to sale and leaseback transactions 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 sale and leaseback transactions and the prevalence of those transactions;
- (b) key terms and conditions of individual sale and leaseback transactions;
- (c) payments not included in the measurement of lease liabilities; and
- (d) the cash flow effect of sale and leaseback transactions in the reporting period.

A seller-lessee may be required to provide additional qualitative and quantitative information about its leasing activities that is necessary to meet the disclosure objective in IFRS 16. Refer to section 4.8 *Disclosure* on lessee disclosure requirements.

A seller-lessee is also required to disclose any gains and losses arising from sale and leaseback transactions separately from gains and losses on disposals of other assets under paragraph 53(i) of IFRS 16.



## 8. Business combinations

### 8.1 Acquiree in a business combination is a lessee

#### Extract from IFRS 3

##### Leases in which the acquiree is the lessee

28A The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with IFRS 16 in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

- (a) leases for which the lease term (as defined in IFRS 16) ends within 12 months of the acquisition date; or
- (b) leases for which the underlying asset is of low value (as described in paragraphs B3-B8 of IFRS 16).

28B The acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) as if the acquired lease were a new lease at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.

#### 8.1.1 Initial measurement of a lease

Consequential amendments to IFRS 3 specify the initial measurement requirements for leases that are acquired in a business combination.

The acquirer measures the acquired lease liability as if the lease contract were a new lease at the acquisition date. That is, the acquirer applies IFRS 16's initial measurement provisions, using the present value of the remaining lease payments at the acquisition date. The acquirer follows the requirements for determining the lease term, lease payments and discount rate as discussed in section 3 *Key concepts*. The discount rate is determined from the perspective of the acquiree, as the acquiree is the customer in the lease contract. However, the determination of the lessee's incremental borrowing rate will take into account that the acquiree is now part of the new group. This is discussed further in 3.6.1 above.

The right-of-use asset is measured at an amount equal to the recognised liability, adjusted to reflect the favourable or unfavourable terms of the lease, relative to market terms. Because the off-market nature of the lease is captured in the right-of-use asset, the acquirer does not separately recognise an intangible asset or liability for favourable or unfavourable lease terms relative to market.

The acquirer is not required to recognise right-of-use assets and lease liabilities for leases with lease terms which end within 12 months of the acquisition date and leases for low-value assets. The IASB considered whether to require an acquirer to recognise assets and liabilities relating to off-market terms for short-term leases and leases of low-value assets. However, the IASB indicated in the Basis for Conclusions (BC 298) that the effect of off-market terms would rarely be material for short-term leases and leases of low-value assets and so decided not to require this.

### 8.1.2 Subsequent measurement of a lease

The subsequent measurement requirements for an acquired lease liability and right-of-use asset are the same as the requirements for any other existing lease arrangement.

## 8.2 Acquiree in a business combination is a lessor

### Extract from IFRS 3

17 This IFRS provides two exceptions to the principle in paragraph 15:

- (a) classification of a lease contract in which the acquiree is the lessor as either an operating lease or a finance lease in accordance with IFRS 16 *Leases*.
- (b) [deleted]

The acquirer shall classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

B42 In measuring the acquisition-date fair value of an asset such as a building or a patent that is subject to an operating lease in which the acquiree is the lessor, the acquirer shall take into account the terms of the lease. The acquirer does not recognise a separate asset or liability if the terms of an operating lease are either favourable or unfavourable when compared with market terms.

IFRS 16 requires an acquirer to classify acquired lessor leases as either finance or operating leases using the contractual terms and conditions at the inception of the lease, or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification. Therefore, the classification is not changed as a result of a business combination unless a lease is modified. Refer to section 5.5 *Lease modifications*.

## 9. Effective date and transition

### 9.1 Effective date

#### Extract from IFRS 16

##### Effective Date

C1 An entity shall apply this Standard for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply IFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of this Standard. If an entity applies this Standard earlier, it shall disclose that fact.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted, provided that IFRS 15 has been applied, or is applied at the same date as IFRS 16. An entity that elects to early adopt IFRS 16 is required to disclose that fact.

#### How we see it

The application date for IFRS 15 is for annual reporting periods beginning on or after 1 January 2018. Because the IASB aligned several concepts in IFRS 16 with concepts in IFRS 15 (e.g., determining whether the transfer of an asset is a sale in a sale and leaseback transaction), some entities, particularly those that are primarily lessors, may consider applying IFRS 16 one year early, in order to have one transition date for both standards.

### 9.2 Transition

#### Extract from IFRS 16

##### Transition

C2 For the purposes of the requirements in paragraphs C1-C19, the date of initial application is the beginning of the annual reporting period in which an entity first applies this Standard.

IFRS 16's transition provisions are applied at the beginning of the annual reporting period in which the entity first applies the standard (i.e., the date of initial application). For example, an entity with a reporting date of 31 December 2019, applies the transition provisions on 1 January 2019.

#### 9.2.1 Definition of a lease

#### Extract from IFRS 16

##### Definition of a lease

C3 As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted:

- (a) to apply this Standard to contracts that were previously identified as leases applying IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease*. The entity shall apply the transition requirements in paragraphs C5-C18 to those leases.

#### Extract from IFRS 16 (cont'd)

b) not to apply this Standard to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

C4 If an entity chooses the practical expedient in paragraph C3, it shall disclose that fact and apply the practical expedient to all of its contracts. As a result, the entity shall apply the requirements in paragraphs 9 - 11 only to contracts entered into (or changed) on or after the date of initial application.

Lessees and lessors are permitted to make an election not to reassess whether existing contracts contain a lease as defined under IFRS 16. If an entity elects this practical expedient, contracts that do not contain a lease under IAS 17 and IFRIC 4 (e.g., service arrangements) are not reassessed either.

The IASB provided this practical expedient because it believes requiring entities to reassess existing contracts by applying the lease definition guidance in IFRS 16 would not justify the costs.

If an entity chooses to apply the practical expedient, it must be applied to all contracts that are ongoing at the date of initial application (i.e., an entity is not permitted to apply the option on a lease-by-lease basis) and that fact is disclosed.

#### How we see it

As the accounting for operating leases under IAS 17 is similar to accounting for service contracts, entities may not have always focused on determining whether an arrangement is a lease or a service contract. Some entities may need to revisit assessments made under IAS 17 and IFRIC 4 because, under IFRS 16, most leases are recognised on lessees' balance sheets and the effects of treating an arrangement as a service instead of an arrangement containing a lease may be material.

We believe that IFRS 16's practical expedient that allows an entity not to reassess whether a contract contains a lease only applies to arrangements that were appropriately assessed under IAS 17 and IFRIC 4.

### 9.3 Lessee transition

#### Extract from IFRS 16

##### Lessees

C5 A lessee shall apply this Standard to its leases either:

- (a) retrospectively to each prior reporting period presented applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or
- (b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application in accordance with paragraphs C7-C13.

C6 A lessee shall apply the election described in paragraph C5 consistently to all of its leases in which it is a lessee.

#### Extract from IFRS 16 (cont'd)

C7 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall not restate comparative information. Instead, the lessee shall recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

A lessee is required to apply IFRS 16 to its leases either:

- ▶ Retrospectively to each prior reporting period presented, applying IAS 8 (Full retrospective approach)
- ▶ Retrospectively with cumulative effect of initially applying IFRS 16 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of the initial application (Modified retrospective approach)

A lessee applies the elected transition approach consistently to all leases in which it is lessee.

#### 9.3.1 Full retrospective approach

#### Extract from IAS 8

##### *Retrospective application*

22 Subject to paragraph 23, when a change in accounting policy is applied retrospectively in accordance with paragraph 19(a) or (b), the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

##### *Limitations on retrospective application*

- 23 When retrospective application is required by paragraph 19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.
- 24 When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity shall apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and shall make a corresponding adjustment to the opening balance of each affected component of equity for that period.
- 25 When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, the entity shall adjust the comparative information to apply the new accounting policy prospectively from the earliest date practicable.

### Extract from IAS 8 (cont'd)

26 When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable unless it is practicable to determine the cumulative effect on the amounts in both the opening and closing statements of financial position for that period. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Usually the adjustment is made to retained earnings. However, the adjustment may be made to another component of equity (for example, to comply with an IFRS). Any other information about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.

27 When it is impracticable for an entity to apply a new accounting policy retrospectively, because it cannot determine the cumulative effect of applying the policy to all prior periods, the entity, in accordance with paragraph 25, applies the new policy prospectively from the start of the earliest period practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities and equity arising before that date. Changing an accounting policy is permitted even if it is impracticable to apply the policy prospectively for any prior period. Paragraphs 50-53 provide guidance on when it is impracticable to apply a new accounting policy to one or more prior periods.

An entity electing the full retrospective adoption will apply the provisions of IFRS 16 to each period presented in the financial statements, in accordance with IAS 8.

### Extract from IAS 1

#### *Change in accounting policy, retrospective restatement or reclassification*

40A An entity shall present a third statement of financial position as at the beginning of the preceding period in addition to the minimum comparative financial statements required in paragraph 38A if:

- (a) it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements; and
- (b) the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period.

Under the full retrospective approach, an entity applies IFRS 16 as if it had been applied since the inception of all lease contracts that are presented in the financial statements. If the standard is applied at 1 January 2019, this means that, in the 31 December 2019 financial statements, the comparative period to 31 December 2018 (assuming that this is the only comparative period presented) must be restated. A restated opening balance sheet at 1 January 2018 will also need to be disclosed as required by IAS 1.

### 9.3.2 Lessee modified retrospective approach

#### 9.3.2.1 Leases previously classified as operating leases

##### Extract from IFRS 16

##### Leases previously classified as operating leases

- C8 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall:
- (a) recognise a lease liability at the date of initial application for leases previously classified as an operating lease applying IAS 17. The lessee shall measure that lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.
  - (b) recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying IAS 17. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:
    - (i) its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or
    - (ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.
  - (c) apply IAS 36 *Impairment of Assets* to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient in paragraph C10(b).
- C9 Notwithstanding the requirements in paragraph C8, for leases previously classified as operating leases applying IAS 17, a lessee:
- (a) is not required to make any adjustments on transition for leases for which the underlying asset is of low value (as described in paragraphs B3-B8) that will be accounted for applying paragraph 6. The lessee shall account for those leases applying this Standard from the date of initial application.
  - (b) is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in IAS 40 *Investment Property*. The lessee shall account for the right-of-use asset and the lease liability arising from those leases applying IAS 40 and this Standard from the date of initial application.
  - (c) shall measure the right-of-use asset at fair value at the date of initial application for leases previously accounted for as operating leases applying IAS 17 and that will be accounted for as investment property using the fair value model in IAS 40 from the date of initial application. The lessee shall account for the right-of-use asset and the lease liability arising from those leases applying IAS 40 and this Standard from the date of initial application.

When applying the modified retrospective approach, a lessee does not restate comparative figures. Instead, a lessee recognises the cumulative effect of initially

applying IFRS 16 as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application. Refer to section 9.2 *Transition*. For leases previously classified as operating leases under IAS 17, a lessee recognises a lease liability measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee measures the right-of-use asset on a lease-by-lease basis, at either:

- ▶ Its carrying amount as if IFRS 16 had always been applied since the commencement date, but using a discount rate based on the lessee's incremental borrowing rate at the date of initial application
- ▶ An amount equal to the lease liability, adjusted for previously recognised prepaid or accrued lease payments

A lessee applies IAS 36 to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient for onerous leases discussed in section 9.3.2.2 *Practical expedients for leases previously classified as operating leases*.

IFRS 16 does not specify whether the lessee's incremental borrowing rate at the date of initial application should be determined based on the original lease term or the remaining lease term. We believe that both approaches are acceptable and an entity has an accounting policy choice to use either the original lease term or the remaining lease term. The policy chosen should be disclosed in the financial statements and consistently applied.

A lessee is not required to make adjustments on transition for leases of low-value assets. Refer to section 4.1 *Initial recognition* for lessees.

A lessee is also not required to make adjustments on transition for leases previously accounted for as investment property using the fair value model in IAS 40. However, a lessee measures the right-of-use asset at fair value at the date of initial application for leases previously accounted for as operating leases under IAS 17 and that will be accounted for as investment property using the fair value model in IAS 40 from the date of initial application.

### **9.3.2.2 Practical expedients for leases previously classified as operating leases**

#### **Extract from IFRS 16**

C10 A lessee may use one or more of the following practical expedients when applying this Standard retrospectively in accordance with paragraph C5(b) to leases previously classified as operating leases applying IAS 17. A lessee is permitted to apply these practical expedients on a lease-by-lease basis:

- (a) a lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).
- (b) a lessee may rely on its assessment of whether leases are onerous applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to performing an impairment review. If a lessee chooses this practical expedient, the lessee shall adjust the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application.



### Extract from IFRS 16 (cont'd)

- (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. In this case, a lessee shall:
  - (i) account for those leases in the same way as short-term leases as described in paragraph 6; and
  - (ii) include the cost associated with those leases within the disclosure of short-term lease expense in the annual reporting period that includes the date of initial application.
- (d) a lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.
- (e) a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

A lessee is also permitted to apply the following practical expedients to leases previously classified as operating leases, on a lease-by-lease basis:

- ▶ Apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment)
- ▶ Adjust the right-of-use asset for any recognised onerous lease provisions, instead of performing an impairment review. If a lessee chooses this practical expedient, the lessee adjusts the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application. In paragraph BC287 of the Basis for Conclusions, the IASB explained that it could be costly for a lessee to perform an impairment review of each of its right-of-use assets on transition to IFRS 16. In addition, any onerous operating lease liability identified applying IAS 37 is likely to reflect impairment of the right-of-use asset. Thus, even when the provision for an onerous lease is nil immediately before the date of initial application, we believe a lessee is able to rely on this practical expedient and not perform impairment reviews on that date
- ▶ Apply a recognition exemption for leases for which the lease term ends within 12 months of the date of initial application
- ▶ Exclude initial direct costs from the measurement of the right-of-use asset
- ▶ Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease. IFRS 16 does not provide detailed guidance on the use of hindsight. However, we believe, similarly to the requirements of paragraph 53 of IAS 8, that hindsight can only be applied to matters of judgement and estimates and, therefore, would not apply to matters of fact such as changes to an index or rate

IFRS 16 does not specify how a lessee would separate and allocate lease and non-lease components of a contract upon transition when the modified retrospective approach is adopted. We believe lessees could apply IFRS 16.13-16 and allocate the consideration in the contract, determined at lease commencement, to each lease and non-lease component on the basis of the relative stand-alone price of the lease component on that same date unless the lessee elects to use the practical expedient to account for each

lease component and any associated non-lease components as a single lease component. See 3.2 above. Other approaches with similar results may also be acceptable.

### 9.3.3 Leases previously classified as finance leases

#### Extract from IFRS 16

##### Leases previously classified as finance leases

C11 If a lessee elects to apply this Standard in accordance with paragraph C5(b), for leases that were classified as finance leases applying IAS 17, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying IAS 17. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this Standard from the date of initial application.

A lessee will not change its initial carrying amounts for assets and liabilities under finance leases existing at the date of initial application of IFRS 16.

#### Illustration 26 – Accounting for lease contracts at transition using the full retrospective and modified retrospective approaches

A retailer (lessee) entered into 3-year lease of retail space beginning at 1 January 2017 with three annual lease payments of CU1,000 due on 31 December 2017, 2018 and 2019, respectively. The lease is classified as an operating lease under IAS 17. The retailer initially applies IFRS 16 for the first time in the annual period beginning at 1 January 2019.

The incremental borrowing rate at the date of the initial application is 3% p.a. The incremental borrowing rate at the commencement of the lease was 6% p.a. The right-of-use asset is subject to straight-line depreciation over the lease term. The present values of the remaining lease payments as of 1 January 2017 at 6% p.a., 1 January 2017 at 3% p.a. and 1 January 2019 at 3% p.a. are CU2,673, CU2,829 and CU971, respectively. Assume no practical expedients are elected.

For simplicity, this example assumes the lessee did not incur initial direct costs, there were no lease incentives and there were no requirements for the lessee to dismantle and remove the underlying asset, restore the site on which it is located or restore the underlying asset to the condition under the terms and conditions of the lease.

The following example illustrates the lease liability, the right-of-use asset at the date of initial application and expenses applying both the full retrospective and modified retrospective approaches:

##### Full retrospective approach

*Analysis:* Under the full retrospective approach, the lease liability and the right-of-use asset are measured on the commencement date using the incremental borrowing rate at that date. The lease liability is accounted for by the interest method subsequently and the right-of-use asset is subject to depreciation on the straight line basis over the lease term of three years. The following table shows account balances under this method beginning at lease commencement:

**Illustration 26 – Accounting for lease contracts at transition using the full retrospective and modified retrospective approaches (cont'd)**

	Right-of-use asset	Lease liability	Interest expense	Amortisation expense	Retained earnings
1 January 2017	2,673 <sup>1</sup>	2,673 <sup>1</sup>	-	-	-
31 December 2017	1,782 <sup>2</sup>	1,833 <sup>3</sup>	160 <sup>4</sup>	891 <sup>5</sup>	(51)
31 December 2018	891 <sup>6</sup>	943 <sup>7</sup>	110 <sup>8</sup>	891	-
1 January 2019	891	943	-	-	-
31 December 2019	-	-	57 <sup>9</sup>	891	-

1 Present value of three CU1,000 payments at 6%

2  $CU2,673 - (CU2,673 / 3 \text{ years}) = CU1,782$

3  $CU2,673$  (prior period ending lease liability) -  $CU1,000$  (cash payment) +  $CU160$  (current period interest expense) =  $CU1,833$

4  $CU2,673 \times 6\% = 160$

5  $CU2,673 / 3 \text{ years} = 891$

6  $CU1,782 - (CU2,673 / 3 \text{ years}) = CU891$

7  $CU1,833$  (prior period ending lease liability) -  $CU1,000$  (cash payment) +  $CU110$  (current period interest expense) =  $CU943$

8  $CU1,833 \times 6\% = CU110$

9  $CU943 \times 6\% = CU57$

At adoption, the lessee would record the right-of-use asset and lease liability at the 31 December 2017 values from the above table, with the difference between the right-of-use asset and lease liability going to retained earnings as of 1 January 2018 (assuming that only the 2018 financial information is included as comparatives).

Right-of use asset	CU1,782	
Retained earnings	CU51	
Lease liability		CU1,833

*To initially recognise the lease-related asset and liability as of 1 January 2018*

The following journal entries would be recorded during 2018:

Interest expense	CU110	
Lease liability		CU110

*To record interest expense and accrete the lease liability using the interest method*

Depreciation expense	CU891	
Right-of-use asset		CU891

*To record depreciation expense on the right-of-use asset*

Lease liability	CU1,000	
Cash		CU1,000

*To record lease payment*

The following journal entries would be recorded during 2019:

Interest expense	CU57	
Lease liability		CU57

*To record interest expense and accrete the lease liability using the interest method*

Depreciation expense	CU891	
Right-of-use asset		CU891

*To record depreciation expense on the right-of-use asset*

Lease liability	CU1,000	
Cash		CU1,000

*To record lease payment*

**Illustration 26 – Accounting for lease contracts at transition using the full retrospective and modified retrospective approaches (cont'd)**

**Modified retrospective approach (alternative 1)**

*Analysis:* Under the modified retrospective approach (alternative 1), the lease liability is measured based on the remaining lease payments discounted using the incremental borrowing rate as of the date of initial application (i.e. 3% per p.a.). The right-of-use asset is at its carrying amount as if the standard had been applied since the commencement date. The right-of-use asset is subject to depreciation on a straight-line basis over the lease term of three years:

Right-of-use asset	CU943 <sup>10</sup>
Retained earnings	CU28 <sup>11</sup>
Lease liability	CU971 <sup>12</sup>

*To initially recognise the lease-related asset and liability as of 1 January 2019*

The following journal entries would be recorded during 2019:

Interest expense	CU29 <sup>13</sup>
Lease liability	CU29

*To record interest expense and accrete the lease liability using the interest method*

Depreciation expense	CU943
Right-of-use asset	CU943

*To record depreciation expense on the right-of-use asset*

Lease liability	CU1,000
Cash	CU1,000

*To record lease payment*

**Modified retrospective approach (alternative 2)**

*Analysis:* Under the modified retrospective approach (alternative 2), the lease liability is also measured based on the remaining lease payments discounted using the incremental borrowing rate as of the date of initial application. In this example, the carrying amount of the right-of-use asset is an amount equal to the carrying amount of the lease liability on the date of initial application as there are no prepayments or accrual items:

Right-of-use asset	CU971 <sup>12</sup>
Lease liability	CU971 <sup>12</sup>

*To initially recognise the lease-related asset and liability as of 1 January 2019*

The following journal entries would be recorded during 2019:

Interest expense	CU29 <sup>13</sup>
Lease liability	CU29

*To record interest expense and accrete the lease liability using the interest method*

Depreciation expense	CU971 <sup>12</sup>
Right-of-use asset	CU971

*To record depreciation expense on the right-of-use asset*

Lease liability	CU1,000
Cash	CU1,000

*To record lease payment*

10 CU2,829 (present value of three CU1,000 payments at 3%) - (CU2,829 / 3 years) × 2 = CU943

11 CU971 - CU943 = CU28

12 Present value of one CU1,000 payment at 3%

13 CU971 × 3% = CU29

**Illustration 26 – Accounting for lease contracts at transition using the full retrospective and modified retrospective approaches (cont'd)**

A summary of the lease contract's accounting (assuming no changes due to reassessments) is, as follows:

	Full retrospective approach	Modified retrospective approach (alternative 1)	Modified retrospective approach (alternative 2)
<i>Opening balance sheet impact as of 1 January 2019</i>			
Right-of-use asset	CU891	CU943	CU971
Lease liability	CU943	CU971	CU971
<i>Period ended 31 December 2019 activity</i>			
Cash lease payments	CU1,000	CU1,000	CU1,000
<u>Lease expense recognised</u>			
Interest expense	CU57	CU29	CU29
Depreciation expense	<u>CU891</u>	<u>CU943</u>	<u>CU971</u>
Total periodic expense	<u>CU948</u>	<u>CU 972</u>	<u>CU1,000</u>

Immaterial differences may arise in the computation of amounts in the example above due to rounding.

## 9.4 Lessors

### Extract from IFRS 16

#### Lessors

C14 Except as described in paragraph C15, a lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying this Standard from the date of initial application.

With the exception of subleases described below, on transition, a lessor is not required to make any adjustments for leases in which it is a lessor. From the date of initial application, the lessor accounts for those leases applying IFRS 16.

### 9.4.1 Subleases

### Extract from IFRS 16

#### Lessors

C15 An intermediate lessor shall:

- (a) reassess subleases that were classified as operating leases applying IAS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying this Standard. The intermediate lessor shall perform this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date.
- (b) for subleases that were classified as operating leases applying IAS 17 but finance leases applying this Standard, account for the sublease as a new finance lease entered into at the date of initial application.

An intermediate lessor (i.e., an entity that is both the lessee and lessor of the same underlying asset) reassesses each existing operating sublease at the date of initial application to determine whether it is classified as an operating lease or a finance lease under the requirements of IFRS 16. This reassessment is based on the remaining contractual terms of the head lease and the sublease with reference to the right-of-use asset associated with the head lease and not the underlying asset.

If a sublease was classified as an operating lease under IAS 17, but is classified as a finance lease under IFRS 16, the intermediate lessor accounts for the sublease as a new finance lease entered into on the date of initial application. Any gain or loss arising on the sublease arrangement is included in the cumulative catch-up adjustment to retained earnings (or other component of equity, as appropriate) at the date of initial application.

## 9.5 Other considerations

IFRS 16 provides specific guidance on transition for sale and leaseback transactions and amounts previously recognised in a business combination. Such specific guidance is applicable irrespective of the transition approach adopted (i.e., full retrospective and modified retrospective approaches). Thus, lessees are required to follow the specific guidance below, even when adopting the full retrospective approach.

### 9.5.1 Sale and leaseback transition

#### Extract from IFRS 16

##### **Sale and leaseback transactions before the date of initial application**

- C16 An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale.
- C17 If a sale and leaseback transaction was accounted for as a sale and a finance lease applying IAS 17, the seller-lessee shall:
- (a) account for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application; and
  - (b) continue to amortise any gain on sale over the lease term.
- C18 If a sale and leaseback transaction was accounted for as a sale and operating lease applying IAS 17, the seller-lessee shall:
- (a) account for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application; and
  - (b) adjust the leaseback right-of-use asset for any deferred gains or losses that relate to off-market terms recognised in the statement of financial position immediately before the date of initial application.

A seller-lessee is prohibited from reassessing historical sale and leaseback transactions to determine whether a sale occurred in accordance with IFRS 15.

A seller-lessee does not perform any retrospective adjustments to sale and leaseback transactions on transition to IFRS 16. Instead, the leaseback is accounted for on transition in the same way as any other lease ongoing at the date of initial application, subject to the following:

- ▶ For sale and leaseback transactions previously classified as finance leases, any gain on the sale continues to be amortised over the lease term, in the same way as under IAS 17
- ▶ For sale and leaseback transactions previously classified as operating leases, any deferred losses or gains relating to off-market terms at the date of initial application are adjusted against the right-of-use asset

## 9.5.2 Amounts previously recognised in a business combination

### Extract from IFRS 16

#### Amounts previously recognised in respect of business combinations

C19 If a lessee previously recognised an asset or liability applying IFRS 3 *Business Combinations* relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee shall derecognise that asset or liability and adjust the carrying amount of the right-of-use asset by a corresponding amount at the date of initial application.

If a lessee has previously recognised an asset or a liability related to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee will derecognise that asset and liability with a corresponding adjustment to the right-of-use asset.

## 9.6 Disclosure

### 9.6.1 Disclosure requirements on initial application

An entity that applies a standard retrospectively is required to provide the disclosures required in IAS 8, as follows:

### Extract from IAS 8

#### Disclosure

28 When initial application of an IFRS has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

- (a) the title of the IFRS;
- (b) when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
- (c) the nature of the change in accounting policy;
- (d) when applicable, a description of the transitional provisions;
- (e) when applicable, the transitional provisions that might have an effect on future periods;
- (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;
- (g) the amount of the adjustment relating to periods before those presented, to the extent practicable; and
- (h) if retrospective application required by paragraph 19(a) or (b) is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.



### 9.6.2 Additional disclosure for lessees using the modified retrospective approach

#### Extract from IFRS 16

##### Disclosure

C12 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall disclose information about initial application required by paragraph 28 of IAS 8, except for the information specified in paragraph 28(f) of IAS 8. Instead of the information specified in paragraph 28(f) of IAS 8, the lessee shall disclose:

- (a) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the statement of financial position at the date of initial application; and
- (b) an explanation of any difference between:
  - (i) operating lease commitments disclosed applying IAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application as described in paragraph C8(a); and
  - (ii) lease liabilities recognised in the statement of financial position at the date of initial application.

C13 If a lessee uses one or more of the specified practical expedients in paragraph C10, it shall disclose that fact.

A lessee is required to make specific disclosures to help users understand the effect of the new standard compared to IAS 17. Instead of the requirements of paragraph 28(f) of IAS 8, a lessee is required to disclose the following:

- ▶ The weighted average incremental borrowing rate at the date of initial application
- ▶ Explanation of any differences between:
  - ▶ The result of discounting the operating lease commitments reported under IAS 17 at the end of the annual reporting period preceding the date of initial application; and
  - ▶ Lease liabilities recognised on the balance sheet immediately after posting the cumulative catch-up adjustment on the date of initial application. Differences could arise because of the application of recognition exemptions for short-term leases and leases of low-value assets.

## Appendix A: IFRS 16 Defined terms

The following table summarises the terms that are defined in Appendix A of IFRS 16.

Term	Definition
<i>Commencement date of the lease (commencement date)</i>	The date on which a lessor makes an underlying asset available for use by a lessee.
<i>Economic life</i>	Either the period over which an asset is expected to be economically usable by one or more users, or the number of production or similar units expected to be obtained from an asset by one or more users.
<i>Effective date of the modification</i>	The date when both parties agree to a lease modification.
<i>Fair value</i>	For the purpose of applying the lessor accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
<i>Finance lease</i>	A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.
<i>Fixed payments</i>	Payments made by a lessee to a lessor for the right to use an underlying asset during the lease term, excluding variable lease payments.
<i>Gross investment in the lease</i>	The sum of: (a) The lease payments receivable by a lessor under a finance lease; and (b) Any unguaranteed residual value accruing to the lessor.
<i>Inception date of the lease (inception date)</i>	The earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
<i>Initial direct costs</i>	Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease.
<i>Interest rate implicit in the lease</i>	The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.
<i>Lease</i>	A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.
<i>Lease incentives</i>	Payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.

<b>Term</b>	<b>Definition</b>
<i>Lease modification</i>	A change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, of extending or shortening the contractual lease term).
<i>Lease payments</i>	<p>Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:</p> <ul style="list-style-type: none"> <li>(a) Fixed payments (including in-substance fixed payments), less any lease incentives;</li> <li>(b) Variable lease payments that depend on an index or a rate;</li> <li>(c) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and</li> <li>(d) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.</li> </ul> <p>For the lessee, lease payments also include amounts expected to be payable by the lessee under residual value guarantees. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.</p> <p>For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.</p>
<i>Lease term</i>	<p>The non-cancellable period for which a lessee has the right to use an underlying asset, together with both:</p> <ul style="list-style-type: none"> <li>(a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and</li> <li>(b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.</li> </ul>
<i>Lessee</i>	An entity that obtains the right to use an underlying asset for a period of time in exchange for consideration.
<i>Lessee's incremental borrowing rate</i>	The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.
<i>Lessor</i>	An entity that provides the right to use an underlying asset for a period of time in exchange for consideration.
<i>Net investment in the lease</i>	The gross investment in the lease discounted at the interest rate implicit in the lease.

<b>Term</b>	<b>Definition</b>
<i>Operating lease</i>	A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.
<i>Optional lease payments</i>	Payments to be made by a lessee to a lessor for the right to use an underlying asset during periods covered by an option to extend or terminate a lease that are not included in the lease term.
<i>Period of use</i>	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
<i>Residual value guarantee</i>	A guarantee made to a lessor by a party unrelated to the lessor that the value (or part of the value) of an underlying asset at the end of a lease will be at least a specified amount.
<i>Right-of-use asset</i>	An asset that represents a lessee's right to use an underlying asset for the lease term.
<i>Short-term lease</i>	A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.
<i>Sublease</i>	A transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and the lessee remains in effect.
<i>Underlying asset</i>	An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.
<i>Unearned finance income</i>	The difference between: (a) The gross investment in the lease; and (b) The net investment in the lease.
<i>Unguaranteed residual value</i>	That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor.
<i>Variable lease payments</i>	The portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

The following terms are defined in other standards and are used in IFRS 16 with the same meaning.

<i>Contract</i>	An agreement between two or more parties that creates enforceable rights and obligations.
<i>Useful life</i>	The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

## Appendix B: Key differences between IFRS 16 and IAS 17

The following is a summary of the key differences between IFRS 16 and IAS 17.

	IFRS 16	IAS 17
<b>Definition of a lease</b>	<p>Under IFRS 16, a lease is a contract, or part of a contract, that conveys the right to control the use of an asset (the underlying asset) for a period of time in exchange for consideration.</p> <p>To determine if the right to control has been conveyed to the customer, an entity assesses whether, throughout the period of use, the customer has the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset.</p> <p><i>Section 2.1 Determining whether an arrangement contains a lease</i></p>	<p>IAS 17 defines a lease as an agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time. Under IFRIC Interpretation 4 <i>Determining whether an Arrangement contains a Lease</i>, it is not necessary for an arrangement to convey the right to control the use of an asset to be in scope of IAS 17.</p>
<b>Recognition exemptions</b>		
Short term leases - lessees	<p>Lessees can elect, by class of underlying asset to which the right of use relates, to apply a method similar to IAS 17 operating lease accounting, to leases with a lease term of 12 months or less and without a purchase option.</p> <p><i>Section 4.1.1 Short-term leases</i></p>	Not applicable
Leases of low value assets - lessees	<p>Lessees can elect, on a lease-by-lease basis, to apply a method similar to IAS 17 operating lease accounting, to leases of low-value assets (e.g., tablets and personal computers, small items of office furniture and telephones).</p> <p><i>Section 4.1.2 Leases of low-value assets</i></p>	Not applicable

	IFRS 16	IAS 17
<b>Classification</b>		
Lease classification - lessees	<p>Lessees apply a single recognition and measurement approach for all leases, with options not to recognise right-of-use assets and lease liabilities for short-term leases and leases of low-value assets.</p> <p>Section 4.1 <i>Initial recognition</i></p>	<p>Lessees apply a dual recognition and measurement approach for all leases. Lessees classify a lease as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. Otherwise a lease is classified as an operating lease.</p>
<b>Measurement</b>		
Lease payments included in the initial measurement - lessees	<p>At the commencement date, lessees (except short-term leases and leases of low-value assets) measure the lease liability at the present value of the lease payments to be made over the lease term. Lease payments include:</p> <ul style="list-style-type: none"> <li>(a) Fixed payments (including in-substance fixed payments), less any lease incentives receivable</li> <li>(b) Variable lease payments that depend on an index or a rate, initially measured using the index or rate at the commencement date</li> <li>(c) Amounts expected to be payable by the lessee under residual value guarantees</li> <li>(d) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option</li> <li>(e) Payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease</li> </ul> <p>Section 4.2.2 <i>Lease liability</i></p> <p>In addition, the cost of the right-of-use asset comprises:</p> <ul style="list-style-type: none"> <li>(a) The lease liability</li> <li>(b) Lease payments made at or before the commencement date, less any lease incentives received</li> <li>(c) Initial direct costs</li> <li>(d) Asset retirement obligations,</li> </ul>	<p>At the commencement of the lease term, lessees recognise finance leases as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease.</p> <p>Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, for a lessee, any amounts guaranteed by the lessee or by a party related to the lessee.</p> <p>No assets and liabilities are recognised for the initial measurement of operating leases.</p>

	IFRS 16	IAS 17
	<p>unless those costs are incurred to produce inventories</p> <p>Section 4.2.1 <i>Right-of-use assets</i></p>	
Reassessment of lease liability - lessees	<p>After the commencement date, lessees are required to remeasure the lease liability when there is a lease modification (i.e., a change in the scope of a lease, or the consideration for a lease that was not part of the original terms and conditions of the lease) that is not accounted for as a separate contract.</p> <p>Section 4.5 <i>Lease modifications</i></p> <p>Lessees are also required to remeasure lease payments upon a change in any of the following:</p> <ul style="list-style-type: none"> <li>▶ The lease term (section 3.4.1)</li> <li>▶ The assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset (section 3.4.1.1)</li> <li>▶ The amounts expected to be payable under residual value guarantees (section 3.5.6)</li> <li>▶ Future lease payments resulting from a change in an index or rate (section 3.5.3)</li> </ul> <p>Section 3.5.9 <i>Reassessment of the lease liability</i></p>	Not dealt with by IAS 17
Measurement basis for right-of-use assets other than cost model - lessees	<p>If a lessee applies the fair value model in IAS 40 to its investment property, under IFRS 16, the lessee also applies the fair value model to right-of use assets that meet the definition of investment property.</p> <p>Section 4.3.1 <i>Right-of-use assets</i></p>	Property interests held by lessees that are accounted for as investment property is measured under IAS 40 and thus outside the scope of IAS 17.

	IFRS 16	IAS 17
<b>Lease modifications</b>		
Lease modifications to an operating lease - lessors	<p>Lessors account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.</p> <p>Section 5.5.2 <i>Modification to an operating lease</i></p>	Not dealt with by IAS 17
Lease modifications which do not result in new separate leases - lessees and lessors	<p>Lessees:</p> <ul style="list-style-type: none"> <li>(a) Allocate the consideration in the modified contract</li> <li>(b) Determine the lease term of the modified lease</li> <li>(c) Remeasure the lease liability by discounting the revised lease payments using a revised discount rate with a corresponding adjustment to right-of-use asset</li> </ul> <p>In addition, lessees recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.</p> <p>Lessors:</p> <p>If a lease would have been an operating lease, had the modification been in effect at the inception date, lessors in a finance lease:</p> <ul style="list-style-type: none"> <li>(i) Account for the modification as a new lease</li> <li>(ii) Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the modification</li> </ul> <p>Otherwise the modification is accounted for in accordance with IFRS 9 <i>Financial Instruments</i>.</p> <p>Sections 4.5.2 <i>Lessee accounting for a modification that does not result in a separate lease</i> and 5.5.1.2 <i>Lessor accounting for a modification that does not result in a separate lease</i> for lessees and lessors, respectively.</p>	Not dealt with by IAS 17



	IFRS 16	IAS 17
<b>Presentation and disclosure</b>		
Presentation - lessees	<p>Statement of financial position- present right-of-use assets (other than those that meet the definition of an investment property) separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee is required to include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned and disclose which line items in the statement of financial position include those right-of-use assets.</p> <p>Lease liabilities are also presented separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee is required to disclose which line items in the statement of financial position include those liabilities.</p> <p>Statement of profit or loss - present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of IAS 1 <i>Presentation of Financial Statements</i> requires to be presented separately in the statement of profit or loss.</p> <p>Cash flow statement - classify cash payments for the principal portion of the lease liability within financing activities; cash payments for the interest portion of the lease liability applying the requirements in IAS 7 for interest paid; and short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.</p> <p>Section 4.7 <i>Presentation</i></p>	<p>Presentation in the statement of financial position- not dealt with by IAS 17</p> <p>Statement of profit or loss - operating lease expense is presented as a single item</p> <p>Cash flow statement- for operating leases, cash payments are included within operating activities</p>

	IFRS 16	IAS 17
Disclosure-lessees and lessors	Detailed disclosures including the format of disclosure, are required under IFRS 16. In addition, qualitative and quantitative information about leasing activities is required in order to meet the disclosure objective.  Sections 4.8 <i>Disclosure</i> and 5.8 <i>Disclosure</i> for lessees and lessors, respectively	Quantitative and qualitative disclosures are required, but generally fewer disclosures are required than under IFRS 16.
<b>Sale and leaseback transactions</b>		
Sale and leaseback transactions - determining whether a sale has occurred	Seller-lessees and buyer-lessors apply the requirements in IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction.  Section 7.1 <i>Determining whether the transfer of an asset is a sale</i>	IAS 17 focuses on whether the leaseback is an operating or finance lease and does not explicitly require the transfer of the asset to meet the requirements for a sale in accordance with IAS 18 for seller-lessees and buyer-lessors.
Sale and leaseback transactions - accounting by seller-lessees	The seller-lessee measures the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of-use retained by the seller-lessee and recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.  Section 7.2.1 <i>Accounting for the sale</i>	If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount are deferred and amortised over the lease term.  If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss is recognised immediately.
Sale and leaseback transactions - accounting by seller-lessees for transactions not at fair value	If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity is required to measure the sale proceeds at fair value with an adjustment either as a prepayment of lease payments (any below market terms) or additional financing (any above market terms) as appropriate.  Section 7.2.3 <i>Adjustment for off-market terms</i>	If a sale and leaseback transaction results in an operating lease and the sale price is <ul style="list-style-type: none"> <li>▶ Below fair value - any profit or loss is recognised immediately except that, if the loss is compensated for by future lease payments at below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used</li> <li>▶ Above fair value - the excess over fair value is</li> </ul>

	IFRS 16	IAS 17
		deferred and amortised over the period for which the asset is expected to be used
<b>Business combinations</b>		
Business combinations - acquiree is a lessee - initial measurement	<p>The acquirer is not required to recognise right-of-use assets and lease liabilities for leases with a remaining lease term less than 12 months from the acquisition date, or leases for which the underlying asset is of low value.</p> <p>The acquirer measures the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease, relative to market terms.</p> <p><i>Section 8.1.1 Initial measurement of a lease</i></p>	<p>There is no exemption for leases with a remaining lease term less than 12 months from the acquisition date, or leases for which the underlying asset is of low value.</p> <p>An intangible asset is recognised if terms of operating lease are favourable relative to market terms and a liability is recognised if terms are unfavourable relative to market terms.</p> <p>An intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is at market terms.</p>

## Appendix C: Key differences between IFRS 16 and ASC 842

The IASB issued IFRS 16 after joint deliberations with the US FASB, which issued a similar standard, ASC 842 *Leases*. While IFRS 16 and ASC 842 both require lessees to put most leases on their balance sheets, there are a number of differences between the standards. The following table summarises the key differences and includes references to the IASB's and FASB's discussion of the differences in the Basis for Conclusions for each standard (i.e., IFRS 16 and ASU 2016-2).

	IFRS 16	US GAAP ASC 842
<b>Scope and measurement exceptions</b>		
<i>Low-value asset exemption</i> <sup>5</sup>	Lessees may elect, on a lease-by-lease basis, not to recognise leases when the value of the underlying asset is low (e.g., US\$5,000 or less when new).	There is no recognition exemption for leases based on the value of the underlying asset.
<i>Scope exemption for intangible assets</i> <sup>6</sup>	Lessees may apply IFRS 16 to leases of intangible assets other than rights held by a lessee under licensing agreements within the scope of IAS 38 <i>Intangible Assets</i> , for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. Lessors are required to apply IFRS 16 to leases of intangible assets, except for licences of intangible property that are in the scope of IFRS 15 <i>Revenue from Contracts with Customers</i> .	All leases of intangible assets are excluded from the scope of ASC 842.
<b>Key concepts</b>		
<i>Lease liability - reassessment of variable lease payments</i> <sup>7</sup>	Changes in variable lease payments based on an index or rate result in a remeasurement of the lease liability whenever there is a change in the contractual cash flows (i.e., when the adjustment to the lease payment takes effect).	Changes in variable lease payments based on an index or rate result in a remeasurement of the lease liability when the lease liability is remeasured for another reason (e.g., a change in the lease term).
<i>Determination of the discount rate</i>	Lessees determine the discount rate at lease commencement but lessors determine the rate implicit in the lease at the lease inception date.	Lessees and lessors determine the discount rate at the lease commencement date.

<sup>5</sup> IFRS 16 BC308 and ASC 842 BC421

<sup>6</sup> ASC 842 BC431

<sup>7</sup> IFRS 16 BC309 and ASC 842 BC425

	IFRS 16	US GAAP ASC 842
<i>Determination of a lessee's incremental borrowing rate</i>	IFRS 16 does not address whether a lessee may consider the effect of lease term options (e.g., purchase and renewal options) that are not included in the lease term.  IFRS 16 does not provide accounting alternatives for private companies.	A lessee may consider the effect of lease term options (e.g., purchase and renewal options) that are not included in the lease term.  Entities that are not public business entities (PBEs) may elect to use a risk-free rate for initial and subsequent measurements of the lease liability.
<i>Initial direct costs (IDCs)</i>	IDCs are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained. However, costs incurred by a manufacturer or dealer lessor in connection with a finance lease are expensed as incurred.	IDCs are incremental costs that would not have been incurred if the lease had not been obtained. Lessors expense IDCs for sales-type leases if the fair value of the underlying asset is different from the carrying amount of the underlying asset at lease commencement.
<b>Lease classification</b>		
<i>Lessee lease classification<sup>8</sup></i>	All leases are accounted for based on a right-of-use model (similar to finance leases under ASC 842), unless a recognition exemption is adopted.	Recognised leases are classified as either finance or operating. Lessees classify leases at the lease commencement date.
<i>Lessor lease classification</i>	Leases are classified as finance or operating leases at the inception date of the lease.	Leases are classified as operating, direct financing or sales-type leases at the lease commencement date.
<i>Lessor - lease classification criteria</i>	All classification criteria can be considered individually or in combination. IFRS 16 provides examples and indicators of situations that can be considered individually, or in combination, and would result in a lease being classified as a finance lease. Meeting a single criterion would not automatically result in the lease being classified as a finance lease.	Each classification criterion is determinative (i.e., if any single criterion is met, the lease will be a sales-type lease).
<i>Collectability</i>	IFRS 16 does not include explicit guidance for considering collectability of lease payments.	Collectability of lease payments is considered when determining if a lease is classified as a direct financing or operating lease.
<i>Subleases</i>	When classifying a sublease, a sublessor classifies the sublease based on the right-of-use asset recognised as part of the head lease.	When classifying a sublease, the sublessor classifies the sublease based on the underlying asset rather than the right-of-use asset on the head lease.

<sup>8</sup> IFRS 16 BC304 and ASC 842 BC420

Lessee accounting		
<i>Short-term leases - existence of a purchase option</i>	A lease may not qualify as a short-term lease if it includes a purchase option, regardless of whether the lessee is reasonably certain to exercise the option.	A lease may not qualify as a short-term lease if it includes a purchase option that is reasonably certain to be exercised.
<i>Short-term leases - change in lease term</i>	A change in the terms of a short-term lease creates a new lease. If that new lease has a lease term greater than 12 months, it cannot qualify as a short-term lease.	A lease may no longer qualify as a short-term lease when there is a change in a lessee's assessment of either of the following: <ul style="list-style-type: none"> <li>▶ The lease term so that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term</li> <li>▶ Whether the lessee is reasonably certain to exercise an option to purchase the underlying asset.</li> </ul>
<i>Allocating variable consideration not dependent on an index or rate between lease and non-lease components of a contract</i>	Under IFRS 16 lessees may allocate variable consideration entirely to a non-lease component of a contract. Refer to IFRS 16's Illustrative Examples - Example 12	Lessees allocate variable consideration not depending on an index or rate to the lease and non-lease components of a contract.
<i>Lease modifications that do not result in a separate contract and shorten the contractual lease term</i>	Lease modifications that do not result in a separate contract and shorten the contractual lease term may result in the recognition of a gain or loss for the difference between the decrease in the lease liability and the proportionate decrease in the right-of-use asset. Refer to IFRS 16's Illustrative Examples - Example 18.	Lease modifications that do not result in a separate contract and shorten the contractual lease term do not result in the recognition of a gain or loss. A lessee recognises the amount of the remeasurement of the lease liability as an adjustment to the corresponding right-of-use asset without affecting profit or loss. However, if the right-of-use asset is reduced to zero, a lessee would recognise any remaining amount in profit or loss.
<i>Component-isation</i>	A lessee applies the depreciation requirements in IAS 16 <i>Property, Plant and Equipment</i> in depreciating right-of-use assets, which requires that each item of property, plant and equipment with a cost that is significant in relation to the total cost of the item be depreciated separately (i.e., a component approach).	Component depreciation is permitted but not common.

Lessor accounting		
<i>Practical expedient to not separate lease and non-lease components</i>	IFRS 16 does not include a practical expedient for lessors.	A lessor can elect, by class of underlying asset, not to separate lease and related non-lease components if certain criteria are met. Additionally, if the non-lease component is the predominant component of the combined component, the combined component is accounted for in accordance with ASC 606.
<i>Recognition of selling profit for direct financing leases<sup>9</sup></i>	IFRS does not distinguish between sales-type and direct financing leases. Selling profit on finance leases is recognised at lease commencement.	Selling profit on direct financing leases is deferred at lease commencement and amortised into income over the lease term.
<i>Collectability – sales-type leases and operating leases</i>	IFRS 16 does not include explicit guidance for considering collectability of lease payments.	Collectability of lease payments is assessed for purposes of initial recognition and measurement of sales-type leases. It is also evaluated to determine the income recognition pattern of operating leases.
<i>Modification of a sales-type or direct financing lease<sup>10</sup> (under US GAAP) or a finance lease (under IFRS) that does not result in a separate contract</i>	If the modification of a finance lease is not accounted for as a separate contract, the accounting for the modification depends on whether the finance lease would have been classified as an operating lease had the modification been in effect at lease inception. IFRS 16 then specifies how to account for the modified lease based on that classification.	If the modification of a sales-type or direct financing lease is not accounted for as a separate contract, the entity reassesses the classification of the lease as of the effective date of the modification based on the modified terms and conditions, and the facts and circumstances as of that date. ASC 842 then specifies how to account for the modified lease based on the classification of the modified lease.

<sup>9</sup> ASC 842 BC427

<sup>10</sup> IFRS 16.80 and ASC 842 BC429

	IFRS 16	US GAAP ASC 842
<i>Allocating variable consideration not dependent on an index or rate between lease and non-lease components of a contract</i>	IFRS 16 does not give guidance for variable consideration related to the lease component. Lessors would allocate the consideration in the contract based on the guidance in paragraphs 73-90 of IFRS 15, which is to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.	If the terms of a variable payment that is not dependent on an index or rate relate, even partially, to the lease component, the lessor will recognise those payments (allocated to the lease component) as income in profit or loss in the period when the changes in facts and circumstances on which the variable payment is based occur (e.g., when the lessee's sales on which the amount of the variable payment depends occur). When the changes in facts and circumstances on which the variable payment is based occur, the lessor will allocate those payments to the lease and non-lease components of the contract. The allocation is based on the same basis as the initial allocation of the consideration in the contract or the most recent modification not accounted for as a separate contract unless the variable payment meets the criteria in 606-10-32-40 to be allocated only to the lease component(s).
<b>Sale and leaseback transactions</b>		
<i>Assessing if a transfer of an asset is a sale in a sale/purchase and leaseback transaction</i>	<p>To determine whether the transfer of an asset is accounted for as a sale, a seller-lessee and a buyer-lessor apply the requirements in IFRS 15 (including those for repurchase agreements) to assess whether the buyer-lessor has obtained control of the asset.</p> <p>IFRS 16 does not contain the same lease classification criteria included in US GAAP, which precludes sale accounting if the leaseback would be classified as a sales-type lease by the buyer-lessor or a finance lease by the seller-lessee. However, entities should carefully consider the requirements in IFRS 15 (i.e., whether the buyer-lessor obtains control of the asset) to determine whether the transfer of an asset is accounted for as a sale and purchase. Entities may often reach similar conclusions on whether a sale and purchase have occurred under both standards.</p>	<p>To determine whether an asset transfer is a sale and purchase, a seller-lessee and a buyer-lessor consider the following:</p> <ul style="list-style-type: none"> <li>▶ Whether the transfer meets the sale criteria under ASC 606 (however, certain fair value repurchase options would not result in a failed sale)</li> <li>▶ Whether the leaseback would be classified as a sales-type lease by the buyer-lessor or a finance lease by the seller-lessee (i.e., a sale and purchase does not occur when the leaseback is classified as a sales-type lease by the buyer-lessor or as a finance lease by the seller-lessee)</li> </ul>



	IFRS 16	US GAAP ASC 842
<i>Gain or loss recognition in sale and leaseback transactions<sup>11</sup></i>	The seller-lessee recognises only the amount of any gain or loss, adjusted for off-market terms, that relates of the rights transferred to the buyer- lessor.	The seller-lessee recognises any gain or loss, adjusted for off-market terms, immediately.
<i>Failed sales - seller/lessee</i>	Asset transfers that do not qualify as sales should be accounted for as financings in accordance with IFRS 9 <i>Financial Instruments</i> by the lessor and lessee. IFRS 16 does not provide additional guidance on interest rate adjustments.	Asset transfers that do not qualify as sales should be treated as financings by the lessor and lessee. ASC 842 provides additional guidance on adjusting the interest rate in certain circumstances (e.g., to ensure there is not a built-in loss).
<b>Other considerations</b>		
<i>Related party transactions</i>	IFRS 16 does not address related party lease transactions. IAS 24 <i>Related Party Disclosures</i> contains guidance on related party disclosures.	Entities classify and account for related party leases (including sale and leaseback transactions) based on the legally enforceable terms and conditions of the lease. Disclosure of related party transactions is required.
<i>Identified asset - subsurface rights</i>	When evaluating whether a contract that includes the right to use specified underground space to place an asset (i.e., subsurface rights) contains a lease, an entity would conclude the identified asset is the specified underground space.	When evaluating whether a contract that includes the right to use specified underground space to place an asset (i.e., subsurface rights) contains a lease, an entity would conclude the identified asset is either the land, including the specified underground space, or only the specified underground space.
<i>Rent concessions related to the Covid-19 pandemic</i>	The IASB amended IFRS 16 to provide relief to lessees to elect not to assess whether a Covid-19-related rent concession from a lessor is a lease modification when certain conditions are met. A lessee that makes this election accounts for any change in lease payments resulting from the Covid-19-related rent concession the same way it would account for the change under IFRS 16, if the change were not a lease modification. The practical expedient is not available to lessors.	In a Q&A document, the FASB staff said that entities can elect to not evaluate whether a concession provided by a lessor due to Covid-19 is a lease modification. An entity that makes this election can then elect whether to apply the modification guidance (i.e., assume the concession was always contemplated by the contract or assume the concession was not contemplated by the contract). The FASB staff said both lessees and lessors could make these elections.
<b>Effective date and transition</b>		

<sup>11</sup> IFRS 16 BC306 and ASC 842 BC430.

	IFRS 16	US GAAP ASC 842
<i>Effective date</i>	For all entities, IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019.	For PBEs and certain other entities, ASC 842 is effective for fiscal years beginning after 15 December 2018.  For certain not-for-profit entities, ASC 842 is effective for annual periods beginning after 15 December 2019.  For other entities, ASC 842 is effective for fiscal years beginning on or after 15 December 2021.
<i>Early adoption</i>	Early adoption is permitted for entities that apply IFRS 15 at or before the date of initial application of IFRS 16.	Early adoption is permitted in all cases.
<i>Modified retrospective transition - application to comparative periods</i>	Comparative periods are not adjusted.	ASC 842 provides an option to apply the transition provisions as of the beginning of the earliest comparative period presented in the financial statements or as of the effective date. Comparative periods are adjusted when an entity elects to apply the transition provisions as of the earliest comparative period presented in the financial statements. Comparative periods are not adjusted when an entity elects to apply the transition provisions as of the effective date.
<i>Modified retrospective transition - specific transition guidance</i>	Transition guidance primarily addresses lessee's leases previously classified as operating leases under IAS 17 Leases.	Specific transition guidance is provided for all leases depending on the lease classification before and after application of ASC 842.
<i>Full retrospective transition</i>	This is permitted under IFRS.	This is prohibited under US GAAP.
<i>Leveraged leases</i>	Leveraged lease accounting is not permitted under IFRS 16.	Leveraged lease accounting is eliminated for leases that commence on or after the effective date of ASC 842. However, leveraged leases that commenced before the effective date are grandfathered. If an existing leveraged lease is modified on or after the effective date, the lease would no longer be accounted for as a leveraged lease, but would instead be accounted for under ASC 842.

## Appendix D: Summary of lease reassessment and remeasurement requirements

This table summarises lessee and lessor reassessment and remeasurement requirements under IFRS 16. Refer to section 9 *Effective date and transition*, for the requirements for leases that commenced prior to the effective date of IFRS 16.

	Lessees	Lessors
Reassess whether a contract is or contains a lease	Reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed. <i>Section 2.1.7 Reassessment of the contract</i>	Reassess whether a contract is or contains a lease only if the terms and conditions of the contract are changed. <i>Section 2.1.7 Reassessment of the contract</i>
Allocation of consideration in the contract between lease and non-lease components	Allocate upon a modification that is not accounted for as a separate lease <i>Section 4.5.2 Lessee accounting for a modification that does not result in a separate lease</i>	Not specifically addressed
Reassessment of lease term and purchase options	Reassess the lease term and the purchase options upon the occurrence of either a significant event or a significant change in circumstances that: <ul style="list-style-type: none"> <li>▶ Is within the control of the lessee; and</li> <li>▶ Affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term</li> </ul> Revise the lease term if there is a change in the non-cancellable period of a lease. <i>Section 3.4.2.1 Reassessment of the lease term and purchase options - lessees</i>	Revise the lease term if there is a change in the non-cancellable period of a lease. <i>Section 3.4.2.2 Reassessment of the lease term and purchase options - lessors</i>
Remeasurement of lease payments (including variable lease payments that depend on an index or rate, the exercise of a purchase option and, for lessees only, amounts expected to be	Remeasure upon any of the following: <ul style="list-style-type: none"> <li>▶ A lease modification that is not accounted for as a separate lease</li> <li>▶ Upon a change in any of the following: <ul style="list-style-type: none"> <li>▶ The lease term</li> <li>▶ The assessment of an option to purchase the underlying asset</li> </ul> </li> </ul>	Remeasure upon a change in the non-cancellable period of a lease <i>Section 3.4.2.2 Reassessment of the lease term and purchase options - lessors</i>

	Lessees	Lessors
payable under a residual value guarantee)	<ul style="list-style-type: none"> <li>▶ The amounts expected to be payable under a residual value guarantee</li> <li>▶ Future lease payments resulting from a change in an index or rate used to determine those payments</li> <li>▶ A change in in-substance fixed lease payments</li> </ul> <p>Section 3.5.9 <i>Reassessment of the lease liability</i>, and section 4.5.2 <i>Lessee accounting for a modification that does not result in a separate lease</i></p>	
Reassessment of lease classification	Not applicable	Reassess upon a lease modification Section 5.1.2 <i>Reassessment of lease classification</i>
Reassessment of unguaranteed residual values	Not applicable	Review regularly the estimated unguaranteed residual values used in computing the gross investment in the lease Section 5.3.4 <i>Unguaranteed residual values</i>
Reassessment of the discount rate	<p>Reassess upon any of the following:</p> <ul style="list-style-type: none"> <li>▶ A change in the lease term</li> <li>▶ A change in the assessment of an option to purchase the underlying asset</li> <li>▶ A modification that is not accounted for as a separate lease</li> </ul> <p>A change in lease payments resulting from a change in floating interest rates</p> <p>Section 3.5.9 <i>Reassessment of the lease liability</i>, and section 4.5.2 <i>Lessee accounting for a modification that does not result in a separate lease</i></p>	IFRS 16 does not have specific requirements on the assessment of the discount rate

**Note:** Refer to section 4.5 *Lease modifications*, and section 5.5 *Lease modifications*, for further details on accounting for lease modifications by lessees and lessors, respectively.

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