



Leases

A guide to IFRS 16

June 2016

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Foreword

This guide is intended to assist preparers and users of financial statements to understand the impact of IFRS 16 *Leases*, issued in January 2016 and effective for accounting periods beginning on or after 1 January 2019.

We begin with a high-level executive summary of the new requirements, followed by a specific focus on the important issues and choices available for entities on transition to the new Standard. Our detailed guide covers the requirements of the new Standard, supplemented by interpretations and examples to give clarity to those requirements, and pointers regarding practical issues that are likely to arise.

In the appendices, we provide:

- a summary of the important illustrative examples accompanying IFRS 16 dealing with the identification of leases;
- convenient checklists for IFRS 16's presentation and disclosure requirements (separately for lessees and lessors); and
- a brief comparison with US Generally Accepted Accounting Principles (US GAAP).

We trust that you will find this guide informative and a useful reference source.

Within the detailed guide, paragraphs that represent the authors' interpretations, material drawn from the IASB's Basis of Conclusions on IFRS 16, and examples other than those cited in IFRSs are highlighted by green shading.

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Executive summary

IFRS 16 *Leases* was issued by the IASB in January 2016. It will replace IAS 17 *Leases* for reporting periods beginning on or after 1 January 2019. It can be applied before that date by entities that also apply IFRS 15 *Revenue from Contracts with Customers*.

IFRS 16 sets out a comprehensive model for the identification of lease arrangements and their treatment in the financial statements of both lessees and lessors. IFRS 16 applies a control model for the identification of leases, distinguishing between leases and service contracts on the basis of whether there is an identified asset controlled by the customer. While, for the majority of contracts, the classification under the new Standard as either a lease or a service contract may not be different to the classification under the IAS 17 'risks and rewards' model, divergence may emerge, for example, when the pricing of the contract was a significant consideration under IAS 17. Importantly, both lessors and lessees are entitled to 'grandfather' assessments regarding whether a contract existing at the date of initial application of IFRS 16 contains a lease so that entities are not required to incur the costs of detailed reassessments.

One of the most notable aspects of IFRS 16 is that the lessee and lessor accounting models are asymmetrical. While the IASB has retained IAS 17's finance lease/operating lease distinction for lessors (and carried into IFRS 16 the related requirements virtually intact), the distinction is no longer relevant for lessees.

For lessors, the changes introduced by IFRS 16 are not significant and, except in respect of subleases, a lessor is not required to make any adjustments on transition for leases in which it is a lessor. Additional requirements have been introduced for subleases and lease modifications, and lessor disclosure requirements have been expanded.

For lessees, the picture is fundamentally different and IFRS 16 can be expected to have a significant impact, particularly for entities that have previously kept a large proportion of their financing 'off-balance sheet' in the form of operating leases. This operating lease-style accounting treatment is no longer available, except for short-term leases (lease term 12 months or less) and leases of low-value assets ('low value' is not specifically defined but the IASB has indicated that it has in mind assets with a value, when new, in the order of magnitude of US\$5,000 or less).

All other leases within the scope of IFRS 16 are required to be brought on-balance sheet by lessees – recognising a 'right-of-use' asset and the related lease liability at commencement of the lease, with subsequent accounting generally similar to the finance lease model under IAS 17.

How these new requirements affect a lessee's financial statements will obviously depend on the mix of lease agreements in place, and also on which of the Standard's exceptions and practical expedients are applied. However, the expectation for lessees will be:

- an increase in recognised assets and liabilities (right-of-use assets and liabilities recognised other than for short-term leases and leases of low-value assets);
- more lease expenses recognised in the early periods of a lease, and less in the later periods ('front-loaded' finance charge on lease liability versus straight-line expense under IAS 17's operating lease approach);

- a shift in lease expense classification from operating expenses to financing costs and amortisation (i.e. moving below metrics such as operating profit, EBITDA or EBIT). There are some exceptions: any variable lease payments not included in the initial measurement of the lease liability are classified as operating expenses, as are the expenses associated with short-term and low-value asset leases for which recognition exemptions are applied; and
- for entities that present cash flows related to interest on leases as financing flows, a shift of the payments previously associated with operating leases to the financing category (unless they change their policy regarding presentation of interest cash flows). Cash from operations and financing activity outflows will both increase for these entities.

A number of aspects of the application of IFRS 16 will require the exercise of judgement – particularly in respect of the definition of a lease and the assessment of the lease term. Entities will also need to take time to consider whether to avail of practical expedients and recognition exemptions (including, in particular, reliefs available on transition, as discussed in detail in the next section of this guide).

In addition, there are important business considerations – including whether changes are needed to systems and processes (e.g. to track leases individually or at a portfolio level, or to accumulate the information needed for disclosures); any potential tax impacts (if the treatment of a lease for tax purposes is based on its treatment in the financial statements); and the impact of changes in the amounts reported on key metrics, debt covenants and management compensation.



IFRS 16 Key judgements, policy choices and exemptions	Detailed guide reference
Judgement: Identifying a lease will sometimes require a significant amount of judgement based on the elements of the definition of a lease	Identifying a lease (section 3)
Judgement: Determining whether it is reasonably certain that an extension or termination option will be exercised	Lease term (section 5)
Judgement: Identifying the appropriate rate to discount the lease payments may involve significant judgement	Discount rate (section 7.4.2.2)
Exemption: Exemptions may be taken for short-term leases (by class of asset) or low-value asset leases (lease-by-lease basis)	Recognition (section 7.2)
Policy choice: Requirements of IFRS 16 can be applied to a portfolio of similar leases provided that such aggregation is not expected to have a material effect	Application to portfolios (section 1.3)
Policy choice: Lessee may elect not to separate non-lease components from lease components by class of asset	Components (section 4)
Policy choice: Lessee may, but is not required to, apply IFRS 16 to leases of intangible assets	Scope (section 2)
Policy choice: The transition choices available are: full retrospective approach or cumulative catch-up approach, definition of a lease – choice to grandfather all or none, initial direct costs in measurement of right-of-use asset – choice lease-by-lease, and other practical expedients on transition	Transition (section 11)



Dealing with transition

Although IFRS 16 is not mandatorily effective until periods commencing on or after 1 January 2019, for many entities the scale of the challenge ahead means that they will be starting to think about implementation sooner rather than later. For some, there will be technical accounting questions that require careful consideration but, for many, the primary challenge will be gathering the necessary data, ensuring that it is reliable and that systems are ready. This section of our guide highlights some of the primary considerations entities should have in mind as they begin to prepare for transition to IFRS 16.

Who to involve?

Good project governance will be essential in preparing for the implementation of IFRS 16 and, when appropriate, representatives from the following departments should be involved in discussions and planning:

- accounting/finance;
- real estate/property;
- operations;
- procurement;
- information technology;
- tax;
- treasury; and
- investor relations.

Once the various stakeholders have been identified, conversations can begin regarding timelines and responsibilities. Support from external providers may also be desirable at some stages during the transition project.

Readiness assessment

A readiness assessment is a good way to gauge the scale of the challenge ahead and to identify which aspects of implementation are likely to prove trickiest, requiring the most time and effort. To begin this process, here are 10 questions for management to ask themselves.

10 Key questions for management

1. Do you know which of the entity's contracts are, or contain, leases?
2. Are your systems and processes capturing all of the required information?
3. Are systems and processes capable of monitoring leases and keeping track of the required ongoing assessments?
4. Have you considered the potential use of IFRS 16's recognition exemptions and practical expedients?
5. Do you know which transition reliefs are available, and whether you will apply any of them?
6. Do you know what discount rates you will be using for your different leases?
7. Have you considered the impact of the changes on financial results and position?
8. How will you communicate the impact to affected stakeholders?
9. Have you planned when you will consider the tax impacts?
10. Have you considered whether your leasing strategy requires revision?

Data gathering and systems readiness

Compiling all of the data necessary for reporting under IFRS 16, and ensuring that it is robust, may take considerable time and effort, particularly in global organisations where lease information is spread around various jurisdictions, sometimes in electronic format and sometimes not. Real estate teams may be in possession of property leases, operations personnel in possession of equipment leases and finance teams in possession of others.

Some entities will have stronger starting points than others in terms of their existing records, but even when data points such as future rentals and lease terms have previously been gathered, items such as discount rates are unlikely to have been previously determined for those leases classified as operating leases under IAS 17. Estimating appropriate discount rates may prove time consuming and require specialist input, whether it be for the purpose of determining residual values (and, in turn, the interest rate implicit in a lease), or ascertaining the rate an entity would have to pay on incremental borrowings (which potentially bear little resemblance to debt instruments already in issue).

For smaller entities with relatively few leases, the data gathering may be undertaken by a project team, whereas those with larger portfolios may look to ascertain whether technology can offer assistance. For example, contract-reader technology has developed considerably in recent years, often handling multiple languages and extracting information in a fraction of the time it would take humans.



Gathering the data for transition is not the end of the story; systems need to be able to store this information and update it on an ongoing basis. Accounting software providers are developing various offerings to deal with the ongoing accounting for leases under IFRS 16. The more comprehensive lease management tools may offer this functionality alongside features designed to enable entities to manage their leasing portfolios, prompt monthly payments, highlight extension options due to be exercised, schedule restoration works and much more besides. Unsurprisingly, the more powerful the system the more it tends to cost, meaning that different solutions are likely to be appropriate for different entities.

Whichever technology strategy is adopted, adequate testing will need to be undertaken and 'dry runs' performed to avoid last minute problems.

Considering the effects and communicating impacts

The knock-on effects of IFRS 16 are potentially significant for many entities. For lessees, balance sheets will be expanded by the recognition of new liabilities and assets, although these will not always be equal and opposite. In the income statement, the lease expense profile will be front-loaded, at least for any individual lease, and presented as depreciation and interest rather than as an operating expense (with the exception of variable rentals which will be expensed as incurred). This means that numerous key performance indicators may be affected – EBITDA being a prime example. The statement of cash flows is affected too, with payments needing to be split between repayment of principal and interest.

Entities would be well advised to consider the potential knock-on effects in the following areas:

- key performance indicators;
- bonus targets and executive remuneration schemes;
- contingent consideration in business combinations;
- tax;
- debt covenants (if not based on 'frozen' GAAP);
- ability to pay dividends; and
- regulatory capital requirements.

To avoid unforeseen and potentially undesirable consequences, contractual arrangements may need to be renegotiated and, for arrangements under negotiation between now and transition to IFRS 16, the effects of the new accounting carefully considered and pre-empted.

Investors will not welcome surprises when amounts and adjustments reported on transition are considerably different to those that had been anticipated, and the sooner the potential impacts are communicated the better. IAS 8 sets out specific disclosure requirements regarding the potential impact of Standards in issue but not yet effective and regulators are likely to be scrutinising information on IFRS 16 in this regard. If an incentive were needed, then entities would do well to examine their existing disclosures regarding operating lease commitments to ensure that they are doubly confident in the information presented therein, given that it might be expected to bear some resemblance to amounts arising on transition.

Commercially, the new accounting may prompt entities to reconsider their lease-buy strategy and/or whether to move to shorter leases or leases involving more variable rentals so as to minimise the assets and liabilities to be added to the balance sheet. Of course, commercial decisions on whether to lease an asset and how long to lease it for are driven by a whole range of factors, not just the accounting. For example, some lessees and some lessors may not appreciate the lack of security offered by entering into shorter leases. From a cash perspective, leasing will unsurprisingly still remain an attractive proposition for many.

Transition reliefs

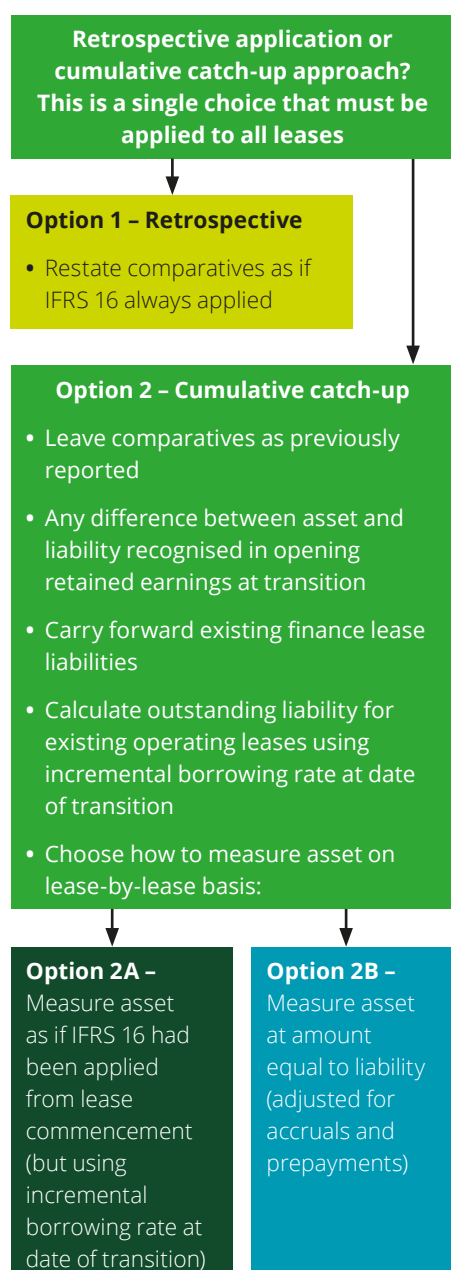
As set out in section 11 of our detailed guide, there are numerous reliefs available on transition, particularly for lessees (given that it is their accounting that has changed most significantly).

Both lessees and lessors are able to 'grandfather' previous conclusions reached under IFRIC 4 and IAS 17 as to whether contracts existing at transition are, or contain, leases, although this exemption must be applied either for all contracts or none (no 'cherry-picking' permitted). It is also worth noting that this exemption does not mean that items previously identified as operating leases can remain off-balance sheet for lessees (unless they qualify for a recognition exemption); it merely saves the entity the costs and effort of reassessing those contracts existing at the date of transition against IFRS 16's new definition of a lease. New contracts entered into after transition will, unsurprisingly, need to be assessed against IFRS 16's definition rather than relying on historical conclusions for similar contracts.



For lessees, the main choices regarding how to transition to IFRS 16 and bring assets and liabilities on-balance sheet are summarised in the decision tree below. The reliefs are described in more detail in section 11 of this guide.

Options for lessees transitioning to IFRS 16



Comparison of transition options

On the next page, we have set out an example illustrating the application of the options described above. This example reveals the potential for differing impacts on the statement of financial position at transition and the subsequent expense recognised in the income statement.

Summary

The challenge of preparing for IFRS 16 should not be underestimated. With the implementation of IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 *Financial Instruments* also looming on the horizon, attention may have been focussed on those Standards, but entities now need to start thinking about IFRS 16, establishing project teams and a timeline for transition in the near future. Data gathering, establishing systems readiness, assessing and communicating the knock-on effects, and a thorough consideration of the available transition reliefs should all be high on the list of priorities. History has demonstrated the benefits of early planning and preparation for new Standards, and IFRS 16 will be no exception.



Application of transition options – example

Example facts:

- 5-year lease, entered into on 1 January 2017;
- CU100 payable on second day of each year;
- 8 per cent discount rate at lease commencement;
- 12 per cent incremental borrowing rate at date of transition; and
- straight-line depreciation of the right-of-use asset is appropriate.

Option 1

The liability and asset are both calculated as if IFRS 16 had always been applied, with comparative amounts restated. The liability on the commencement date of the lease is calculated as the present value of the future rentals, discounted using a rate of 8 per cent.

The impact on the statement of financial position as at the date of transition is a reduction in net assets of CU19 (asset of CU259 and liability of CU278), with an expense of CU281 recognised in the income statement post-transition.

Date	Asset	Liability	Total expense
Lease commencement – 1 Jan 2017	431	431	
Year ended 31 Dec 2017	345	358	113
Year ended 31 Dec 2018	259	278	106
Amounts recognised at transition on 1 Jan 2019	259	278	
Year ended 31 Dec 2019	172	193	102
Year ended 31 Dec 2020	86	100	93
Year ended 31 Dec 2021	0	0	86
Total expense post-transition			281

Option 2A

Comparative amounts are not restated and the liability is calculated as the present value of the three outstanding rentals of CU100, discounted using the incremental borrowing rate at the date of transition of 12 per cent.

The asset is calculated as if IFRS 16 had always been applied, but using the incremental borrowing rate at the date of transition of 12 per cent.

Date	Asset	Liability	Total expense
Lease commencement – 1 Jan 2017	404		
Year ended 31 Dec 2017	323		
Year ended 31 Dec 2018	242		
Amounts recognised at transition on 1 Jan 2019	242	269	
Year ended 31 Dec 2019	161	189	101
Year ended 31 Dec 2020	81	100	92
Year ended 31 Dec 2021	0	0	81
Total expense post-transition			274

The impact on the statement of financial position as at the date of transition is a reduction in net assets of CU27 (asset of CU242 and liability of CU269), with an expense of CU274 recognised in the income statement post-transition.

Option 2B

Comparative amounts are not restated and the liability is calculated as the present value of the three outstanding rentals of CU100, discounted using the incremental borrowing rate at the date of transition of 12 per cent. The asset is then set equal to the liability.

Date	Asset	Liability	Total expense
Amounts recognised at transition on 1 Jan 2019	269	269	
Year ended 31 Dec 2019	179	189	110
Year ended 31 Dec 2020	90	100	100
Year ended 31 Dec 2021	0	0	90
Total expense post-transition			300

The net impact on the statement of financial position as at the date of transition is nil (asset = liability) but the expense post-transition is CU300.

Comparison of transition options

Overall, it can be seen that in straightforward scenarios Options 1 and 2A both reduce net assets on transition, although if the incremental borrowing rate at the date of transition is different to the original implicit discount rate, the amount of the reduction will likely differ.

Option 2B leads to nil impact on net assets at transition but, because the asset is set higher than it otherwise would have been, the expense post-transition is higher than under Options 1 and 2A.

An advantage of Options 2A and 2B is that they don't require an entity to go back and determine what the discount rate would have been at lease commencement. For longer-term leases that began several years ago, this may result in significant time savings, albeit determining an incremental borrowing rate can still present its own challenges.



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Section 1 General principles

1.1 Objective of IFRS 16 and general application

The objective of IFRS 16 is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents their lease transactions in their financial statements. This information provides 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 16:1]

When applying IFRS 16, an entity is required to consider:

- all relevant facts and circumstances; and
- the terms and conditions of contracts.

A contract is defined as “an agreement between two or more parties that creates enforceable rights and obligations”. [IFRS 16:Appendix A]

Note that the application of IFRS 16 is not restricted to contracts, or portions of contracts, that are specifically described or labelled as leases (see **section 3**).

1.2 Requirement to apply IFRS 16 consistently

IFRS 16 should be applied consistently to contracts with similar characteristics and in similar circumstances. [IFRS 16:2]

1.3 Practical expedient – application to a portfolio of leases

Although IFRS 16 specifies the accounting for an individual lease, as a practical expedient the Standard can be applied to a portfolio of leases with similar characteristics provided that it is reasonably expected that the effects on the financial statements of applying a portfolio approach will not differ materially from applying IFRS 16 to the individual leases within that portfolio. When accounting for a portfolio, estimates and assumptions that reflect the size and composition of the portfolio should be used. [IFRS 16:B1]

Falling within the scope of this practical expedient are circumstances when an entity enters into a single contract to lease a number of identical assets. Take, for example, a contract to lease 20 printers (assumed for the purposes of this example to be high-volume commercial printers that do not qualify as low-value assets (see **7.2.3**)).

As discussed at **4.1**, if the printers can be operated on a stand-alone basis, the right to use each printer is required to be accounted for as a separate lease component. The practical expedient helps to reduce that complexity by permitting the entity to account for the leases as one portfolio, rather than recognising and accounting for 20 leases separately.

The following example, which is reproduced from the illustrative examples accompanying IFRS 16, illustrates how an entity might identify portfolios of leases for the purpose of applying this practical expedient. It also illustrates the accounting for leases of low-value assets (see **7.2** for explanation and detailed requirements).



Example 1.3 Portfolio application

[IFRS 16: Illustrative example 11]

A lessee in the pharmaceutical manufacturing and distribution industry (Lessee) has the following leases:

- a) leases of real estate (both office buildings and warehouses).
- b) leases of manufacturing equipment.
- c) leases of company cars, both for sales personnel and senior management and of varying quality, specification and value.
- d) leases of trucks and vans used for delivery purposes, of varying size and value.
- e) leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones).
- f) leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as Lessee has needed to increase the storage capacity of the servers.
- g) leases of office equipment:
 - i) office furniture (such as chairs, desks and office partitions);
 - ii) water dispensers; and
 - iii) high-capacity multifunction photocopier devices.

Leases of low-value assets [see 7.2 for explanation and detailed requirements]

Lessee determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are individually of low value:

- a) leases of IT equipment for use by individual employees; and
- b) leases of office furniture and water dispensers.

Lessee elects to apply the requirements in [IFRS 16:6] in accounting for all of those leases.

Although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low-value assets. This is because each module is highly interrelated with other parts of the servers. Lessee would not lease the modules without also leasing the servers [(see 7.2.3.5 for further discussion)].

Portfolio application

As a result, Lessee applies the recognition and measurement requirements in IFRS 16 to its leases of real estate, manufacturing equipment, company cars, trucks and vans, servers and high-capacity multifunction photocopier devices. In doing so, Lessee groups its company cars, trucks and vans into portfolios.



Lessee's company cars are leased under a series of master lease agreements. Lessee uses eight different types of company car, which vary by price and are assigned to staff on the basis of seniority and territory. Lessee has a master lease agreement for each different type of company car. The individual leases within each master lease agreement are all similar (including similar start and end dates), but the terms and conditions generally vary from one master lease agreement to another. Because the individual leases within each master lease agreement are similar to each other, Lessee reasonably expects that applying the requirements of IFRS 16 to each master lease agreement would not result in a materially different effect than applying the requirements of IFRS 16 to each individual lease within the master lease agreement. Consequently, Lessee concludes that it can apply the requirements of IFRS 16 to each master lease agreement as a portfolio. In addition, Lessee concludes that two of the eight master lease agreements are similar and cover substantially similar types of company cars in similar territories. Lessee reasonably expects that the effect of applying IFRS 16 to the combined portfolio of leases within the two master lease agreements would not differ materially from applying IFRS 16 to each lease within that combined portfolio. Lessee, therefore, concludes that it can further combine those two master lease agreements into a single lease portfolio.

Lessee's trucks and vans are leased under individual lease agreements. There are 6,500 leases in total. All of the truck leases have similar terms, as do all of the van leases. The truck leases are generally for four years and involve similar models of truck. The van leases are generally for five years and involve similar models of van. Lessee reasonably expects that applying the requirements of IFRS 16 to portfolios of truck leases and van leases, grouped by type of underlying asset, territory and the quarter of the year within which the lease was entered into, would not result in a materially different effect from applying those requirements to each individual truck or van lease. Consequently, Lessee applies the requirements of IFRS 16 to different portfolios of truck and van leases, rather than to 6,500 individual leases.

1.4 Combining contracts

Two or more contracts that are interdependent should be combined and accounted for as a single contract. This requirement applies when:

[IFRS 16:B2]

- the contracts are entered into at or near the same time; and
- the contracts are with the same counterparty (or related parties of the counterparty); and
- one or more of the following criteria are met:
 - the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together; or
 - the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
 - 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 IFRS 16:B32 (see **4.1.2**).

The requirements of IFRS 16:B2 are intended to capture circumstances in which an entity enters into a number of contracts in contemplation of one another such that the transactions, in substance, form a single arrangement that achieves an overall commercial objective that cannot be understood without considering the contracts together.

For example, assume that a lessee enters into a one-year lease of an asset with particular characteristics. The lessee also enters into a one-year lease for an asset with those same characteristics starting in one year's time and a similar forward contract starting in two years' time and in three years' time. The terms and conditions of all four contracts are negotiated in contemplation of each other such that the overall economic effect cannot be understood without reference to the series of transactions as a whole. In effect, the lessee has entered into a four-year lease. In such situations, accounting for the contracts independently of each other might not result in a faithful representation of the combined transaction. [IFRS 16:BC130]



Section 2 Scope

2.1 Scope – general

IFRS 16 should be applied to all leases except the following:

[IFRS 16:3]

- a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

IFRS 6 *Exploration for and Evaluation of Mineral Resources* specifies the accounting for rights to explore for and evaluate mineral resources.

- b) leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee;

Biological assets that are bearer plants are within the scope of IAS 16 *Property, Plant and Equipment* rather than IAS 41 and, consequently, are within the scope of IFRS 16. Therefore, for example, leases of bearer plants such as orchards and vineyards held by a lessee are within the scope of IFRS 16. [IFRS 16:BC68(b)]

- 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.

A lessee is permitted, but not required, to apply IFRS 16 to leases of intangible assets other than those described in IFRS 16:3(e). [IFRS 16:4]

Leases of 'other' intangible assets in the context of IFRS 16:4 might include, for example, exclusive licences for brands or trademarks held by a lessee. Such leases were previously considered to fall within the scope of IAS 17. The IASB decided to permit, but not require, entities to account for these leases in accordance with IFRS 16. Although there is no conceptual basis for excluding them from the scope of IFRS 16, the Board considered that a more comprehensive review of the accounting for intangible assets is required before requiring leases of intangible assets to be accounted for under the new Standard. [IFRS 16:BC71]

2.2 Long-term leases of land

The IASB considered, but decided against, a scope exclusion for long-term leases of land (see IFRS 16:BC78). Therefore, such leases should be accounted for in accordance with IFRS 16.



2.3 Leases of investment property

Unlike IAS 17, IFRS 16 contains no scope exclusions in relation to investment property. Therefore, all aspects of leases of investment property are accounted for under IFRS 16.

Consequential amendments arising from IFRS 16 have amended the definition of investment property in IAS 40 *Investment Property* to include both owned investment property and investment property held by a lessee as a right-of-use asset. Under IFRS 16:34 (see **7.5.1.5**), if a lessee applies IAS 40's fair value model to its owned investment property, it is also required to apply that fair value model to right-of-use assets that meet the definition of investment property.

2.4 Subleases

Leases of right-of-use assets in a sublease are within the scope of IFRS 16, subject to the exclusions set out at **2.1**. [IFRS 16:3]

Subleases are required to be accounted for in the same way as other leases (see **8.6**) and, accordingly, are within the scope of IFRS 16. [IFRS 16:BC73]

2.5 Leases of inventories

IFRS 16 does not specifically exclude leases of inventories from its scope. However, the IASB believes that few such transactions would meet the definition of a lease under IFRS 16 because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business, or for consumption in the process of production for sale in the ordinary course of business. [IFRS 16:BC74]

2.6 Derivatives embedded in a lease

The IASB decided to require an entity to separate from a lease any derivatives embedded in the lease (as defined in IFRS 9 *Financial Instruments*), and account for the derivatives applying IFRS 9. Nonetheless, IFRS 16 includes specific requirements for features of a lease such as options and residual value guarantees that may meet the definition of a derivative. The IASB noted that the lease accounting model in IFRS 16 was not developed with derivatives in mind and, consequently, IFRS 16 would not provide an appropriate basis on which to account for derivatives. Accordingly, if derivatives embedded in leases were not accounted for separately, unrelated derivative contracts could be bundled with leases to avoid measuring the derivatives at fair value. [IFRS16:BC81]



Thinking it through

Care will be needed to distinguish between variable lease payments, for which the accounting is specified in IFRS 16, and derivatives embedded in a lease, which cause the payments to be variable but based on a factor that has economic risks and characteristics that are not closely related to those of the right-of-use asset.

2.7 Short-term leases and leases of low-value items

IFRS 16 applies to all leases except those specifically excluded under IFRS 16:3 (see **2.1**). However, the Standard includes recognition exemptions available to lessees for short-term leases and leases of low-value items and specifies alternative requirements (see **7.2**).



Section 3 Identifying a lease

3.1 Definition of a lease

A lease is defined as “[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”. [IFRS 16:Appendix A]

IFRS 16 supersedes IFRIC 4 *Determining whether an Arrangement contains a Lease* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. Although the detailed requirements regarding the identification of a lease are amended by IFRS 16, the key principles of IFRIC 4 and SIC-27 are carried forward, i.e. that:

- some arrangements that do not take the legal form of a lease nevertheless meet the definition of a lease under the Standard; and
- not all transactions that involve the legal form of a lease will fall within the definition of a lease under the Standard.

3.2 Determination as to whether a contract is, or contains, a lease

3.2.1 Requirement to assess whether a contract is, or contains, a lease

At inception of a contract, an entity is required to 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. [IFRS 16:9]

Key aspects of this definition are that:

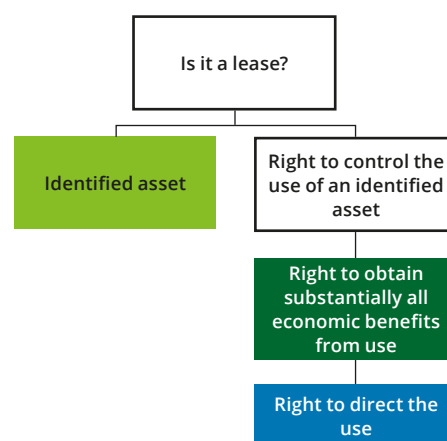
- the asset that is the subject of a lease must be specifically identified (see **3.3**); and
- a lease must convey the right to control the use (see **3.4**) of that identified asset for a period of time.

For the purposes of IFRS 16:9, a ‘period of time’ may be described in terms of the amount of use of an identified asset (e.g. the number of production units that an item of equipment will be used to produce). [IFRS 16:10]

An entity is required to assess whether a contract contains a lease at inception of the contract, rather than at commencement of the lease term (see **5.3** for an explanation of these terms). This is necessary because a lessor is required to classify a lease as either a finance lease or an operating lease at the inception date (see **8.1**). In addition, a lessee is required to disclose information about leases not yet commenced to which the lessee is committed if that information is relevant to users of financial statements. [IFRS 16:BC110]

Examples 1 to 10 of the illustrative examples accompanying IFRS 16 (summarised in **Appendix 1**) illustrate how an entity determines whether a contract is or contains a lease. Although the IASB believes that, in most cases, the assessment as to whether a contract is or contains a lease should be straightforward, it acknowledges that significant judgement will be required to make this assessment in some cases. [IFRS 16:BC109]

See **3.5** for a flowchart, reproduced from IFRS 16, which summarises the steps involved in the assessment as to whether a contract is, or contains, a lease. These steps are discussed in detail in **3.3** and **3.4**.



3.2.2 Lease vs 'in-substance' sale or purchase

When assessing the nature of a contract, an entity should consider whether the contract transfers control of the underlying asset itself (as opposed to conveying the right to control the use of the underlying asset for a period of time). If so, the transaction is a sale or purchase within the scope of other Standards (e.g. IFRS 15 *Revenue from Contracts with Customers* or IAS 16 *Property, Plant and Equipment*). [IFRS 16:BC140]

3.2.3 Leases vs service contracts

IFRS 16 aims to distinguish a lease from a service contract on the basis of whether a customer is able to control the use of the asset being leased. If the customer controls the use of an identified asset (see 3.3) for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way to that in which it makes decisions about owned assets that it uses (see 3.4). In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service. [IFRS 16:BC105]

3.2.4 Customer has control for only a portion of the term of a contract

If the customer has the right to control the use of an identified asset for only a portion of the term of a contract, the contract contains a lease for that portion of the lease term. [IFRS 16:B10]

3.2.5 Assessment required for each potential separate lease component

The assessment as to whether a contract contains a lease should be made for each potential separate lease component (see section 4). [IFRS 16:B12]

3.2.6 Assessing whether a contract contains a lease when the customer is a joint arrangement

When a contract to receive goods or services is entered into by, or on behalf of, a joint arrangement (as defined in IFRS 11 *Joint Arrangements*), the joint arrangement is considered to be the customer in the contract. Accordingly, when assessing whether such a contract contains a lease, an entity should assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use. [IFRS 16:B11]

IFRS 16:B11 clarifies that when a contract is entered into by, or on behalf of, a joint arrangement, it is the joint arrangement (rather than the parties to the joint arrangement) that should be considered to be the customer when assessing whether the contract contains a lease, irrespective of which entity signed the contract. Accordingly, if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use through their joint control of the arrangement, the contract contains a lease. It is not appropriate to conclude that a contract does not contain a lease on the grounds that each of the parties to the joint arrangement either obtains only a portion of the economic benefits from use of the underlying asset or does not unilaterally direct the use of the underlying asset. [IFRS 16:BC126]

This guidance is particularly relevant for joint operations where each of the parties has direct rights and obligations for the lease and for which, in the absence of this guidance, it might not have been clear whether control should be viewed from the perspective of the joint operation.

3.2.7 Reassessment as to whether a contract is, or contains, a lease

An entity should reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed. [IFRS 16:11]



3.3 Identified asset

3.3.1 Identification of an asset – general

The asset that is the subject of a lease must be specifically identified. This will be case if either of the following applies:

[IFRS 16:B13]

- the asset is explicitly specified in the contract (e.g. a specific serial number); or
- the asset is implicitly specified at the time that it is made available for use by the customer (e.g. when there is only one asset that is capable of being used to meet the contract terms).

3.3.2 Substantive substitution rights

3.3.2.1 Right to use an identified asset is undermined by substantive substitution right

Even if an asset is specified as discussed in **3.3.1**, a customer is not considered to have the right to use an identified asset (and, therefore, the contract is not a lease) if the supplier has a substantive right to substitute the asset throughout the period of use. [IFRS 16:B14]

The 'period of use' is "the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)". [IFRS 16:Appendix A]

If a supplier has a substantive right to substitute the asset throughout the period of use, there is no identified asset and the contract does not contain a lease. This is because the supplier, and not the customer, controls the use of the asset in such circumstances. [IFRS 16:BC112]

If a substitution clause is not substantive because it does not change the substance of the contract (i.e. the conditions set out in **3.3.2.2** are not met), that substitution clause does not affect an entity's assessment as to whether a contract contains a lease. [IFRS 16:BC113]

The illustrative examples accompanying IFRS 16 (as summarised in **Appendix 1**) include a number of scenarios in which substitution rights are considered.

3.3.2.2 Substantive substitution right – definition

A supplier's right to substitute an asset is substantive only if both of the following conditions are met:

[IFRS 16:B14]

- 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 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
- the supplier would benefit economically from exercising 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).

Substitution rights are not substantive if it is not likely, or practically or economically feasible, for the supplier to exercise those rights. The IASB believes that, in many cases, it will be clear that the supplier would not benefit from the exercise of a substitution right because of the costs associated with substituting the asset. [IFRS 16:BC113]



3.3.2.3 Substitution on or after a specified future date or dependent on the occurrence of a specified event

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. [IFRS 16:B15]

3.3.2.4 Evaluation to be based on circumstances at inception and to exclude consideration of future events not considered likely to occur

An entity's evaluation of whether a supplier's substitution right is substantive should be based on facts and circumstances at inception of the contract. [IFRS 16:B16]

Future events that, at inception of the contract, are not considered likely to occur should be excluded from the evaluation. Examples of such future events include:

[IFRS 16:B16]

- 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; and
- 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.

If a supplier would benefit from substitution only in circumstances that are not likely to occur, such as those listed in IFRS 16:B16, those substitution rights are not substantive, regardless of whether the circumstances are specified in the contract. [IFRS 16:BC114]

3.3.2.5 Substitution costs generally higher when the asset is located at the customer's premises or elsewhere

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.

[IFRS 16:B17]

3.3.2.6 Substitution for repairs or technical upgrade

A 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. [IFRS 16:B18]

3.3.2.7 Customer cannot readily determine whether the supplier has substantive substitution rights

If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer should presume that any substitution right is not substantive. [IFRS 16:B19]

The IASB believes that it should generally be relatively clear from the facts and circumstances whether substitution rights are substantive, and the Board intends that customers should assess whether substitution rights are substantive if they are reasonably able to do so. However, the requirement in IFRS 16:B19 is intended to clarify that a customer is not expected to exert undue effort in order to provide evidence that a substitution right is not substantive. [IFRS 16:BC115]



3.3.3 Portions of assets

A capacity portion of an asset is an identified asset if it is physically distinct (e.g. a floor of a building). [IFRS 16:B20]

A capacity or other portion of an asset that is not physically distinct (e.g. a capacity portion of a fibre optic cable or a pipeline) 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. [IFRS 16:B20]

The IASB concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct because decisions about the use of the asset are typically made at the larger asset level. [IFRS 16:BC116]



Thinking it through

The determination as to whether an asset is physically distinct may not be difficult for items such as buildings, where it is clearly accepted and acknowledged in IFRS 16 that a floor of a building can be distinct, even though the ability to use it depends on having access through common areas used or controlled by others. However, it may be more difficult to conceptualise for assets such as technology assets (e.g. a satellite), whether there is a distinct portion that can be controlled, when the ability to use that portion may require access or power, say, from a portion that is not controlled.

3.4 The right to control the use of an identified asset

3.4.1 Elements of 'control'

To assess whether a contract conveys the right to control the use of an identified asset for a period of time (as required under IFRS 16:9 – see **3.2.1**), an entity is required to assess whether, throughout the period of use, the customer has both of the following:

- the right to obtain substantially all of the economic benefits from use of the identified asset (see **3.4.2**); and
- the right to direct the use of the identified asset (see **3.4.3**).

The 'period of use' is "[t]he total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)". [IFRS 16:Appendix A]

As discussed in the following sections, the IASB decided that to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a 'benefits' element) but also the ability to direct the use of that asset (a 'power' element). The shift in focus from 'risks and rewards' to 'control' is consistent with other recent Standards (e.g. IFRS 10 *Consolidated Financial Statements* and IFRS 15 *Revenue from Contracts with Customers*) and with the IASB's proposals regarding control in the Conceptual Framework exposure draft.

3.4.2 Right to economic benefits from use

3.4.2.1 Customer must have the right to obtain substantially all of the economic benefits from use of the asset

To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (e.g. by having exclusive use of the asset throughout that period). [IFRS 16:B21]

Therefore, in circumstances when an asset might be considered to be implicitly identified (e.g. the supplier has only one machine capable of delivering the customer's requirements), if the supplier can regularly use the machine for other purposes during the course of the contract (e.g. to supply other customers), the customer does not have the right to obtain substantially all of the economic benefits from the use of that asset and there is no lease.



3.4.2.2 Nature of economic benefits from use of the asset

Economic benefits from use of an asset can be obtained by the customer in many ways (e.g. by using, holding or sub-leasing the asset); they include the primary output and by-products generated from use of the asset, and other economic benefits from using the asset that could be realised from a commercial transaction with a third party. [IFRS 16:B21] All of these benefits should be considered in the assessment of whether the contract conveys the right to substantially all of the economic benefits from the use of the asset.

The assessment as to whether a contract contains a lease should not consider economic benefits relating to ownership of an asset (e.g. tax benefits as a result of owning an asset). This is because a lease does not convey ownership of the underlying asset. [IFRS 16:BC118]

3.4.2.3 Restrictions on economic benefits available to the customer

The economic benefits to be considered are those that are available within the defined scope of the customer's right to use the asset. For example:

[IFRS 16:B22]

- if a contract limits the use of a motor vehicle to only one particular territory during the period of use, only the economic benefits from use of the motor vehicle within that territory should be considered; and
- 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, only the economic benefits from use of the motor vehicle for the permitted mileage should be considered.

Therefore, potential additional economic benefits outside the scope of the customer's rights (e.g. in the second bullet point above, beyond the specified mileage for the motor vehicle) are not relevant to the determination as to whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.



Thinking it through

Sometimes it may be difficult to make the assessment of the economic benefits within the defined scope of the right-of-use asset, in which case it may be helpful to consider the arrangement not just from the customer's perspective but also from the perspective of whether another party can use the asset for its own benefit during the period of the contract. In the examples above it can be seen that another party could not, during the contract, use the motor vehicle to drive in other territories, or drive additional mileage.

3.4.2.4 Customer required to pay a portion of the cash flows derived from use of the asset as consideration

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 should be considered to be part of the economic benefits that the customer obtains from use of the asset. [IFRS 16:B23]

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 total 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.

[IFRS 16:B23]



3.4.3 Right to direct the use

3.4.3.1 Circumstances when the customer has the right to direct the use of an identified asset

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

[IFRS 16:B24]

- a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (see **3.4.3.2**); or
- b) the relevant decisions about how and for what purpose the asset is used are predetermined and specified conditions are met (see **3.4.3.3**).

If neither of the conditions in IFRS 16:B24 is met, the supplier directs how and for what purpose the asset is used and, consequently, the contract does not contain a lease.

3.4.3.2 How and for what purpose the asset is used

Note that, as explained in IFRS 16:BC120, '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).

A customer has the right to direct how and for what purpose the asset is used if it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, the focus is on whether the customer has decision-making rights that affect the economic benefits to be derived from use of the asset. [IFRS 16:B25]

The decision-making rights that are most relevant for this purpose are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract. Depending on the circumstances, these could include rights to change:

[IFRS 16:B25 & B26]

- the type of output that is produced by the asset (e.g. 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);
- when the output is produced (e.g. to decide when an item of machinery or a power plant will be used);
- where the output is produced (e.g. to decide upon the destination of a truck or a ship, or to decide where an item of equipment is used); and
- whether the output is produced, and the quantity of that output (e.g. to decide whether to produce energy from a power plant and how much energy to produce from that power plant).

Rights that are limited to operating or maintaining the asset are examples of rights that do not grant the right to change how and for what purpose the asset is used. Although such rights 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.

[IFRS 16:B27]



Therefore, for example, if a contract covers the use of a fleet of trucks for an agreed period and the customer has the right to decide how and when the trucks are used, the fact that the supplier continues to operate and maintain the trucks does not undermine the customer's ability to direct the use of the trucks.

In the IASB's view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset. This is because decisions about how and for what purpose an asset is used determine how, and what, economic benefits are derived from use. [IFRS 16:BC120]

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 as contemplated in IFRS 16:B24(b)(i) (see **3.4.3.3**).

3.4.3.3 Relevant decisions are predetermined

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. [IFRS 16:B28]

When decisions about how and for what purpose an asset is used are predetermined, they cannot be changed by either the customer or the supplier during the period of use. The IASB noted that it would expect these circumstances to arise in relatively few cases. [IFRS 16:BC121]

When the relevant decisions about how and for what purpose the asset is used are predetermined, a customer has the right to direct the use of an identified asset throughout the period of use only if either:

[IFRS 16:B24(b)]

- 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.



The approach to determining whether a customer has the right to direct the use of an identified asset changes if the decisions about how and for what purpose an asset is used are predetermined. IFRS 16 clarifies that, in such circumstances, a customer can still direct the use of an asset if it has the right to operate the asset, or if it designed the asset in a way that predetermines how and for what purpose the asset will be used. In either of these cases, the customer controls rights of use that extend beyond the rights of a customer in a typical supply or service contract (i.e. the customer has rights that extend beyond solely ordering and receiving output from the asset). In these cases, the customer has the right to make (or, in the case of design, has already made) decisions that affect the economic benefits to be derived from use of the asset throughout the period of use. [IFRS 16:BC122]

For example, consider a contract for the use of a fleet of trucks for an agreed period where the contract specifies how and for what purpose the trucks are to be used (e.g. to carry rock from a specified quarry site to crushing facilities); these matters have been agreed between the parties prior to the commencement date and they cannot be changed. In such circumstances, if the customer has the right to operate the trucks throughout the period of use, under IFRS 16:B24(b)(i) it has the right to direct the use of the trucks, notwithstanding its inability to change how and for what purpose the trucks are used. In contrast, if the supplier is the operator, then the customer does not have the right to direct the use of the trucks, and there is no lease.

The concept of directing use through design (as contemplated in IFRS 16:B24(b)(ii)) is explored in Example 9A of the illustrative examples accompanying IFRS 16 (see **Appendix 1** for summary). In the situation described, the customer purchases all of the output of a solar farm with predetermined activities. Although the customer makes no decisions during the life of the farm, it has the right to direct the use of the farm as a result of having designed the asset before it was constructed.

3.4.3.4 Decisions determined during and before the period of use

In assessing whether a customer has the right to direct the use of an asset, an entity should 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 IFRS 16:B24(b)(ii) (see **3.4.3.3**). Consequently, unless the conditions in IFRS 16:B24(b)(ii) exist, an entity should not consider decisions that are predetermined before the period of use. [IFRS 16:B29]

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. [IFRS 16:B29]

It will not be unusual for a customer to specify its requirements prior to the commencement of a contract and to reach an agreement with the supplier as to how those requirements will be met. For example, a customer requires a supply of iron over an extended period. It agrees with the supplier prior to the commencement of supply that this requirement will be met by utilising all of the capacity of a specifically identified smelting plant operating for an agreed number of hours over that period. Assuming that the customer was not involved in the design of the smelting plant, the fact that it is able to specify the output of the smelting plant before the period of use does not mean that it has the right to direct the use of the plant. In this scenario:

- if the customer has the right to change how and for what purpose the smelting plant is used during the period of use, the customer has the right to direct the use of the smelting plant and, subject to other conditions, there may be a lease;
- if the supplier has the right to change how and for what purpose the smelting plant is used during the period of use, the supplier has the right to direct the use of the smelting plant and there is no lease; and
- if neither party has the right to change how and for what purpose the smelting plant is used, its activities are predetermined, and the right to direct its use will be determined by which entity is operating the smelting plant during the period of use (see **3.4.3.3**).



3.4.3.5 Protective rights

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:

[IFRS 16:B30]

- specify the maximum amount of use of an asset or limit where or when the customer can use the asset; or
- require a customer to follow particular operating practices; or
- require a customer to inform the supplier of changes in how an asset will be used.

Rights of this nature 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. [IFRS 16:B30]

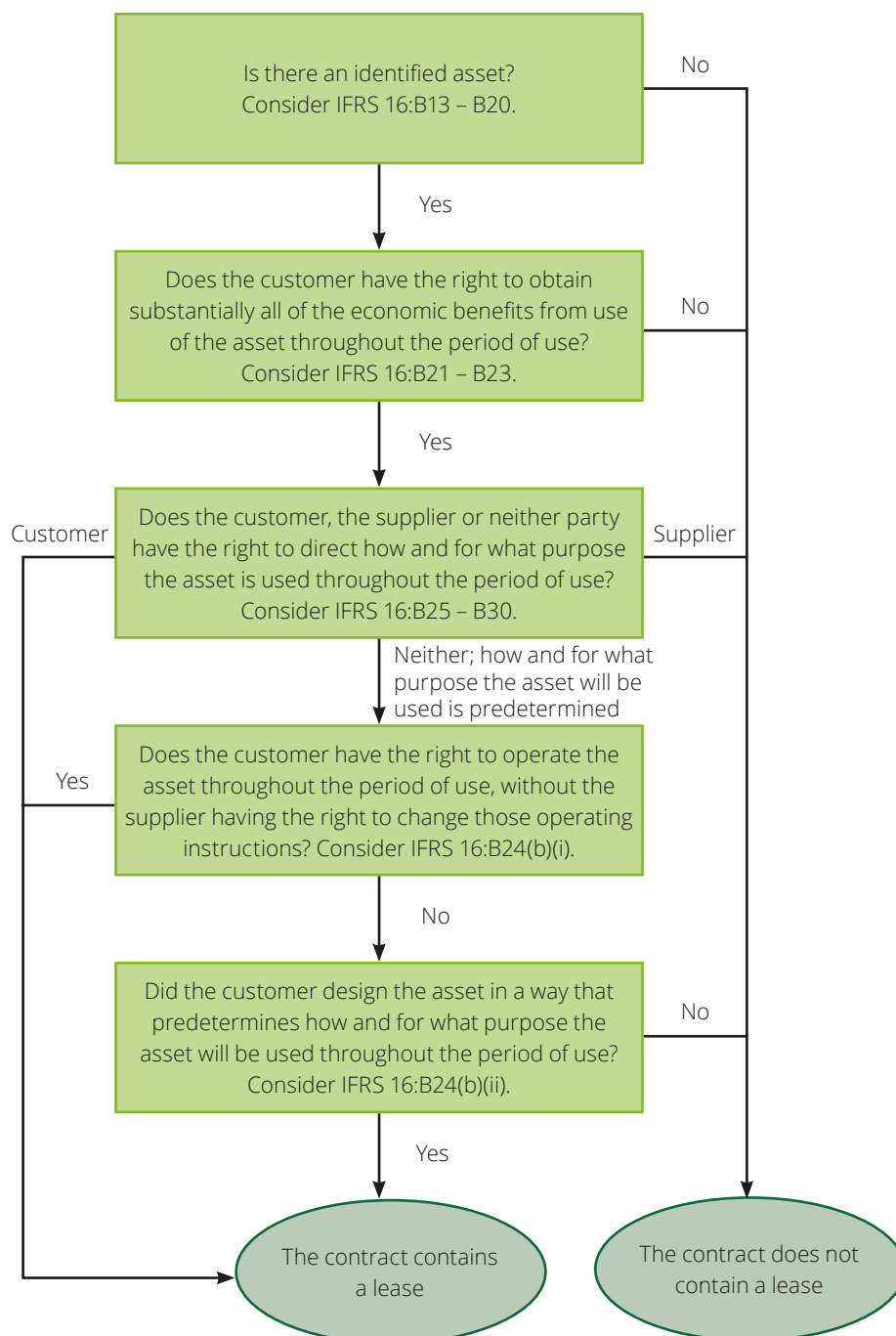
The illustrative examples accompanying IFRS 16 cite examples of protective rights, including the following.

- Example 1 describes a situation in which the customer generally determines when, where and how rail cars are used, but subject to restrictions on the types of cargo (e.g. explosives) that can be carried. These restrictions are considered to be protective rights of the supplier and to define the scope of the customer's right to use the rail cars, but not to limit the customer's right to direct the use of the rail cars within that defined scope.
- Example 6B describes a situation in which the customer generally determines whether, where and when a ship sails, as well as the cargo it will carry, but contractual restrictions prevent the customer from sailing the ship into waters at a high risk of piracy or carrying hazardous material as cargo. Again, these restrictions are considered to be protective rights that protect the supplier's investment in the ship and the supplier's personnel. They define the scope of the customer's right to use the ship but they do not limit the customer's right to direct the use of the ship within that defined scope.



3.5 Summary flowchart

The following flowchart, which is reproduced from IFRS 16, summarises the steps involved in the assessment as to whether a contract is, or contains, a lease. [IFRS 16:B31]



Section 4

Separating components of a contract

4.1 Separating components of a contract – requirements applicable for both lessees and lessors

4.1.1 Requirement to separate components of a contract

If a contract is, or contains, a lease, an entity is required to 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 IFRS 16:15 (see **4.2.3**).

Some contracts contain both lease and non-lease (service) components. For example, a contract for a car may combine a lease with maintenance services. Other contracts contain two or more lease components. For example, a single contract may include leases of land, buildings and equipment. [IFRS 16:BC133]

The IASB considers that the identification of separate lease components in a lease contract is similar to the identification of performance obligations in a revenue contract – in both circumstances, an entity is trying to identify whether a customer or a lessee is contracting for a number of separate deliverables or contracting for one deliverable that may incorporate a number of different assets. Accordingly, rather than developing new requirements addressing how to identify separate lease components, the IASB decided to include in IFRS 16 requirements similar to those in IFRS 15 *Revenue from Contracts with Customers* on the identification of performance obligations. The IASB intends that those requirements in IFRS 16 are applied in a similar way to their application within the context of a revenue contract in IFRS 15. [IFRS 16:BC134]

Note that the effect of the practical expedient described in **4.2.3** is that lessees have a choice as to whether to separate the non-lease components of a contract.

4.1.2 Identification of separate lease components

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

[IFRS 16:B32]

- 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
- 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.

Take, for example, a contract for the hire of a pneumatic hammer and an air-compressor for breaking up concrete (assume that the contract meets the definition of a lease). The hammer only works with an air-compressor. However, the hammer is not linked to the specific air-compressor and could be used with a different compressor purchased or hired elsewhere. In this example, having regard to the conditions in IFRS 16:B32, the contract is considered to have two separate lease components.



In contrast, consider a contract for the hire of two interdependent items of equipment that have been specifically configured to work in unison so that neither item can be readily substituted. In this case, the contract is likely to be considered to consist of only one lease.

Note that, even when separate lease components are identified, if the lease components have similar characteristics, it may be possible to account for them as a single portfolio under IFRS 16:B1 (see **1.3**).

The following example, which is reproduced from the illustrative examples accompanying IFRS 16, illustrates the application of IFRS 16:B32.

Example 4.1.2 **Identification of lease components**

[IFRS 16:Illustrative example 12 (part)]

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, 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.

Lessee accounts for the non-lease components (maintenance services) separately from each lease of equipment applying [IFRS 16:12]. Lessee does not elect the practical expedient in [IFRS 16:15 – see **4.2.3**]. Lessee considers the requirements in [IFRS 16:B32] 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.

continued at example 4.2.1

4.1.3 Activities and costs that do not transfer a good or service to the lessee

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.

[IFRS 16:B33]



For example, a contract includes a lease component (hire of a machine) and a non-lease component (maintenance of the machine over the lease term). The contract also provides for an additional charge for administrative tasks of 2 per cent of the amounts otherwise payable under the contract. Because these administrative tasks do not transfer a good or service to the lessee, the additional charge is not considered to be a separate component of the contract. Rather, assuming that the lessee does not elect to use the practical expedient in IFRS 16:15 (see **4.2.3**), both the lessee and the lessor account for the hire and maintenance components separately and the administration charge is included in the total consideration to be allocated between those components.

4.2 Separating components of a contract – lessees

4.2.1 Consideration to be allocated based on relative stand-alone prices

For lessees, the consideration in a contract should be allocated between lease and non-lease components (if any) on the basis of the relative stand-alone price of each lease component and the aggregate stand-alone price of the non-lease components. [IFRS 16:13]

The relative stand-alone price of lease and non-lease components should 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 should estimate the stand-alone price, maximising the use of observable information. [IFRS 16:14]

IFRS 16:14 permits a lessee to estimate the stand-alone prices of lease components because it may not have the necessary information to determine the lessor's stand-alone prices. The Standard requires the lessee to maximise the use of observable information – for example, the price charged by other suppliers or the price charged by the supplier to other customers.

In addition, having regard to the likelihood that a lessee may not have complete information on the lessor's pricing model, the IASB has granted relief from the requirement to separate non-lease components (see **4.2.3**).



Thinking it through

In order to assist with their estimation process, lessees are likely to look first to lessors for more detailed information on the pricing of bundled contracts. Some lessors can be expected to be relatively forthcoming with such information, but this is unlikely to be the case across the board, meaning that lessees may need to look further afield to make an estimate of the relative stand-alone prices.

In the case of 'wet' leases of aircraft or ships, entities may be able to observe prices for 'dry' leases to begin this estimation process. The determination of stand-alone prices for communal spaces and services linked to a property is likely to be a more difficult process and involve more complex judgements. If non-lease components are not expected to be a significant proportion of the rentals, or if the judgements are difficult, a lessee may decide to use the practical expedient and not separate the lease components, as explained in **4.2.3**.

The following example, which is reproduced from the illustrative examples accompanying IFRS 16, illustrates the application of IFRS 16:13 and 14.



Example 4.2.1 Allocation of consideration between lease and non-lease components

[IFRS 16: Illustrative example 12 (part 2)]

... continued from example 4.1.2

Lessee applies the guidance in [IFRS 16:3 and 14] 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 stand-alone 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:

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.



4.2.2 Accounting for non-lease components

Unless the practical expedient in IFRS 16:15 (see **4.2.3**) is applied, a lessee should account for non-lease components in a contract in accordance with other applicable Standards. [IFRS 16:16]

IFRS 16 only deals with the accounting for lease components of a contract – not the accounting for services. The IASB considers that the accounting for services (or the service components of a contract) should not be affected, regardless of whether the contract is only for services or includes the purchase, or lease, of an asset as well as services. [IFRS 16:BC135]

Consequently, although IFRS 16 requires entities to separate non-lease components (unless the practical expedient in IFRS 16:15 is used) and to allocate consideration to those non-lease components in aggregate, it does not specify how the aggregate allocation should be apportioned between separate non-lease components nor the subsequent accounting for such consideration. These matters will be determined under other applicable Standards.

4.2.3 Relief from requirement to separate non-lease components from lease components – practical expedient

As a practical expedient, a lessee may elect 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. This election should be made by class of underlying asset. [IFRS 16:15]

Note that, if the practical expedient is adopted, an entity accounts for the combined lease and non-lease component as a single lease component – it is not permitted to account for the combined lease and non-lease component as a service. Note also that IFRS 16:15 does not provide any relief from the requirement to account separately for individual lease components if the conditions in IFRS 16:B32 (see **4.1.2**) are met; however, in some circumstances, an entity may be able to apply a portfolio approach (see **1.3**).



Thinking it through

Separating non-lease components reduces the amounts recognised as the leased asset and lease liability. It will also give a smoother expense profile, but the expense related to the non-lease components is classified as operating.

4.2.4 No relief from requirement to separate embedded derivatives

The relief from the requirement to separate non-lease components described in **4.2.3** is not available in respect of embedded derivatives that meet the criteria for separation from a host contract as set out in paragraph 4.3.3 of IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, paragraph 11 of IAS 39 *Financial Instruments: Recognition and Measurement*) – see also **2.6**). [IFRS 16:15]

4.3 Separating components of a contract – lessors

If a contract contains a lease component and one or more additional lease or non-lease components, a lessor should allocate the consideration in the contract by applying paragraphs 73 to 90 of IFRS 15 *Revenue from Contracts with Customers*.

Lessors are therefore required to allocate the consideration in a contract between lease and non-lease components using the requirements in IFRS 15 regarding the allocation of the transaction price to performance obligations. This approach is designed to ensure consistency for entities that are both a lessor and a seller of goods or services in the same contract. [IFRS 16:BC136]

Although IFRS 16 includes a practical expedient permitting lessees not to separate non-lease components from lease components (see **4.2.3**), there is no equivalent practical expedient for lessors. The IASB believes that a lessor should be able to separate payments for lease and non-lease components. This is because the lessor would need to have information about the value of each component, or a reasonable estimate of it, when pricing the contract. [IFRS 16:BC135(a)]



Section 5 Lease term

5.1 Definition of lease term

The lease term is defined as “the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

[IFRS 16:18]

- 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”.

See 5.5 to 5.7 for a discussion of lessor and lessee termination and extension options.



Thinking it through

In order to minimise the impact of applying IFRS 16, lessees may look to enter into leases with shorter terms than they have done historically or to revisit their lease-buy strategies. Although shorter leases can potentially produce more desirable accounting outcomes, operationally they may result in less security for lessees and lessors alike. In addition, lessees may wish to consider how users of financial statements (e.g. analysts) might view such an approach. Historically, for the purpose of making comparisons, analysts have often applied a specific multiple to operating lease expenses to approximate an IFRS 16-type liability; in the future, they could make similar adjustments for those lessees with shorter/longer than average lease terms.

5.2 Consideration of enforceability

As part of its assessment of the lease term and the length of the non-cancellable period of a lease, an entity should consider the definition of a contract (“[a]n agreement between two or more parties that creates enforceable right and obligations”) and determine the period for which the contract is enforceable. [IFRS 16:B34]

For the purposes of IFRS 16, a contract is considered to exist only when it creates rights and obligations that are enforceable. Any non-cancellable period or notice period in a lease meets the definition of a contract and, therefore, should be included as part of the lease term. Any options to extend or terminate the lease that are included in the lease term must also be enforceable.

In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse a request from the lessee to extend the lease. If optional periods are not enforceable (e.g. if the lessee cannot enforce the extension of the lease without the agreement of the lessor), the lessee does not have the right to use the asset beyond the non-cancellable period. By definition, there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. [IFRS 16:BC127]

A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. [IFRS 16:B34]



5.3 Beginning of lease term

The lease term begins on the 'commencement date' of the lease. [IFRS 16:B36] This is defined as the date on which the lessor makes an underlying asset available for use by a lessee. [IFRS 16:Appendix A] It is the date on which the lessee initially recognises and measures right-of-use assets and lease liabilities (see **section 7**). It is also the date on which the lessor recognises assets held under a finance lease in its statement of financial position (see **9.1.1**).

IFRS 16 makes an important distinction between the 'inception date' and the 'commencement date' of a lease. The inception date of the lease is defined as the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. [IFRS 16:Appendix A] This is the date on which an entity evaluates a contract to determine whether it is, or contains, a lease (see **section 3**). For lessors, it is also the date at which the classification of a lease is determined (see **section 8**).

Therefore, although important assessments are made at the inception date, the assets, liabilities, income and expenses resulting from a lease are not recognised in the financial statements or measured until the commencement date (see IFRS 16:BC142 to BC144 for further discussion).

A lessee does not obtain and control its right to use the underlying asset until the commencement date. Before that date, the lessor has not yet performed under the contract. Although a lessee may have a right and an obligation to exchange lease payments for a right-of-use asset from the date of inception, the lessee is unlikely to have an obligation to make lease payments before the asset is made available for its use. [IFRS 16:BC142]. If such circumstances do arise (i.e. if the entity is required to make payments for the right to use the underlying asset before the commencement date), IFRS 16:B44 explicitly requires that they be included in lease payments (see **7.3.2**).

Example 5.3

Lease payments on assets not in use

Company X is planning a major expansion of its oil production capacity beginning in 20X2. In order to ensure sufficient shipping capacity is available when production increases, Company X enters into a lease contract on 1 January 20X1 for rail cars to ship the oil. The rail cars will be made available to Company X from 1 July 20X1. Company X does not expect to use the rail cars for its own shipping purposes until 20X2, but it may consider other options (e.g. to rent out the cars to other producers) in the second half of 20X1. The sole reason for entering into the lease contract in 20X1 is to ensure that the rail cars will be available to Company X in 20X2.

The inception date of the lease is 1 January 20X1 (or any earlier date on which the parties committed to the principal provisions of the lease). This is the date on which Company X evaluates the contract to determine whether it is, or contains, a lease. Assume that, having regard to the requirements set out in **3.3** (identified assets, no substantive substitution rights and, from 1 July 20X1, the right to control the use of the rail cars), Company X determines that the contract is a lease. [In fact, each of the rail cars may be considered a separate lease component – see **section 4**. However, it is assumed that Company X applies the practical expedient in IFRS 16:B1 (see **1.3**) and accounts for the portfolio of leases together.]

The lessor makes the rail cars available for use by Company X on 1 July 20X1. Company X has the right to control the use of the rail cars from that date. Although Company X does not intend to use the rail cars until 20X2, it has the right to determine how and for what purpose the rail cars are used from 1 July 20X1. If Company X chooses to store the rail cars rather than use them for a period of time, this is a demonstration of its control over those cars. Therefore, 1 July 20X1 is the commencement date of the lease and the assets, liabilities, income and expenses resulting from the lease are recognised and measured from that date.

The depreciation of the right-of-use asset should commence from 1 July 20X1 (i.e. the commencement date – see **7.5.1.3**) even if the rail cars are not used until 20X2.



5.4 Rent-free periods

The lease term includes any rent-free periods provided to the lessee by the lessor. [IFRS 16:B36]

5.5 Lessor termination options

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. [IFRS 16:B35]

A lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. [IFRS 16:BC128]

This principle applies for the determination of the lease term for the lessor as well as for the lessee – there is no assessment regarding whether the lessor is reasonably certain not to terminate, as is the case with lessee termination options (see **5.6**).

5.6 Assessment of lessee extension and termination options

In contrast to lessor termination options, if the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease are required to consider those optional periods in their assessment of the lease term. [IFRS 16:BC128]

In accordance with IFRS 16:18 (see **5.1**), the lease term will be considered to extend beyond the non-cancellable period if the lessee has an extension option that it is considered to be reasonably certain to exercise, or a termination option that it is considered to be reasonably certain not to exercise.

At the commencement date, the entity should assess whether the lessee is reasonably certain:

[IFRS 16:B37]

- to exercise an option to extend the lease; or
- to exercise an option to purchase the underlying asset; or
- not to exercise an option to terminate the lease.

In making these assessments, 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. [IFRS 16:19 & B37]

Examples of factors to consider when making these assessments include, but are not limited to:

[IFRS 16:B37]

- contractual terms and conditions for the optional periods compared with market rates, such as:
 - the amount of payments for the lease in any optional period;
 - 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
 - the terms and conditions of any options that are exercisable after initial optional periods (e.g. a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates);



- 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;
- 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; and
 - termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;
- 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
- conditionality associated with exercising the option (i.e. when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

An option to extend or terminate a lease may be combined with one or more other contractual features (e.g. 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 IFRS 16:B42 (see **6.3**), an entity should 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. [IFRS 16:B38]

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. [IFRS 16:B39]

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 a 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 should consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets. [IFRS 16:B40]

5.7 Reassessment of extension and termination options

A lessee should 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:

[IFRS 16:20]

- 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.



In principle, the IASB is of the view that users of financial statements receive more relevant information if lessees reassess extension, termination and purchase options on a regular basis. However, requiring reassessment at each reporting date would be costly for an entity with many leases that include options. In order to address that concern, while still providing useful information to users of financial statements, the Board decided that an appropriate balance would be achieved by requiring reassessment only if both of the criteria in IFRS 16:20 are met. Consequently reassessment is required only upon the occurrence of a significant event or a significant change in circumstances that is within the control of the lessee and that affects whether the lessee is reasonably certain to exercise, or not to exercise, an option to extend a lease, to terminate a lease or to purchase an underlying asset. Limiting the reassessment requirement to events within the control of the lessee means that a lessee is not required to reassess options in response to purely market-based events or changes in circumstances. To assist lessees, IFRS 16:B41 (see below) includes some examples of possible triggering events to help entities apply judgement in identifying significant events or significant changes in circumstances that trigger reassessment. [IFRS 16:BC184 – BC186]

Examples of significant events or changes in circumstances as contemplated in IFRS 16:20 include:

[IFRS 16:B41]

- 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;
- a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
- the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- a business decision of the lessee that is directly relevant to exercising, or not exercising, an option (e.g. 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).

5.8 Revision of lease term

An entity should 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 one of the following occurs:

[IFRS 16:21]

- the lessee exercises an option not previously included in the entity's determination of the lease term;
- the lessee does not exercise an option previously included in the entity's determination of the lease term;
- 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.

The lease term may also be revised following a reassessment as to whether an extension option is reasonably certain to be exercised, or a termination option is reasonably certain not to be exercised (see 5.7). Although such a reassessment does not affect the non-cancellable period, it affects the total lease term comprised of the non-cancellable period and reasonably certain extension periods (see 5.1).



Section 6 Lease payments

6.1 Lease payments – definition

A number of the measurement requirements in IFRS 16 are determined by reference to the ‘lease payments’. Lease payments are defined as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, comprising the following:

[IFRS 16:Appendix A]

- fixed payments (including in-substance fixed payments – see **6.3**), less any lease incentives (see **6.4**);
- variable lease payments that depend on an index or a rate (see **6.5.2**);
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (see **6.6**);
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease; and
- residual value guarantees as set out in **6.7**.

In accordance with IFRS 16:18 (see **5.1**), the lease term will be considered to extend beyond the non-cancellable period if the lessee has an extension option that it is considered to be reasonably certain to exercise, or a termination option that it is considered to be reasonably certain not to exercise. Therefore, lease payments include optional payments payable after the non-cancellable period if it is considered reasonably certain that the lease will extend beyond that period.

Lease payments exclude (1) variable lease payments linked to future performance or use of the underlying asset (see **6.5.3**), and (2) optional payments payable after the non-cancellable period if it is not considered reasonably certain that the lessee will extend the lease beyond that period.

6.2 Exclusion of payments allocated to non-lease components

Entities are generally required to separate lease and non-lease components of a contract (see **section 4**).

For a lessee, lease payments do not include payments allocated to non-lease components of a contract, unless the lessee has elected to combine lease and non-lease components under the practical expedient permitted under IFRS 16:15 (see **4.2.3**). [IFRS 16:Appendix A]

For a lessor, lease payments do not include payments allocated to non-lease components. [IFRS 16:Appendix A]

For a lessor, there is no practical expedient permitting lease and non-lease components to be combined (see **4.3**).

6.3 Fixed payments

Fixed payments are defined as “[p]ayments made by a lessee to a lessor for the right to use an underlying asset during the lease term, excluding variable lease payments”. [IFRS 16:Appendix A]

See **6.5** for a discussion of variable lease payments.

‘In-substance’ fixed lease payments, which are specifically required to be included in lease payments (see **6.1**), are payments that may, in form, contain variability but that, in substance, are unavoidable. [IFRS 16:B42]

In-substance fixed lease payments exist, for example, if:

[IFRS 16:B42]

- 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:



- 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
- 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;
- 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 should include within lease payments the realistic set of payments; and
- 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 should include within lease payments the set of payments that aggregates to the lowest amount (on a discounted basis).

IFRS 16 requires a lessee to include in-substance fixed lease payments in the measurement of lease liabilities because those payments are unavoidable and, therefore, are economically indistinguishable from fixed lease payments. [IFRS 16:BC164]

6.4 Lease incentives

Lease incentives are defined as “[p]ayments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee”. [IFRS 16:Appendix A]

Such incentives may take the form, for example, of an up-front cash payment to the lessee or a reimbursement or assumption by the lessor of costs of the lessee (e.g. relocation costs and costs associated with a pre-existing lease commitment of the lessee).

Such payments are offset against lease payments made by the lessee to the lessor (see 6.1). When any incentives are paid to the lessee, even if they are not part of the formal lease agreement, they should be offset against lease payments.

6.5 Variable lease payments

6.5.1 Variable lease payments – definition

Variable lease payments are defined as “[t]he 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”. [IFRS 16:Appendix A]

Variability arises if lease payments are linked to:

[IFRS 16:BC163]

- price changes due to changes in a market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or a consumer price index (see 6.5.2);
- the lessee’s performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property (see 6.5.3); or
- the use of the underlying asset. For example, a vehicle lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage (see 6.5.3).

6.5.2 Variable lease payments that depend on an index or a rate

6.5.2.1 Lease liability initially measured using the index or rate as at the commencement date

Variable lease payments that depend on an index or a rate (which, as indicated in 6.1, should be included within lease payments) include, for example, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates.[IFRS 16:28]



When measuring a lessee's lease liability (see 7.4.2.1) or a lessor's net investment in a lease (see 9.1.1), such payments should initially be measured using the index or rate as at the commencement date (see 5.3).

Variable lease payments that depend on an index or a rate are included in lease payments. They meet the definition of liabilities for the lessee because they are unavoidable and do not depend on any future activity of the lessee. Any uncertainty, therefore, relates to the measurement of the liability that arises from those payments and not to the existence of that liability. [IFRS 16:BC165]

At initial recognition, such payments are measured using the index or rate at the commencement date (without estimating changes in the index or rate over the remainder of the lease term). The IASB considered that using forecasting techniques or forward rates to estimate changes in the index or rate would be costly, and might introduce measurement uncertainty and reduce comparability between entities. [IFRS 16:BC166]

6.5.2.2 Variable lease payments that depend on an index – example

The following example, which is reproduced from the illustrative examples accompanying IFRS 16, illustrates how a lessee accounts for variable lease payments that depend on an index.

Example 6.5.2.2 **Variable lease payments that depend on an index** [IFRS 16:Illustrative example 14A]

Example 14A – Lessee enters into a 10-year lease of property with annual lease payments of CU50,000, payable at the beginning of each year. The contract specifies that lease payments will increase every two years on the basis of the increase in the Consumer Price Index for the preceding 24 months. The Consumer Price Index at the commencement date is 125. This example ignores any initial direct costs. The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset	CU405,391
Lease liability	CU355,391
Cash (lease payment for the first year)	CU50,000

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.



During the first two years of the lease, Lessee recognises in aggregate the following related to the lease.

Interest expense	CU33,928	
Lease liability		CU33,928
Depreciation charge (CU405,391 ÷ 10 × 2 years)	CU81,078	
Right-of-use asset		CU81,078

At the beginning of the second year, Lessee makes the lease payment for the second year and recognises the following.

Lease liability	CU50,000	
Cash		CU50,000

At the beginning of the third year, before accounting for the change in future lease payments resulting from a change in the Consumer Price Index and making the lease payment for the third year, the lease liability is CU339,319 (the present value of eight payments of CU50,000 discounted at the interest rate of 5 per cent per annum = CU355,391 + CU33,928 – CU50,000).

At the beginning of the third year of the lease the Consumer Price Index is 135.

The payment for the third year, adjusted for the Consumer Price Index, is CU54,000 (CU50,000 × 135 ÷ 125). Because there is a change in the future lease payments resulting from a change in the Consumer Price Index used to determine those payments, Lessee remeasures the lease liability to reflect those revised lease payments, ie the lease liability now reflects eight annual lease payments of CU54,000.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of CU54,000 discounted at an unchanged discount rate of 5 per cent per annum, which is CU366,464. Lessee increases the lease liability by CU27,145, which represents the difference between the remeasured liability of CU366,464 and its previous carrying amount of CU339,319. The corresponding adjustment is made to the right-of-use asset, recognised as follows.

Right-of-use asset	CU27,145	
Lease liability		CU27,145

At the beginning of the third year, Lessee makes the lease payment for the third year and recognises the following.

Lease liability	CU54,000	
Cash		CU54,000



6.5.2.3 Variable lease payments that depend on a rate – example

When variable payments depend on a rate, the accounting is a little different, as illustrated in the following example.

Example 6.5.2.3

Variable lease payment that depend on a rate

Entity B enters into a lease for 10 years, with a single lease payment payable at the beginning of each year. The initial lease payment is CU1,000. Lease payments will increase by the rate of LIBOR each year. At the date of commencement of the lease, LIBOR is 2 per cent. Assume that the interest rate implicit in the lease is 5 per cent.

In accordance with IFRS 16:27(b), the lease payments should initially be measured using the rate (i.e. LIBOR) as at the commencement date. LIBOR at that date is 2 per cent; therefore, in measuring the lease liability, it is assumed that each year the payments will increase by 2 per cent, as follows.

Year	Lease payment	Discount factor	Present value of lease payment
	CU		CU
1	1000	1	1,000
2	1020	0.952	971
3	1040	0.907	943
4	1061	0.863	916
5	1082	0.822	889
6	1104	0.784	866
7	1126	0.746	840
8	1149	0.711	817
9	1172	0.677	793
10	1195	0.645	771
			8,806

Therefore, the lease liability is initially measured at CU8,806.



6.5.2.4 Rent reviews to market rates or upward-only

When a lease contract includes the potential for rent reviews (whether to market rates or upward only), the lease payments included in the measurement of the lessee's lease liability and the lessor's net investment in the lease at the commencement date will be the payments agreed at inception, without consideration of future rent reviews.

Whether a lease specifies a rent of CU100 annually plus market increases, or CU100 annually resetting up or down to market every five years, the lease payments recognised at the commencement date are CU100 annually. Any increase or decrease as a result of subsequent rent reviews will be recognised when the adjustment to the lease payments takes effect (see **8.5.2.7**).

The basis of any rent review under a lease should be evaluated carefully to determine whether the rent review resets the lease payments to market at the date of the review or whether, in substance, the amount of change in the lease payments at the date of the review was fixed at inception. In the latter case, the changes in rent would represent 'in-substance' fixed payments (see **7.3**) and would therefore be included in lease payments from the commencement date.

6.5.3 Variable lease payments linked to future performance or use of an underlying asset

Variable lease payments linked to future performance or use of an underlying asset are excluded from the measurement of lease liabilities (see IFRS 16:BC168 and BC169 for a discussion of the IASB's considerations in this regard).

Such payments are required to be recognised in profit or loss in the period in which the event or condition that triggers those payments occurs (see **7.5.2.3**).

The following example, which is reproduced from the illustrative examples accompanying IFRS 16, illustrates how a lessee accounts for variable lease payments not included in the measurement of the lease liability.

Example 6.5.3

Variable lease payments linked to sales

[IFRS 16:Illustrative example 14B]

Assume the same facts as **[example 6.5.2.2]** except that Lessee is also required to make variable lease payments for each year of the lease, which are determined as 1 per cent of Lessee's sales generated from the leased property.

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in **[example 6.5.2.2]**. This is because the additional variable lease payments are linked to future sales and, thus, do not meet the definition of lease payments. Consequently, those payments are not included in the measurement of the asset and liability.

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000

Lessee prepares financial statements on an annual basis. During the first year of the lease, Lessee generates sales of CU800,000 from the leased property.

Lessee incurs an additional expense related to the lease of CU8,000 ($CU800,000 \times 1$ per cent), which Lessee recognises in profit or loss in the first year of the lease [see **6.5.2.3**].



6.6 Options to purchase the underlying asset

Purchase options are required to be included in the measurement of a lessee's lease liability and a lessor's lease receivable in the same way as options to extend the term of a lease (i.e. the exercise price of a purchase option is included in the measurement of a lease liability/receivable if the lessee is reasonably certain to exercise that option). The IASB views a purchase option as effectively the ultimate option to extend the lease term. A lessee that has an option to extend a lease for 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. [IFRS 16:BC173]

6.7 Residual value guarantees

A residual value guarantee is defined as "[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". [IFRS 16:Appendix A]

For a lessee, lease payments include amounts expected to be payable by the lessee under residual value guarantees. [IFRS 16:Appendix A]

A lessee should estimate the amount that it expects to pay to the lessor under a residual value guarantee and include that amount in the measurement of its lease liability. This treatment reflects the fact that payments resulting from a residual value guarantee cannot be avoided by the lessee – the lessee has an unconditional obligation to pay the lessor if the value of the underlying asset moves in a particular way. Accordingly, any uncertainty relating to the payment of a residual value guarantee does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary in response to movements in the value of the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee (see **6.5.2**). [IFRS 16:BC170 & BC171]

For a lessor, lease payments 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. [IFRS 16:Appendix A]



Section 7 Accounting by lessees

7.1 Recognition – general

At the commencement date of a lease, a lessee is required to recognise both:

[IFRS 16:22]

- a right-of-use asset; and
- a lease liability.

7.2 Recognition exemptions

7.2.1 Recognition exemptions – general

A lessee may elect not to apply the requirements in IFRS 16:22 to 49 (recognition requirements as described at 7.1, measurement requirements described at 7.4, and presentation requirements described at 7.1) to:

[IFRS 16:5]

- short-term leases (see 7.2.2); and
- leases for which the underlying asset is of low value (see 7.2.3 and subject to the exception in 7.2.3.5).

For short-term leases or leases of low-value items to which this exemption is applied, lease payments are recognised as an expense over the lease term (see 7.2.4).



Thinking it through

Some entities may decide that they do not wish to take advantage of these exemptions, perhaps because recognising lease assets and liabilities and presenting the lease expense as interest and depreciation is considered preferable to an off-balance sheet treatment with an operating expense. Or, for some lessees, while they may see benefit to having such leases off-balance sheet, that benefit may not be sufficient to justify the additional cost or complexity of having two lease accounting systems.

7.2.2 Short-term leases

7.2.2.1 Short-term lease – definition

A short-term lease is defined as “[a] lease that, at the commencement date, has a lease term of 12 months or less”. [IFRS 16:Appendix A]

A lease that contains a purchase option cannot be classified as a short-term lease. [IFRS 16:Appendix A]

For the purposes of the definition of a short-term lease, the lease term should be determined under the general requirements of IFRS 16 (see **section 5**). Consequently, lessees will need to assess the effect of extension and termination options.

Note that the prohibition on a lease containing a purchase option being classified as a short-term lease applies for any lease containing a purchase option, irrespective of the probability that the option will be exercised.

Note also that there is no restriction on qualification as a short-term lease based on the value of the underlying asset or the amount of the consideration paid. This exemption is available for high-value items that are leased for the short term.



7.2.2.2 Election to be made on a class-by-class basis

The election to take the recognition exemption for short-term leases is required to 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. [IFRS 16:8]

For example, consider an entity that has leased several items of office equipment – some for less than 12 months and some for longer than 12 months, with none containing purchase options. Assuming that the items of office equipment are all considered to be of the same class, if the entity wishes to use the short-term lease exemption it must apply that exemption for all of the leases with terms of 12 months or less. The leases with terms longer than 12 months will be accounted for in accordance with the general recognition and measurement requirements for lessees.

7.2.2.3 Impact of lease modifications

If a lessee accounts for short-term leases applying IFRS 16:6 (see **7.2.4**), it should consider the lease to be a new lease for the purposes of IFRS 16 if:

[IFRS 16:7]

- there is a lease modification; or
- there is any change in the lease term (e.g. the lessee exercises an option not previously included in its determination of the lease term).

See **7.7** for the definition of lease modifications and the accounting treatment generally required. In the context of a short-term lease, any lease modification (and, specifically, any change in the lease term) will be considered a new lease which will need to be reassessed to determine if it qualifies for the short-term lease exemption.

See **1.4** for IFRS 16's requirements regarding circumstances when two or more contracts that are interdependent should be combined and accounted for as a single contract. One specific example cited in this regard is when a lessee enters into a number of one-year leases at the same time and with the same counterparty, to follow sequentially such that the overall economic effect is a lease for the entire term. In that situation, if the conditions in IFRS 16:B2 are met, the leases would be combined and accounted for as a single lease (which would not qualify for the short-term lease exemption).

7.2.3 Leases of low-value assets

7.2.3.1 Low-value assets – definition and examples

IFRS 16 does not provide an explicit definition for what is meant by 'low-value' assets. However, the Basis of Conclusions states that "[a]t the time of reaching decisions about the exemption in 2015, the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US\$5,000 or less". [IFRS 16:BC100]

Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones. [IFRS 16:B8]

7.2.3.2 Assessment independent of the size or nature of the lessee

The assessment as to whether an underlying asset is of low value is performed on an absolute basis. Subject to the exception in IFRS 16:B7 regarding head leases (see **7.2.3.6**), and the exclusion of assets that are highly dependent on, or interrelated with, other assets (see **7.2.3.5**), leases of low-value assets qualify for the accounting treatment in IFRS 16:6 (see **7.2.4**) 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. [IFRS 16:B4]



**Thinking it through**

In practice, determining whether items are of 'low value' is going to be challenging given that the pointers in the guidance are so limited. While US\$5,000 may be considered 'low' in some jurisdictions, it may not be in others, and it is possible that some lessees will put more focus on the nature of the underlying assets (the Standard cites as examples tablet and personal computers, small items of office furniture and telephones). It is likely that this will continue to be a significant area of judgement which may become clearer as practice develops.

7.2.3.3 Assessment to be based on the value of the asset when new

The value of an underlying asset should be assessed based on the value of the asset when it is new, regardless of the age of the asset being leased. [IFRS 16:B3]

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. [IFRS 16:B6]

7.2.3.4 Election available on lease-by-lease basis

The exemption for leases of low-value assets is available on a lease-by-lease basis. [IFRS 16:8]

In particular, an entity is not required to consider the aggregate of the leases identified as relating to low-value assets to determine if the overall effect is material (see also **7.2.3.2**).

Subject to IFRS 16's general requirements regarding the combination of interdependent contracts (see **1.4**), and the specific requirements in IFRS 16:B5 regarding assets that are highly interdependent or highly interrelated (see **7.2.3.5**), each lease is assessed separately.

For example, a hospital enters into a rental contract for a large number of hospital beds. Each bed within the contract constitutes an identified underlying asset and the other conditions for identification of a lease are met. The value of an individual hospital bed would be considered to be 'low', even though the contract for all of the beds is not. The conditions of IFRS 16:B5 are met (the hospital can benefit from the use of an individual bed together with other resources that are already available, and each individual bed does not need other assets to make it functional for patients). Consequently each bed qualifies as a low-value asset and the entity can elect to apply the low-value asset exemption to all of the beds under the contract.

7.2.3.5 Assets that are highly dependent on, or highly interrelated with, other assets do not qualify as low-value assets

A lease will qualify for this exemption only if:

[IFRS 16:B5]

- 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
- the underlying asset is not highly dependent on, or highly interrelated with, other assets.



Therefore, if either (1) the lessee cannot benefit from the underlying asset on its own or together with other readily available resources, or (2) the underlying asset is highly dependent on, or highly interrelated with, other underlying assets, the recognition exemption for low-value assets cannot be applied to that individual asset (unless the overall asset, combining the highly dependent or highly interrelated assets, is itself low value). In this context, the IASB had in mind large assets made up of a number of individual leases of low-value assets (such as IT equipment made up of individually low-value component parts).

See **example 1.3** which sets out a scenario in which some items of IT equipment (laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones) qualify for the low-value asset exemption but others (individual modules that increase the storage capacity of mainframe servers) do not. Although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low-value assets. This is because each module is highly interrelated with other parts of the servers.

7.2.3.6 Head leases do not qualify as low-value assets

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. [IFRS 16:B7]

7.2.4 Recognition of lease payments for short-term leases and leases of low-value assets

If a lessee elects to apply the exemption in IFRS 16:5 to either short-term leases or leases of low-value assets, it should recognise the lease payments associated with those leases as an expense on either a straight-line basis over the lease term, or on another systematic basis if that basis is more representative of the pattern of the lessee's benefit. [IFRS 16:6]

For example, if the lease payments for an asset are based on the actual usage of that asset, or are revised periodically to reflect the efficiency of the asset or current market rates, the amounts actually payable may be an appropriate measure.

The lease payments to be spread on a straight-line (or other systematic) basis are after deduction of any lease incentives (see **6.4**). The lease term includes any rent-free periods (see **5.4**). The following examples illustrate the recognition of lease payments under IFRS 16:6 when such features are present.



Example 7.2.4A**Recognition of lease payments (including lease incentives) for low-value assets**

Entity A leases office equipment for 5 years. The total value of the equipment when new is CU5,000 (determined by Entity A to be 'low value'). Entity A elects to apply the low-value asset exemption.

Lease payments are payable as follows.

Year 1 CUnil (rent-free period)

Years 2 and 3: CU1,750 per year

Years 4 and 5: CU1,500 per year

In addition, the lessor provides a lease incentive with a value of CU500. The lessee's benefit under the lease arises on a straight-line basis over the full lease term.

Applying IFRS 16:6 to the lease payments:

Total payments: $(CU1,750 \times 2) + (CU1,500 \times 2) - CU500 = CU6,000$

Length of lease: 5 years

Lease expense recognised each year: CU1,200 $(CU6,000/5)$

Example 7.2.4B**Period over which lease incentives should be recognised**

Entity B leases office equipment for 5 years. The total value of the equipment when new is CU5,000 (determined by Entity B to be 'low value'). Entity B elects to apply the low-value asset exemption.

The lease includes a clause requiring lease payments to be repriced to market rates part-way through the lease term. The lessor grants an incentive to Entity B to enter into the lease arrangement.

Over what period should the lease incentive be recognised (i.e. over the whole of the lease term or over the period up to the repricing of lease payments to market rates)?

The lease incentive should be recognised over the lease term. It should be recognised on a straight-line basis, unless another systematic basis is more representative of the time pattern of Entity B's benefit from use of the leased asset.

The IFRIC (now the IFRS Interpretations Committee) was asked to consider this issue in 2005 (in the context of SIC-15 *Operating Leases – Incentives*, but equally applicable for entities applying the low-value asset exemption under IFRS 16). Specifically, the IFRIC was asked to consider whether the lease incentive should be recognised over the shorter period ending when the lease payments are adjusted to market rates on the basis that the lease expense of a lessee after a lease is repriced to market ought to be comparable with the lease expense of an entity entering into a new lease at that same time at market rates. The IFRIC did not accept this argument and confirmed that the general requirements for spreading lease incentives over the entire lease term should apply.



7.3 Lessee involvement with the underlying asset before the commencement date

7.3.1 Costs of the lessee relating to the construction or design of the underlying asset

Parties 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 a lessee incurs costs relating to the construction or design of an underlying asset, the lessee should account for those costs applying other applicable Standards (e.g. IAS 16 *Property, Plant and Equipment*). [IFRS 16:B43 & B44]

Such costs (e.g. amounts payable by an entity to construct a bespoke property that it will ultimately lease from another entity – sometimes referred to as ‘build-to-suit’ leases) do not qualify as initial direct costs (as discussed at **7.4.1.2**); they are not included within the carrying amount of the right-of-use asset under IFRS 16, but rather are accounted for as a separate asset (assuming the recognition criteria of the relevant Standard are met).

7.3.2 Payments for the right to use the underlying asset made before the commencement date

Costs relating to the construction or design of an underlying asset (as described in **7.3.1**) 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. [IFRS 16:B44] They are included within the initial measurement of the right-of-use asset (see **7.4.1**)

7.3.3 Legal title to the underlying asset

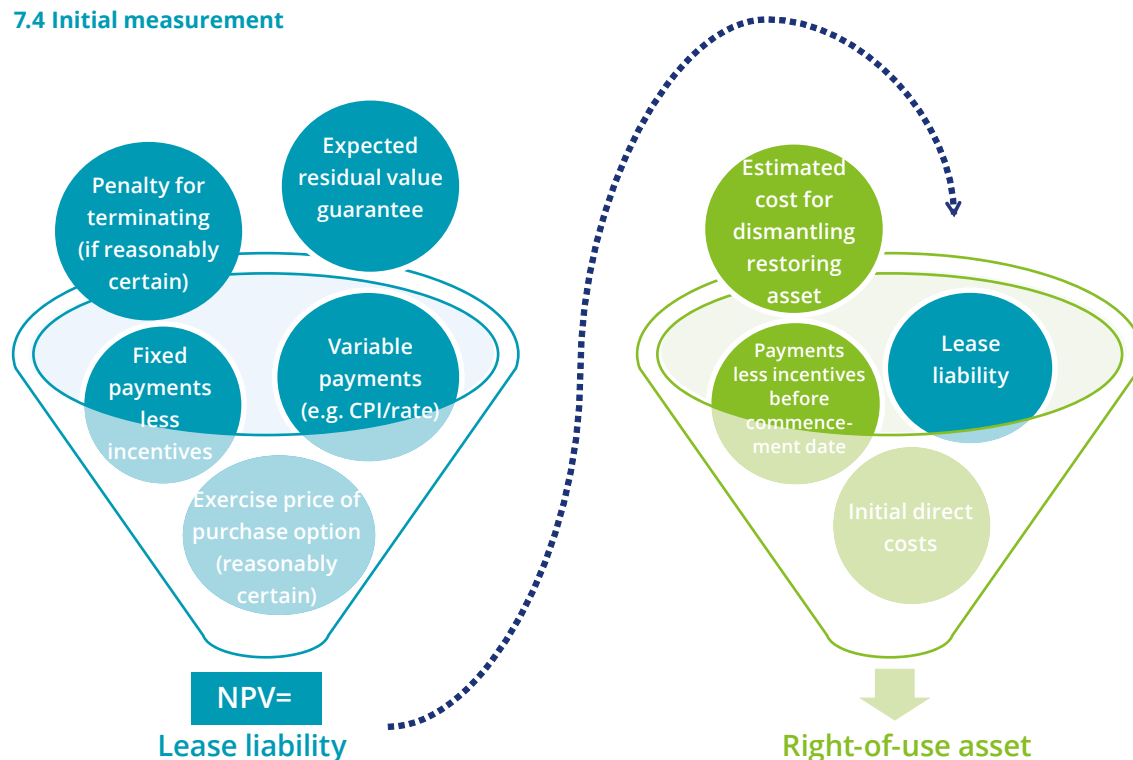
A lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction. [IFRS 16:B45]

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 accounted for by applying IFRS 16:98 to 103 (see **section 10**). [IFRS 16:B46]

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. [IFRS 16:B47]



7.4 Initial measurement



7.4.1 Initial measurement of the right-of-use asset

7.4.1.1 Right-of-use asset to be measured initially at cost

At the commencement date, the right-of-use asset should be measured at cost. [IFRS 16:23]

For this purpose, cost comprises:

[IFRS 16:24]

- the amount of the initial measurement of the lease liability, as described in IFRS 16:26 (see **7.4.2**);
- any lease payments made at or before the commencement date (see **7.3.2**), less any lease incentives received (see **6.4** for a definition of lease incentives);
- any initial direct costs incurred by the lessee (see **7.4.1.2**); and
- 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 asset during a particular period (see **7.4.1.3**).

See **example 7.6** for an illustration of the initial and subsequent measurement of a lessee's right-of-use asset and lease liability.

7.4.1.2 Initial direct costs

Initial direct costs are the “[i]ncremental 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”. [IFRS 16:Appendix A]

Initial direct costs are, typically, costs incurred in negotiating and securing lease arrangements. They exclude costs incurred by a lessee relating to the construction or design of an underlying asset (see **7.3.1**). See **9.1.1.3** for further discussion on the nature of initial direct costs.

7.4.1.3 Restoration costs

Under IFRS 16:24(d), the initial cost of a right-of-use asset includes 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. [IFRS 16:24(d)]

The costs described in IFRS 16:24(d) should be recognised as part of the cost of the right-of-use asset when the lessee incurs an obligation for those costs. The lessee should apply 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 IFRS 16 or IAS 2 are recognised and measured applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. [IFRS 16:25]

At initial recognition, the estimated liability for such restoration costs is recognised as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* if an obligating event has already occurred. It is not included as part of the lease liability.

As a consequential amendment arising from IFRS 16, the scope of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* has been amended to include restoration costs of this nature that are recognised as part of the cost of a right-of-use asset under IFRS 16:24(d). Therefore, any change in the entity's estimate of such costs after initial recognition should be accounted for in accordance with that Interpretation which, for right-of-use assets measured subsequent to initial recognition using a cost model, will result in such changes being added to, or deducted from, the cost of the right-of-use asset.

Sometimes lease contracts stipulate that the underlying asset must be returned to the lessor in the same condition as when originally leased. The appropriate accounting in such circumstances depends on the particular lease clause. For example, the underlying asset may suffer general wear and tear that is merely a result of being used. In such circumstances, it may be necessary gradually to build up a provision to repair or maintain the asset over the lease term, so that it can be returned to the lessor in its original condition. Generally, in these circumstances, it would be inappropriate to recognise a provision for all of the estimated maintenance costs at the outset of the lease. Conversely, other contracts may require specific work to be performed; for example, the contract may stipulate that the asset must be painted at the end of the lease before being returned to the lessor. In such circumstances, it may be appropriate to recognise a provision at the outset of the lease because, by signing the lease contract, the entity has committed itself to painting the asset, irrespective of any wear and tear suffered.



7.4.2 Initial measurement of the lease liability

7.4.2.1 Lease liability to be measured initially at the present value of unpaid lease payments

At the commencement date, the lease liability should be measured at the present value of the lease payments that are not paid at that date. [IFRS 16:26]

See **section 6** for a discussion of the components of 'lease payments' for the purposes of this measurement.



Thinking it through

In some industries, analysts have historically applied a specific multiple to operating lease expenses under IAS 17 to arrive at a proxy for the liability now being recognised under IFRS 16. For example, in the aviation industry, it has been common practice to use a multiple of seven, regardless of the outstanding term of lease arrangements. Accordingly, the liability recognised under IFRS 16 may differ significantly to the proxies previously arrived at by analysts. In such circumstances, entities will want to speak to their investors and analysts to manage expectations and avoid 'surprises'.

The liability may also be treated as 'debt' for some purposes, although this will depend on the particular circumstances.

7.4.2.2 Discount rate

The lease payments should be discounted using:

[IFRS 16:26]

- the interest rate implicit in the lease; or
- if the interest rate implicit in the lease cannot be readily determined, the lessee's incremental borrowing rate.

The interest rate implicit in the lease is defined as "[t]he 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".

[IFRS 16:Appendix A] The unguaranteed residual value is defined as "[t]hat 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". [IFRS 16:Appendix A]

The lessee's incremental borrowing rate is defined as "[t]he 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". [IFRS 16:Appendix A]



When the lease is denominated in a foreign currency, the lessee's incremental borrowing rate should be the rate at which the lessee could obtain funding for the asset in the foreign currency.

The IASB's objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced. With this in mind, the IASB decided that, if readily determinable by the lessee, a lessee should use the interest rate implicit in the lease. [IFRS 16:BC160]

The interest rate implicit in the lease is likely to be similar to the lessee's incremental borrowing rate in many cases. This is because both rates, as they have been defined in IFRS 16, take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs. However, the interest rate implicit in the lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor, such as any initial direct costs of the lessor. Consequently, the IASB noted that it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease. [IFRS 16:BC161]

The IASB noted that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point when determining its incremental borrowing rate for a lease (e.g. the rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases). Nonetheless, because the lessee's incremental borrowing rate is defined to take into account the terms and conditions of the lease, a lessee should adjust such observable rates as needed to determine its incremental borrowing rate. [IFRS 16:BC162]



Thinking it through

In attempting to arrive at an appropriate discount rate, some lessees may decide to approach lessors in order to obtain greater insight into the pricing of contracts and returns being made by lessors. In some industries and for some lessors, this may not be sensitive information and the lessors may readily provide it. In other cases, lessors may be reluctant to divulge such information for commercial reasons and lessees will need to consider whether the implicit rate is readily determinable by other means, before resorting to the incremental borrowing rate.

7.5 Subsequent measurement

7.5.1 Subsequent measurement of the right-of-use asset

7.5.1.1 Subsequent measurement of the right-of-use asset – general

After the commencement date, the right-of-use asset should be measured using a cost model (see **7.5.1.2**), unless it applies either of the measurement models described in IFRS 16:34 and 35 (see **7.5.1.5** and **7.5.1.6**, respectively). [IFRS 16:29]

7.5.1.2 Cost model for right-of-use assets

Under the cost model, the right-of-use asset is measured at cost:

[IFRS 16:30]

- less any accumulated depreciation and any accumulated impairment losses (see **7.5.1.3** and **7.5.1.4**, respectively); and
- adjusted for any remeasurement of the lease liability specified in IFRS 16:36(c) (see **7.5.2.1**).



7.5.1.3 Depreciation for right-of-use assets

Right-of-use assets measured under the cost model should be depreciated in accordance with the depreciation requirements in IAS 16, subject to the following:

[IFRS 16:31 & 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 right-of-use asset should be depreciated from the commencement date to the end of the useful life of the underlying asset;
- otherwise, the right-of-use asset should be depreciated from the commencement date to the earlier of the end of the useful life of the right-of-use asset and the end of the lease term.

The useful life of an asset is defined as “[t]he 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”. [IFRS 16:Appendix A]

Therefore, if the ownership of the underlying asset transfers to the lessee at the end of the lease term, or it is reasonably certain that the lessee will exercise a purchase option, depreciation is based on the useful life of the underlying asset. Otherwise, depreciation is determined by reference to the useful life of the right-of-use asset (provided that is not longer than the lease term).

7.5.1.4 Impairment for right-of-use assets

A lessee should apply IAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified. [IFRS 16:33]

7.5.1.5 Right-of-use assets that meet the definition of investment property

If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, it is also required to apply that fair value model to right-of-use assets that meet the definition of investment property in IAS 40. [IFRS 16:34]

IFRS 16 has amended the scope of IAS 40 by defining investment property to include both owned investment property and investment property held by a lessee as a right-of-use asset. A lessee is required to account for right-of-use assets that meet the definition of investment property in a manner consistent with its policy for owned investment property – i.e. using either the cost model and disclosing fair value, or using the fair value model. [IFRS 16:BC178]

7.5.1.6 Right-of-use assets that relate to a class of revalued property, plant and equipment

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. [IFRS 16:35]

Therefore, for property, plant and equipment:

- if the class of owned assets to which right-of-use assets relate is measured using the cost model, the right-of-use assets should also be accounted for using the cost model; but
- if the class of assets to which right-of-use assets relate is measured using IAS 16’s revaluation model, a lessee can choose whether to measure right-of-use assets at fair value. This choice is made on a class-by-class basis. This is in contrast to right-of-use assets that meet the definition of investment property for which the accounting model to be followed is determined by the lessee’s accounting policy for owned investment property (see 7.5.1.5).



7.5.2 Subsequent measurement of the right-of-use liability

7.5.2.1 Subsequent measurement of the lease liability – general

After the commencement date, the lease liability should be measured by:

[IFRS 16:36]

- 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 IFRS 16:39 to 46 (see **7.5.2.4**), or to reflect revised in-substance fixed lease payments (see **6.3**).

Lease liabilities are measured on an ongoing basis similarly to other financial liabilities, using an effective interest method, so that the carrying amount of the lease liability is measured on an amortised cost basis and the interest expense is allocated over the lease term. IFRS 16 does not require or permit a lessee to measure lease liabilities at fair value after initial measurement. [IFRS 16:BC182 & BC183]



Thinking it through

Accounting systems will need to be able to cater for scenarios where remeasurement of the liability is required, potentially with an updated discount rate. Basic spreadsheet solutions may struggle to cope with such demands as well as identifying when such remeasurements are required.

7.5.2.2 Recognising interest on the lease liability

Interest on the lease liability in each period during the lease term should be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. For this purposes, the periodic rate of interest is the discount rate used in the initial measurement of the lease liability (see **7.4.2.2**) or, if applicable, the revised discount rate described in IFRS 16:41 or 43 (see **7.5.2.5** to **7.5.2.7**) or IFRS 16:45(c) (see **7.7.3**). [IFRS 16:37]

7.5.2.3 Amounts to be recognised in profit or loss

After the commencement date, a lessee should recognise in profit or loss (unless the costs are included in the carrying amount of another asset under other applicable IFRSs), both:

[IFRS 16:38]

- interest on the lease liability; and
- 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 (see also **6.5.3**).



**Thinking it through**

Because the interest expense on the lease liability will be front-loaded, this leads to an overall front-loading of the expense when combined with straight-line depreciation of the right-of-use asset. This means that, for an individual lease, the expense will typically be higher in the earlier years (compared to the previous IAS 17 expense) and lower in the later years. However, when an entity has a portfolio of leases of varying maturities which are renewed on a rolling basis, the overall effect may still resemble an approximately straight-line expense, similar to that reported under IAS 17.

Recognising an interest and depreciation expense under IFRS 16, rather than an operating expense for rentals paid under IAS 17, means that metrics such as EBITDA will increase compared to amounts reported when IAS 17 is applied. This may have a knock-on effect on an entity's KPIs, bonus targets, contingent consideration arrangements, lending covenants and more.

7.5.2.4 Remeasurement of the lease liability – general

After the commencement date, if changes to the lease payments occur, the lease liability should be remeasured in accordance with IFRS 16:40 to 43 (see **7.5.2.5** to **7.5.2.7**). The amount of the remeasurement of the lease liability should generally be recognised as an adjustment to the right-of-use asset (see **7.5.1.2**). 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, the remaining remeasurement should be recognised in profit or loss. [IFRS 16:39]

7.5.2.5 Remeasurements arising from a change in the lease term or reassessment of purchase option

The lease liability should be remeasured by discounting the revised lease payments using a revised discount rate, if either:

[IFRS 16:40]

- there is a change in the lease term (see **5.7** and **5.8**), in which case the revised lease payments should be determined on the basis of the revised lease term; or
- there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in IFRS 16:20 and 21 (see **5.7** and **5.8**) in the context of a purchase option, in which case the revised lease payments should be determined to reflect the change in amounts payable under the purchase option.

In most cases, an entity should not reassess the discount rate during the lease term. However, IFRS 16 requires a lessee to remeasure the lease liability using revised payments and a revised discount rate when there is a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset. In the IASB's view, in those circumstances, the economics of the lease have changed and it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of the lease liability (and right-of-use asset). [IFRS 16:B193 & BC194]

In applying IFRS 16:40, the revised discount rate used should be:

[IFRS 16:41]

- the interest rate implicit in the lease for the remainder of the lease term; or
- if the interest rate implicit in the lease cannot be readily determined, the lessee's incremental borrowing rate at the date of reassessment.

7.5.2.6 Remeasurements arising from a change in the amounts expected to be payable under a residual value guarantee

The lease liability should be remeasured by discounting the revised lease payments (i.e. reflecting the change in the residual value guarantee) using an unchanged discount rate, unless the change in the residual value guarantee results from a change in floating interest rates, in which case the lessee should use a revised discount rate that reflects changes in the interest rate. [IFRS 16:42(a) & 43]



7.5.2.7 Remeasurements arising from a change in future lease payments resulting from a change in an index or a rate

These requirements apply when 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). In such circumstances, the lease liability should be remeasured to reflect those revised lease payments only when there is a change in the cash flows (i.e. when the adjustment to the lease payments takes effect – see **example 7.5.2.7**). [IFRS 16:42(b)]

The IASB decided that a lessee should reassess variable lease payments that are determined by reference to an index or a rate only when there is a change in the cash flows resulting from a change in the reference index or rate. This approach is considered to be less complex and costly to apply than requiring a lessee to reassess variable lease payments at each reporting date. [IFRS 16:BC190]

The revised lease payments for the remainder of the lease term should be determined based on the revised contractual payments. They should be discounted using an unchanged discount rate, unless the change in the lease payments results from a change in floating interest rates, in which case the lessee should use a revised discount rate that reflects changes in the interest rate. [IFRS 16:42(b) & 43]

IFRS 16 generally does not permit an entity to reassess the discount rate during the lease term. An exception is made when there is a change in the lease term or a change in the assessment regarding a purchase option (see **7.5.2.5**). The IASB also decided that, in a floating interest rate lease, a lessee should use a revised discount rate to remeasure the lease liability when there is a change in lease payments resulting from changes in the floating interest rate. This approach is consistent with the requirements in IFRS 9 *Financial Instruments* for the measurement of floating-rate financial liabilities subsequently measured at amortised cost. [IFRS 16:BC195]



Example 7.5.2.7**Remeasurements arising from a change in future lease payments resulting from a change in an index**

On 1 January 20X1, Entity A leases a property for a lease term of 8 years. The lease payments for the first three years have been agreed at CU100 per year. The lease payments will be reset on 1 January 20X4 (and, subsequently, on 1 January 20X7) on the basis of the increase in the Retail Price Index (RPI) for the preceding three years. All lease payments are made at the end of the relevant year.

At 1 January 20X1 (the commencement date), the RPI is 100 and Entity A measures its lease liability at CU646 (8 payments of CU100 payable in arrears, discounted at the interest rate implicit in the lease of 5 per cent).

On 1 January 20X2, 20X3 and 20X4, respectively, the RPI is 103, 107 and 108. On 1 January 20X7, the RPI is 113.

In its financial statements for the years ended 31 December 20X1, 31 December 20X2 and 31 December 20X3, Entity A makes no adjustment for increases in RPI because there is no change in cash flows in those years. In its financial statements for year ended 31 December 20X4 (and subsequently 20X7), Entity A recalculates its liability based on the increased RPI. These adjustments are added to the carrying amount of the lease liability and the related right-of-use asset, subject to the requirements of IFRS 16:39 (see 7.5.2.4).

Year	Opening lease liability	Adjustment	Interest	Repayment	Closing lease liability
	CU	CU	CU	CU	CU
20X1	646	-	32	-100	578
20X2	578	-	29	-100	507
20X3	507	-	25	-100	432
20X4	432	35 ^a	22	-108	381
20X5	381	-	19	-108	292
20X6	292	-	16	-108	200
20X7	200	9 ^b	11	-113	107
20X8	107	-	6	-113	0

a) Difference between five remaining payments of CU100 discounted at 5 per cent and five remaining payments of CU108 discounted at 5 per cent.

b) Difference between two remaining payments of CU108 discounted at 5 per cent and two remaining payments of CU113 discounted at 5 per cent.

7.5.2.8 Foreign currency exchange

IFRS 16 does not provide specific requirements as to how a lessee should account for the effects of foreign currency exchange differences relating to lease liabilities that are denominated in a foreign currency. In line with other financial liabilities, a lessee's lease liability is a monetary item and consequently, if denominated in a foreign currency, is required to be remeasured using closing rates at the end of each reporting period applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Such foreign exchange differences are recognised in profit in loss and not as an adjustment to the carrying amount of the right-of-use asset. [IFRS 16:BC196 – BC198]



**Thinking it through**

In industries such as the aviation industry, it is common for leases to be denominated in US dollars (USD). For entities with functional currencies other than USD, the effects of retranslating the liability and recognising a gain or loss in profit or loss may be significant. Entities may wish to consider their treasury strategy and whether they can apply hedge accounting to address this volatility.

7.6 Illustrative example – lessee measurement

The following example, reproduced from the illustrative examples accompanying IFRS 16, illustrates how a lessee measures right-of-use assets and lease liabilities. It also illustrates how a lessee accounts for a change in the lease term.

Example 7.6**Measurement by a lessee and accounting for a change in the lease term**

[IFRS 16: Illustrative example 13]

Part 1 – Initial measurement of the right-of-use asset and the lease liability

Lessee enters into a 10-year lease of a floor of a building, with an option to extend for five years. Lease payments are CU50,000 per year during the initial term and CU55,000 per year during the optional period, all payable at the beginning of each year. To obtain the lease, Lessee incurs initial direct costs of CU20,000, of which CU15,000 relates to a payment to a former tenant occupying that floor of the building and CU5,000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to Lessee for entering into the lease, Lessor agrees to reimburse to Lessee the real estate commission of CU5,000 and Lessee's leasehold improvements of CU7,000.

At the commencement date, Lessee concludes that it is not reasonably certain to exercise the option to extend the lease and, therefore, determines that the lease term is 10 years.

The interest rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives lease incentives from Lessor and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

Lessee initially recognises assets and liabilities in relation to the lease as follows.

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000
Right-of-use asset	CU20,000	
Cash (initial direct costs)		CU20,000
Cash (lease incentive)	CU5,000	
Right-of-use asset		CU5,000



Lessee accounts for the reimbursement of leasehold improvements from Lessor applying other relevant Standards and not as a lease incentive applying IFRS 16. This is because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset.

Part 2 – Subsequent measurement and accounting for a change in the lease term

In the sixth year of the lease, Lessee acquires Entity A. Entity A has been leasing a floor in another building. The lease entered into by Entity A contains a termination option that is exercisable by Entity A. Following the acquisition of Entity A, Lessee needs two floors in a building suitable for the increased workforce. To minimise costs, Lessee (a) enters into a separate eight-year lease of another floor in the building leased that will be available for use at the end of Year 7 and (b) terminates early the lease entered into by Entity A with effect from the beginning of Year 8.

Moving Entity A's staff to the same building occupied by Lessee creates an economic incentive for Lessee to extend its original lease at the end of the non-cancellable period of 10 years. The acquisition of Entity A and the relocation of Entity A's staff is a significant event that is within the control of Lessee and affects whether Lessee is reasonably certain to exercise the extension option not previously included in its determination of the lease term. This is because the original floor has greater utility (and thus provides greater benefits) to Lessee than alternative assets that could be leased for a similar amount to the lease payments for the optional period – Lessee would incur additional costs if it were to lease a similar floor in a different building because the workforce would be located in different buildings. Consequently, at the end of Year 6, Lessee concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Entity A.

Lessee's incremental borrowing rate at the end of Year 6 is 6 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a nine-year term, and with similar collateral. Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

The right-of-use asset and the lease liability from Year 1 to Year 6 are as follows.

Year	Lease liability				Right-of-use asset		
	Beginning balance	Lease payment	5% interest expense	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
1	355,391	-	17,770	373,161	420,391	(42,039)	378,352
2	373,161	(50,000)	16,158	339,319	378,352	(42,039)	336,313
3	339,319	(50,000)	14,466	303,785	336,313	(42,039)	294,274
4	303,785	(50,000)	12,689	266,474	294,274	(42,039)	252,235
5	266,474	(50,000)	10,823	227,297	252,235	(42,039)	210,196
6	227,297	(50,000)	8,865	186,162	210,196	(42,039)	168,157



At the end of the sixth year, before accounting for the change in the lease term, the lease liability is CU186,162 (the present value of four remaining payments of CU50,000, discounted at the original interest rate of 5 per cent per annum). Interest expense of CU8,865 is recognised in Year 6. Lessee's right-of-use asset is CU168,157.

Lessee remeasures the lease liability at the present value of four payments of CU50,000 followed by five payments of CU55,000, all discounted at the revised discount rate of 6 per cent per annum, which is CU378,174. Lessee increases the lease liability by CU192,012, which represents the difference between the remeasured liability of CU378,174 and its previous carrying amount of CU186,162. The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional right of use, recognised as follows.

Right-of-use asset	CU192,012
Lease liability	CU192,012

Following the remeasurement, the carrying amount of Lessee's right-of-use asset is CU360,169 (ie CU168,157 + CU192,012). From the beginning of Year 7 Lessee calculates the interest expense on the lease liability at the revised discount rate of 6 per cent per annum.

The right-of-use asset and the lease liability from Year 7 to Year 15 are as follows.

Year	Lease liability				Right-of-use asset		
	Beginning balance	Lease payment	5% interest expense	Ending balance	Beginning balance	Depreciation charge	Ending balance
	CU	CU	CU	CU	CU	CU	CU
7	378,174	(50,000)	19,690	347,864	360,169	(40,019)	320,150
8	347,864	(50,000)	17,872	315,736	320,150	(40,019)	280,131
9	315,736	(50,000)	15,944	281,680	280,131	(40,019)	240,112
10	281,680	(50,000)	13,901	245,581	240,112	(40,019)	200,093
11	245,581	(55,000)	11,435	202,016	200,093	(40,019)	160,074
12	202,016	(55,000)	8,821	155,837	160,074	(40,019)	120,055
13	155,837	(55,000)	6,050	106,887	120,055	(40,019)	80,036
14	106,887	(55,000)	3,113	55,000	80,036	(40,018)	40,018
15	55,000	(55,000)	-	-	40,018	(40,018)	-

7.7 Lease modifications

7.7.1 Lease modification – definition

A 'lease modification' is defined as "[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)". [IFRS 16:Appendix A]

The 'effective date of the modification' is "[t]he date when both parties agree to a lease modification". [IFRS 16:Appendix A]



7.7.2 Conditions for treating a lease modification as a separate lease

A lease modification should be accounted for as a separate lease if both of the following apply:

[IFRS 16:44]

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- 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.

When the conditions in IFRS 16:44 are met, the modification is considered to result in the creation of a new lease that is separate from the original lease. [IFRS 16:BC202] The agreement for the right to use one or more additional assets is accounted for as a separate lease (or leases) to which the requirements of IFRS 16 are applied independently of the original lease.

The following example, reproduced from the illustrative examples accompanying IFRS 16, illustrates a modification that should be accounted for as a separate lease.

Example 7.7.2

Measurement by a lessee and accounting for a change in the lease term

[IFRS 16:Illustrative example 15]

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.



7.7.3 Lease modifications that are not accounted for as a separate lease

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

[IFRS 16:45]

- a) allocate the consideration in the modified contract applying the requirements of IFRS 16: 13 to 16 (see **4.2**);
- b) determine the lease term of the modified lease applying the requirements of IFRS 16:18 and 19 (see **section 5**); and
- c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as:
 - i) the interest rate implicit in the lease for the remainder of the lease term; or
 - ii) if the interest rate implicit in the lease cannot be readily determined, the lessee's incremental borrowing rate at the effective date of the modification.

The lessee should account for the remeasurement of the lease liability as follows:

[IFRS 16:46]

- a) for lease modifications that decrease the scope of the lease, by decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease. Any gain or loss relating to the partial or full termination of the lease should be recognised in profit or loss; and
- b) for all other lease modifications, making a corresponding adjustment to the right-of-use asset.

For the lease modifications dealt with under IFRS 16:46(b), the original lease is not terminated because there is no decrease in scope. The lessee continues to have the right to use the underlying asset identified in the original lease. For lease modifications that increase the scope of a lease, the adjustment to the carrying amount of the right-of-use asset effectively represents the cost of the additional right of use acquired as a result of the modification. For lease modifications that change the consideration paid for a lease, the adjustment to the carrying amount of the right-of-use asset effectively represents a change in the cost of the right-of-use asset as a result of the modification. The use of a revised discount rate in remeasuring the lease liability reflects that, in modifying the lease, there is a change in the interest rate implicit in the lease (which the discount rate is intended to approximate). [IFRS 16:BC203(b)]



Example 7.7.3A**Modification that increases the scope of the lease by extending the contractual lease term**

[IFRS 16: Illustrative example 16]

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.

Example 7.7.3B**Modification that decreases the scope of the lease**

[IFRS 16: Illustrative example 17]

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 7.7.3C**Modification that both increases and decreases the scope of the lease**

[IFRS 16: Illustrative example 18]

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.

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

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 (ie 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.

Right-of-use asset	CU131,216	
Lease liability		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 7.7.3D

Modification that is a change in consideration only

[IFRS 16: Illustrative example 19]

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.



Section 8

Classification of leases by lessors

8.1 Classification of leases – general

8.1.1 Each lease to be classified as either an operating lease or a finance lease

A lessor is required to classify each of its leases as either an operating lease or a finance lease. [IFRS 16:61]

The key distinction to be made by lessors in accounting for leases under IFRS 16 is whether the lease in question is either:

- a simple short-term hire arrangement (an operating lease), whereby rentals are dealt with in profit or loss with the only impact on the statement of financial position relating to the timing of payments; or
- in the nature of an arrangement for financing the acquisition of an asset (a finance lease), when the presentation in the financial statements will depart from the legal form of the transaction and be based on the economic substance (i.e. as if the underlying asset had been sold to the lessee).

8.1.2 Lease classification determined at the inception date

Lease classification is determined at the inception date and is reassessed only if there is a lease modification. [IFRS 16:66]

A lease modification is defined as “[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)”. [IFRS 16:Appendix A]

Changes in estimates (e.g. changes in estimates of the economic life or of the residual value of the underlying asset), or changes in circumstances (e.g. default by the lessee), do not give rise to a new lease classification. [IFRS 16:66]

See **9.1.4** for the appropriate treatment for modifications to finance leases and **9.2.8** for the appropriate treatment for modifications to operating leases.

If a lease contract includes terms and conditions to adjust the lease payments for particular changes that occur between the inception date and the commencement date (e.g. a change in the lessor’s cost of the underlying asset or a change in the lessor’s cost of financing the lease), for the purposes of classifying the lease, the effect of any such changes is deemed to have taken place at inception. [IFRS 16:B54]

There may be a time lag between the inception date and the commencement date (see **5.3** for an explanation of both terms), and the amounts involved in the lease arrangement may change between the two – most commonly when the asset is being constructed and the final cost is not known at inception.

8.1.3 Classification of leases acquired in a business combination

When a group acquires a new subsidiary in a business combination, the classification of the subsidiary’s leases in which it is the lessor is not reassessed at the date of the business combination for the purposes of the consolidated financial statements. The subsidiary’s leases will be classified in the consolidated financial statements on the basis of their terms at original inception, and without regard to the remaining lease term from the acquisition date. Thus, in particular, if the acquiree has appropriately treated a lease as a finance lease, that lease will also be treated as a finance lease in the consolidated financial statements, even if the majority of the lease term has expired before the acquisition date.

This treatment is required under paragraph 17 of IFRS 3 *Business Combinations* as an exception to that Standard’s general principle that an acquirer should classify the assets acquired and liabilities assumed in a business combination on the basis of conditions as they exist at the acquisition date. IFRS 3:17 requires the acquiree’s lease contracts in which it is the lessor to be classified 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).



8.2 Distinction between a finance lease and an operating lease

8.2.1 Finance lease – definition

A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset to the lessee. [IFRS 16:62]

8.2.2 Operating lease – definition

An operating lease is a lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset. [IFRS 16:62]

8.2.3 Nature of risks and rewards incidental to ownership

Based on the definitions in 8.2.1 and 8.2.2, the classification of leases for lessors under IFRS 16 is determined according to the extent to which the risks and rewards incidental to ownership of the underlying asset lie with the lessor or the lessee.

[IFRS 16:B53]

- The risks incidental to ownership include, but are not limited to, the possibility of losses from idle capacity or technological obsolescence, and of variations in the future economic benefits expected to flow to the entity due to changing economic conditions.
- The rewards incidental to ownership include, but are not limited to, an expectation of profitable operation over the underlying asset's economic life and of gain from appreciation in value or realisation of a residual value.

8.2.4 Classification to be determined based on the substance of the transaction

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. [IFRS 16:63]

8.3 Situations that will generally lead to finance lease classification

IFRS 16 gives examples of situations that, individually or in combination, would normally lead to a lease being classified as a finance lease. The indicators in IFRS 16:63 relate to transfer of title and other factors in the primary period of the lease and should be regarded as the primary indicators. IFRS 16:64 sets out additional indicators, which will sometimes be relevant. Primary indicators of a finance lease are:

[IFRS 16:63]

- the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;

A lease can be considered to transfer ownership of the underlying asset when transfer of legal title, and thus continued ownership of risks and rewards, is automatic either under the lease agreement or under a side agreement that forms part of the overall lease arrangement (e.g. when the lessor has entered into a separate forward sale agreement with the lessee). This condition will also be met, in substance, when the lessor has a put option requiring the lessee to acquire legal title, and the option is structured in such a manner that it is reasonably certain to be exercised by the lessor.

- the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception date, it is reasonably certain that the option will be exercised;



This condition extends that referred to in the previous bullet point to a lessee call option at a price that makes its exercise commercially likely to occur. An option to purchase at a low or nominal amount is a typical example of this type of arrangement.

In some lease arrangements, rather than the lessee having a bargain purchase option, its parent (perhaps with no operations other than to act as an investment holding company) has the option to acquire the underlying asset at a low or nominal value at the end of the lease term. In these circumstances, it is reasonably certain that the parent will exercise the option to acquire the underlying asset. Although the option to acquire the underlying asset is not held by the lessee, the substance of the arrangement is that only the lessee will have use of the underlying asset. As a result, such arrangements will normally lead to classification of the lease as a finance lease.

When a lease involves identical put and call options (at the end of the lease term, the lessee has a call option to acquire the underlying asset at a specified price and the lessor has a corresponding put option for the same value), the substance is that of a forward contract. At the end of the lease term, the lessee will exercise the call option if the market value of the underlying asset exceeds the exercise price of the option; the lessor will exercise the put option if the market price is less than the exercise price of the option. Therefore, either the put option or the call option is reasonably certain to be exercised at the end of the lease term, and the lessee will acquire the underlying asset at the end of the lease term. Consequently, the lease should normally be classified as a finance lease.

- the lease term is for the major part of the economic life of the underlying asset, even if title is not transferred;

This condition covers the circumstances when substantially all the economic benefits of the underlying asset are consumed over the lease term during which the lessee controls the underlying asset. There is no specific threshold in IFRS 16 delineating the 'major part' of an asset's economic life and thresholds established by other GAAPs should not be considered definitive. Instead, it is necessary to consider the substance of a lease and to classify it according to whether the agreement transfers substantially all of the risks and rewards of ownership as discussed at **8.2.3**.



Example 8.3**Evaluating the economic life of a building**

Company A constructs a building and, on completion of construction, leases it to Company B for 25 years. At the end of the lease term, the title to the land and building is retained by Company A. If the economic life of the building is 50 years, this lease apparently is not for the major part of the economic life of the building; therefore, in the absence of other indicators that the lease is a finance lease, it is likely that Company A would classify the building as an operating lease. To determine the economic life of the building, Company A should consider a number of factors:

- if all important maintenance and refurbishment costs are paid by the lessee and this obligation forms part of the lease, this requirement should be taken into account because it may extend the economic life;
- if the lease requires Company B to maintain the building in the same condition as at the inception of the lease ('making good dilapidations'), this requirement could extend the economic life;
- if the building is unlikely to be leased for any additional period in its present condition because of an aspect of its design, operation or location (i.e. it is 'functionally obsolete'), the economic life may be shorter; and
- if the building is considered to be functionally obsolete, but a tenant still wants to rent it, the building will retain a degree of economic life.

This list is not exhaustive and each building should be considered separately based on the specific facts and circumstances.

Consideration of the economic life of a building will often reveal a difference between the life of the shell of the building and the life of the interior of the building. In many scenarios, the shell of the building will be key to the overall economic life of that asset. For example, in the case of shops or offices, the interior of the building is usually regularly refurbished by the lessee (often as required under the lease) in order for it to continue to be an economically viable property for the lessee. If refurbishment of the interior is carried out at regular (e.g. 10-year) intervals, consideration of the economic life of the building based on the expected life of the shell of the property may be appropriate. Regular repair and refurbishment would extend the expected economic life of the asset and, when this is contractually required under the lease, should be taken into account in the assessment of economic life at the inception of the lease.

Note that when renewal or purchase options exist, these should be assessed at the inception date (see **5.3**) to determine whether it is reasonably certain that the option will be exercised. The lease term will include the further term when, at the inception date, exercise of the option is assessed to be reasonably certain.

- at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset;

This condition tests whether the lessor receives a full return of its initial investment. As with economic life, there is no specific threshold in IFRS 16 delineating what constitutes 'substantially all' of the fair value of an underlying asset and thresholds established by other GAAPs should not be considered definitive. Instead, as discussed above, it is necessary to consider the substance of a lease and determine its classification based on whether the agreement transfers substantially all of the risks and rewards of ownership.

When the lease term has been extended by renewal or purchase options (as discussed in the previous point), the lease payments will include payments due with respect to this further term.



- the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

When this condition is met, it is likely that the underlying asset will have been constructed to the lessee's specifications such that its market value is limited. It follows that the lessor will seek to recover its investment from the primary lease term.

Other indicators that, individually or in combination, could also lead to a lease being classified as a finance lease are:

[IFRS 16:64]

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from fluctuations in the fair value of the residual accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease);

If the lessee does not acquire legal title by the end of the lease, it may nevertheless bear the risk of variation in the residual value of the underlying asset; leases will commonly provide for a substantial fixed final rental (a 'balloon rental') followed by a repayment equal to all or substantially all of the sales proceeds from disposal of the underlying asset.

When the risk of variation in the residual value of the underlying asset is shared between the lessor and the lessee, it is necessary to consider the specific facts and circumstances in order to assess whether the risk retained by the lessor is significant. A risk of variation in the residual value of the asset retained by the lessor that may be significant only in circumstances considered to be remote may suggest that the lease is appropriately classified as a finance lease.

- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

A bargain renewal option exists when a lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent. The rent for a secondary period would be considered substantially lower than market rent if it would be economically rational for the lessee to continue the lease at that lower rent.

Rental for a secondary period either at a nominal amount or substantially below market rates suggests both that (1) the lessor has received the required return from its initial investment, and (2) that the lessee is likely to choose to enter into such a secondary period.

Factors to consider in determining whether a renewal option represents a bargain include:

- the nature of the underlying asset;
- the possibility of technological obsolescence;
- the possibility of higher operating and maintenance costs over the secondary rent period; and
- costs to be incurred by the lessor to find a new lessee and to prepare the underlying asset for a new lessee.

Assume that the rental payments in the renewal period are equal to a specified percentage of the original monthly payments. One approach to assessing whether this represents a bargain would be to compare the implicit interest rates determined by assuming that (1) the lease is terminated at the end of the original lease term, and (2) that the lease is renewed at the reduced rental payments. Appropriate estimates of the residual value of the underlying asset at the end of the original term and at the end of the renewal period should be included in the computations. If the implicit interest rate increases or remains substantially the same when the renewal option is assumed to be exercised, it is appropriate to conclude that the renewal option is not a bargain. The assessment of whether the interest rate differential is a bargain is made at the inception date and will depend on both the economic conditions prevailing in the relevant jurisdiction and the circumstances of the parties to the lease agreement.

Although the factors set out above are intended to identify the key characteristics of a finance lease, they are not always conclusive. IFRS 16 underlines the requirement to consider the whole of the arrangement, and the extent to which the risks and rewards incidental to ownership are transferred. Although a lease may appear to fall within the definition of a finance lease, having regard to the characteristics referred to above, there may be other features that demonstrate that the lease does not transfer substantially all of the risks and rewards incidental to ownership of the underlying asset. By way of example, the Standard cites circumstances in which ownership of the asset transfers at the end of the lease, but in exchange for a variable payment equal to its then fair value. Similarly, if there are variable lease payments, as a result of which the lessee does not have substantially all of the risks and rewards incidental to ownership of the underlying asset, the lease will not be classified as a finance lease. [IFRS 16:65]

8.4 Effect of exercise of options on lease classification

The following examples illustrate how the exercise of an option will not affect the classification of a lease, which is only reassessed if there is a lease modification (see 8.1.2).

Example 8.4A

Exercise of a renewal option in an operating lease arrangement

Company A leases a property to Company B for 10 years. The lease includes a renewal option under which Company B may extend the lease contract at the end of the lease. At the inception of the lease, exercise of the renewal option is not considered to be reasonably certain, and the lease is classified as an operating lease.

Company B must give notice no later than two years before the end of the lease term if it intends to exercise the renewal option. The commercial rationale for this deadline is to allow Company A to market the leased asset for sale or lease to another party if Company B chooses not to exercise the renewal option. Towards the end of the eighth year of the lease, Company B serves notice that it will renew the lease contract, thereby extending the lease.

The notification that a renewal option will be exercised does not require reassessment of the classification of the lease because it does not represent a lease modification as defined in IFRS 16:Appendix A as follows.

"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)". [IFRS 16:Appendix A]



In the circumstances described, the lease contains a renewal option but, at the inception date, exercise of the option is not considered to be reasonably certain. Subsequent notification by Company B represents a change in circumstance indicating the intention to renew, but this option was part of the original terms and conditions of the lease; consequently, the lease is not reassessed. When the lease is renewed at the end of the lease term, Company A effectively enters into a new lease that is classified in accordance with the general requirements of IFRS 16 (see **8.3**). The inception of the new lease will occur on the date of exercise of the option, but the commencement date will be two years later, at the end of the original lease.

However, if (1) the original lease did not include a renewal option and the lease is renegotiated in Year 8 to include one, or (2) the terms of an existing renewal option in a lease are changed, such an adjustment constitutes a modification in accordance with IFRS 16. In such circumstances, classification of the lease should be reassessed at the date of modification (i.e. in Year 8).

Example 8.4B **Exercise of a renewal option in a finance lease arrangement**

An asset is leased under a finance lease under which the lease term is shorter than the useful life of the leased asset. Subsequent to initial recognition, an option to renew the lease is exercised. At the inception of the lease, it was not reasonably certain that the option would be exercised and, consequently, the renewal option was not taken into account in assessing the lease term.

In substance, the renewal of the lease is a separate lease agreement; therefore, the existing lease should continue to be accounted for as a finance lease to the end of its original term. Subsequently, the renewed lease should be classified as a finance lease or an operating lease according to the facts and circumstances and accounted for in accordance with IFRS 16's requirements for finance or operating leases, as appropriate.

Example 8.4C **Exercise of a purchase option in a lease arrangement**

Company A leases a property to Company B for 10 years. The lease includes an option under which Company B may purchase the asset at the market price of the asset at the end of the lease. Company B may exercise the option no later than two years before the lease expires. The commercial rationale for this is to allow Company A to market the leased asset for sale or lease to a third party if Company B chooses not to exercise the purchase option. At the inception date, Company A assesses that it is not reasonably certain that the purchase option will be exercised and the lease is classified as an operating lease.

Towards the end of Year 8, Company B serves notice that it will purchase the property, thereby creating a binding purchase commitment. Company B will not acquire legal title to the property until exercise of the option at the end of Year 10.

Notification that the purchase option will be exercised does not lead to reassessment of the classification of the lease because it does not represent a lease modification as defined in IFRS 16:Appendix A (see **example 8.4A**). In the circumstances described, the purchase price for the asset will be determined at the end of the original 10-year lease term, and paid for on exercise of the option at the end of Year 10. The original terms of the operating lease agreement have not been modified. Company A continues to account for the operating lease until the purchase option is exercised at the end of Year 10, when Company A will account for a sale of the property.

However if, at the date of notification, the option price is renegotiated to be the market price for the asset at the date of notification and the original lease term is shortened to eight years, this would constitute a lease modification (see **9.1.4**), and would be accounted for accordingly.



8.5 Leases of land and buildings

8.5.1 Requirement to assess the classification of land and buildings elements separately

When a lease includes both land and buildings elements, a lessor should assess the classification of each element as a finance or an operating lease separately in accordance with IFRS 16:62 to 66, B53 and B54 (see **8.2**). In determining whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life. [IFRS 16:B55]

Leases of land are assessed in the same way as all other leases. Land normally has an indefinite economic life, so it is unlikely that the lease term will be for the major part of the economic life of the asset. Nevertheless, some of the other characteristics described at **8.2** may be met, in which case a lease of land may be a finance lease. In particular, if, at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset, it is possible that a lease of land will be a finance lease. Note, however, that leases of land (and buildings) for long periods will often be subject to rent reviews, which may mean that the lessor has not transferred substantially all the risks and rewards incidental to ownership.

8.5.2 Splitting leases of land and buildings

Whenever necessary in order to classify and account for a lease of land and buildings, a lessor should allocate the lease payments (including any lump-sum up-front 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. [IFRS 16:B56]

Note that this split is not on the basis of the relative fair values of the land and buildings. The IASB concluded that the allocation of the minimum lease payments should reflect the extent to which they are intended to compensate the lessor for the use of the separate elements. The future economic benefits of a building are likely to be consumed to some extent over the term of a lease. Therefore, the lease payments allocated to the buildings should reflect not only the lessor's return on its investment in the buildings, but also the recovery of the value of the buildings consumed over the lease term. In contrast, land with an indefinite useful life should maintain its value beyond the lease term and, therefore, the lessor does not normally need compensation for any consumption of the economic benefits inherent in the land. [IFRS 16:BCZ246 & BCZ247]

If the lease payments cannot be allocated reliably between the land and buildings 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. [IFRS 16:B56]

One of the most common applications of the previous paragraphs is likely to be in legal jurisdictions where the ownership of property is held only via leasehold interests. Typically, the government retains ownership of all land, and leasehold interests in land and buildings are the only means of purchasing such assets. In these circumstances, because similar land and buildings are not sold or leased separately, it may not be possible to arrive at a meaningful allocation of the lease payments.

For a lease of land and buildings under which the amount for the land element is immaterial to the lease, IFRS 16 allows that the land and buildings may be treated as a single unit for the purpose of lease classification. The IASB considers that, in such circumstances, the benefits of separating the two elements and accounting for each separately may not outweigh the costs. The lease is classified in accordance with the general criteria discussed in **8.2**. In such cases, the economic life of the buildings is regarded as the economic life of the entire underlying asset. [IFRS 16:B57 & BCZ249]



8.6 Subleases

8.6.1 Subleases – classification

IFRS 16 requires an intermediate lessor to account for a head lease and a sublease as two separate contracts, applying both the lessee and lessor accounting requirements. This approach is considered to be appropriate because, in general each contract is negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to the head lease. Accordingly, for an intermediate lessor, the obligations that arise from the head lease are generally not extinguished by the terms and conditions of the sublease. [IFRS 16:BC232]

In classifying a sublease, an intermediate lessor should classify the sublease as a finance lease or an operating lease as follows:

[IFRS 16:B58]

- if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying IFRS 16:6 (see **7.2**), the sublease should be classified as an operating lease;
- otherwise, the sublease should be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (e.g. the item of property, plant or equipment that is the subject of the lease).

In classifying a sublease by reference to the right-of-use asset arising from the head lease, an intermediate lessor will classify more subleases as finance leases than it would have done if those same subleases were classified by reference to the underlying asset. The intermediate lessor only has a right to use the underlying asset for a period of time. If the sublease is for all of the remaining term of the head lease, the intermediate lessor has in effect transferred that right to another party. [IFRS 16:BC234]

The following examples, reproduced from the illustrative examples accompanying IFRS 16, illustrate the application of the requirements in IFRS 16 for an intermediate lessor that enters into a head lease and a sublease of the same underlying asset.

Example 8.6.1A

Sublease classified as a finance lease

[IFRS 16:Illustrative example 20]

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 [IFRS 16:61 to 66].



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 8.6.1B

Sublease classified as an operating lease

[IFRS 16: Illustrative example 21]

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 [IFRS 16:61 to 66].

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.



8.6.2 Subleases – presentation

IFRS 16 does not include requirements relating to the presentation of subleases. The IASB decided that specific requirements were not warranted because there is sufficient guidance in other Standards. In particular, applying the requirements for offsetting in IAS 1 *Presentation of Financial Statements*, an intermediate lessor should not offset assets and liabilities arising from a head lease and a sublease of the same underlying asset, unless the financial instruments requirements for offsetting are met. The IASB considered whether to create an exception that would permit or require an intermediate lessor to offset assets and liabilities arising from a head lease and a sublease of the same underlying asset. However, the IASB noted that the exposures arising from those assets and liabilities are different from the exposures arising from a single net lease receivable or lease liability, and concluded that presenting these on a net basis could provide misleading information about an intermediate lessor's financial position, because it could obscure the existence of some transactions. [IFRS 16:BC235]

For the same reasons, the IASB also decided that an intermediate lessor should not offset lease income and lease expenses relating to a head lease and a sublease of the same underlying asset, unless the requirements for offsetting in IAS 1 are met. [IFRS 16:BC236]



Section 9 Accounting by lessors

9.1 Accounting for finance leases by lessors

9.1.1 Recognition and measurement at the commencement date – general

9.1.1.1 Recognition and measurement – general

At the commencement date, a lessor should 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. [IFRS 16:67]

Initially, the lessor will recognise a finance lease receivable under IFRS 16:67, at the amount equal to the net investment in the lease. Subsequently, finance income will be recognised at a constant rate on the net investment under IFRS 16:75 (see **11.3**). During any 'rent-free' period, this will result in the accrued finance income increasing the finance lease receivable.

9.1.1.2 Net investment in the lease – definition

The net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease. The gross investment in the lease is the sum of (1) lease payments receivable by the lessor under a finance lease, and (2) any unguaranteed residual value accruing to the lessor. [IFRS 16:Appendix A]

The interest rate implicit in the lease is the rate of interest that causes the present value of (a) the lease payments, and (b) the unguaranteed residual to equal to the sum of (i) the fair value of the underlying asset, and (ii) any initial direct costs of the lessor. [IFRS 16:Appendix A]

If the lessor grants any incentives to the lessee, such as an initial rent-free period, then, at the inception of the lease, the calculation of the minimum lease payments and determination of the interest rate implicit in the lease will factor in nil payments by the lessee during such a rent-free period.

9.1.1.3 Initial direct costs

Initial direct costs are the “[i]ncremental 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”. [IFRS 16:Appendix A]

This definition is consistent with the definition of incremental costs of obtaining a contract in IFRS 15 *Revenue from Contracts with Customers*. Consequently, the costs incurred by a lessor to obtain a lease are accounted for consistently with costs incurred to obtain other contracts with customers. [IFRS 16:BC237]

For lessors (other than a manufacturer or dealer lessor), initial direct costs should be included in the initial measurement of the investment in the lease, and reduce the amount of income recognised over the lease term. The definition of the interest rate implicit in the lease set out at **9.1.1.2** results in such costs being included automatically in the finance lease receivable; there is no need to add them separately. [IFRS 16:69]

These costs should include only costs that are incremental, and that are directly attributable to negotiating and arranging a lease (e.g. commissions, legal fees and incremental internal costs). General overheads, such as costs of sales and marketing, are excluded.

If a lessor employs permanent staff to negotiate and arrange new leases, it is not appropriate for the salary costs of those staff to be included within the initial measurement of finance lease receivables.



IFRS 16: Appendix A defines initial direct costs as “*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”. (Emphasis added).

Internal fixed costs do not qualify as incremental costs. Only those costs that would not have been incurred if the lease had not been obtained should be included in the initial measurement of the finance lease receivable.

This issue has been considered and affirmed by the IFRS Interpretations Committee (see *IFRIC Update*, March 2014). Although the Committee were dealing with IAS 17 at that time, a similar definition of initial direct costs is carried forward to IFRS 16 and, therefore, the same principle applies. Note that although the IFRS Interpretations Committee considered this issue specifically in the context of finance leases, the guidance applies equally to initial direct costs incurred in negotiating and arranging an operating lease (which are added to the carrying amount of the underlying asset and expensed over the lease term under IFRS 16:83 – see **9.4.3**).

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

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:

[IFRS 16:70]

- fixed payments (including in-substance fixed payments as described in IFRS 16:B42 – see **6.3**), less any lease incentives payable;
- variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (see **6.5.2**);
- 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;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in IFRS 16:B37 – see **6.6**); and
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

9.1.2 Recognition and measurement at the commencement date – manufacturer and dealer lessors

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

[IFRS 16:71]

- revenue, which is 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;
- the cost of sale, which is the cost (or carrying amount if different) of the underlying asset less the present value of the unguaranteed residual value; and
- selling profit or loss (which is the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which IFRS 15 *Revenue from Contracts with Customers* applies. The selling profit or loss on a finance lease should be recognised at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15.



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. [IFRS 16:72]

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, the selling profit should be restricted to that which would apply if a market rate of interest were charged. [IFRS 16:73]

Costs incurred by a manufacturer or dealer lessor in connection with obtaining a finance lease should be recognised as an expense at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit. Such costs are excluded from the definition of initial direct costs (see 9.1.1.3) and, accordingly, are excluded from the net investment in the lease. [IFRS 16:74]

9.1.3 Subsequent measurement

9.1.3.1 Finance lease income recognised at a constant periodic rate of return on the net investment

The lessor recognises finance income over the lease term so as to reflect a constant periodic rate of return on its net investment in the finance lease. [IFRS 16:75] This is achieved by allocating the rentals (net of any charges for services etc.) received by the lessor between finance income to the lessor and repayment of the debtor balance.

9.1.3.2 Derecognition and impairment

The derecognition and impairment requirements of IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*) apply to a lessor's net investment in a lease. [IFRS 16:77]

9.1.3.3 Changes in unguaranteed residual values

IFRS 16 emphasises that estimated unguaranteed residual values used in computing the lessor's gross investment in a lease should be reviewed regularly. When there has been a reduction in the estimated unguaranteed residual value, the income allocation over the lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. [IFRS 16:77]

Changes in the unguaranteed residual value of the underlying asset will only affect the finance lease receivable if the changes indicate impairment of the receivable and, subsequently, reversal of impairment.

IFRS 16:67 requires the lessor's net investment in the finance lease to be shown as a finance lease receivable. The net investment in the finance lease is equal to the unguaranteed residual value accruing to the lessor plus the lease payments receivable, discounted at the interest rate implicit in the lease. The subsequent measurement of the lease receivable is specified by IFRS 16 and by the derecognition and impairment requirements of IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*). The recognition of finance income is based on a constant rate of return on the net investment. Finance income is recognised at the rate implicit in the lease on the total net investment including the unguaranteed residual value.

9.1.3.4 Asset under a finance lease classified as held for sale

When an asset under a finance lease is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it is accounted for in accordance with that Standard. [IFRS 16:78]



9.1.4 Lease modifications

9.1.4.1 Modifications to finance leases accounted for as separate leases

A lessor should account for a modification to a finance lease as a separate lease if both:

[IFRS 16:79]

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- 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.

The IASB considers that a modification meeting both of the conditions in IFRS 16:79 in substance represents the creation of a new lease that is separate from the original lease. This requirement is substantially aligned with equivalent requirements in IFRS 15 *Revenue from Contracts with Customers* that require a seller to account for modifications that add distinct goods or services as separate contracts if those additional goods or services are priced commensurately with their stand-alone selling price. [IFRS 16:BC238]

9.1.4.2 Modifications to finance leases not accounted for as separate leases

For a modification to a finance lease that is not accounted for as a separate lease, a lessor should account for the modification as follows:

[IFRS 16:80]

- if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor should:
 - account for the lease modification as a new lease from the effective date of the modification; and
 - measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification;
- otherwise, the lessor should apply the requirements of IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*).

For modifications to a finance lease that are not accounted for as a separate lease (i.e. modifications that do not meet both of the conditions set out in IFRS 16:80, IFRS 16 requires a lessor to account for the modification applying IFRS 9 (unless the lease would have been classified as an operating lease if the modification had been in effect at the inception date). The IASB expects that this approach will not result in any substantive change to previous lessor accounting for modifications of finance leases. This is because, although IAS 17 did not include requirements relating to lease modifications, the IASB understands that a lessor generally applied an approach that was consistent with the requirements in IFRS 9 (or the equivalent requirements in IAS 39) to the net investment in a finance lease. [IFRS 16:BC239]

9.2 Accounting for operating leases by lessors

9.2.1 Recognition of lease income

Lease payments from operating leases should be recognised as income on a straight-line basis unless another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. [IFRS 16:81]



IFRS 16:81 requires lease payments under an operating lease to be recognised as income on a straight-line basis over the lease term, unless another systematic basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished. The question arises as to whether variable lease payments in an operating lease should be estimated at the inception date and recognised on a straight-line basis over the lease term.

IFRS 16:70 specifies that, for finance leases, the lease payments included in the measurement of the net investment in a lease at commencement date include variable lease payments that depend on an index or a rate; other variable payments (e.g. those linked to future performance or use of an underlying asset) are excluded from the measurement of the net investment and are instead recognised as income when they arise. The treatment adopted for variable lease payments under operating leases should be consistent with these requirements.

Therefore, variable lease payments under operating leases, other than those that are dependent on an index or a rate, should not be estimated and included in the total lease payments to be recognised on a straight-line basis over the lease term; instead, they should be recognised as income in the period in which they are earned.

In July 2006, in the context of IAS 17 *Leases*, the IFRIC (now the IFRS Interpretations Committee) considered whether an estimate of contingent rents payable (receivable) under an operating lease should be included in the total lease payments (lease income) to be recognised on a straight-line basis over the lease term. The IFRIC noted that, although IAS 17 is unclear on this issue, this has not, in general, led to contingent rents being included in the amount to be recognised on a straight-line basis over the lease term. Accordingly, the IFRIC decided not to add this issue to its agenda. This conclusion is equally valid under IFRS 16.

Some contracts provide for annual payments in an operating lease to increase by a fixed annual percentage over the life of the lease. It is sometimes suggested that, if such increases are intended to compensate for expected annual inflation over the lease period, it may be acceptable to recognise them in each accounting period as they arise.

Such a treatment is not appropriate. The lease payments should be recognised on a straight-line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

This was confirmed by the IFRIC (now the IFRS Interpretations Committee) in the November 2005 *IFRIC Update* in the context of IAS 17; the conclusion is equally valid under IFRS 16.

9.2.2 Costs incurred in earning lease income

Costs incurred in earning the lease income, including depreciation, are recognised as an expense. [IFRS 16:82]

9.2.3 Initial direct costs

When initial direct costs are incurred by lessors in obtaining an operating lease, these should be added to the carrying amount of the underlying asset and recognised as an expense over the lease term on the same basis as the lease income. [IFRS 16:83]

See 9.1.1.3 for further discussion on the nature of initial direct costs.

9.2.4 Depreciation of assets subject to operating leases

The depreciation of leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets, and the depreciation expense should be calculated on the basis set out in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*, as appropriate. [IFRS 16:84]



A problem of income and cost matching may arise when a lessor arranges specific finance for the purchase of an asset that is leased under an operating lease. When the finance is repaid from cash generated by rental receipts, the application of the previous paragraphs will result in:

- rental income recognised on a straight-line basis;
- depreciation expense recognised, say, on a straight-line basis; and
- finance costs front-end loaded because they will be charged as a constant percentage of capital outstanding.

The effect may be that the three items taken together show a loss in earlier years, and a profit in later years. It is sometimes argued that one way to address this issue is to view the leased asset as having some of the attributes of a financial asset. A method of depreciation that would be consistent with viewing the asset as having attributes of a financial asset is one which reflects the time value of money, for example the annuity method. This would result in a lower depreciation charge in earlier years and a more constant net profit after interest.

However, use of the annuity method of depreciation is not permitted. IFRS 16:84 states that the lessor should apply its normal depreciation policy for similar assets and the depreciation expense should be calculated on the basis set out in IAS 16. IAS 16:60 states that the depreciation method used should reflect the pattern in which the asset's economic future benefits are expected to be consumed. The method should be based on the economic depreciation of the asset, not on the return from the asset. Therefore, the consideration of the time value of money in the depreciation calculation is not permitted.

9.2.5 Impairment of assets subject to operating leases

IAS 36 *Impairment of Assets* should be applied to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified. [IFRS 16:85]

9.2.6 Accounting by manufacturer and dealer lessors

A manufacturer or dealer lessor should not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale. [IFRS 16:86]

9.2.7 Assets cease to be rented and become held for sale

Entities that, in the course of their ordinary activities, routinely sell items that they have held for rental to others are required to transfer those assets to inventories at their carrying amount when they cease to be rented and become held for sale.

9.2.8 Modifications to operating leases

A lessor should 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. [IFRS 16:87]

The approach set out in IFRS 16:87 is consistent with the approach required by IFRS 15 if, at the time of a contract modification (that is accounted for as a separate contract), the remaining goods or services to be transferred are distinct from the goods or services already transferred. It is also expected that this approach will not result in any substantive change to previous lessor accounting. [IFRS 16:BC240]

9.2.9 Presentation of assets subject to operating leases

Lessors should present assets subject to operating leases in their statements of financial position according to the nature of the underlying asset. [IFRS 16:88]



Section 10

Sale and leaseback transactions

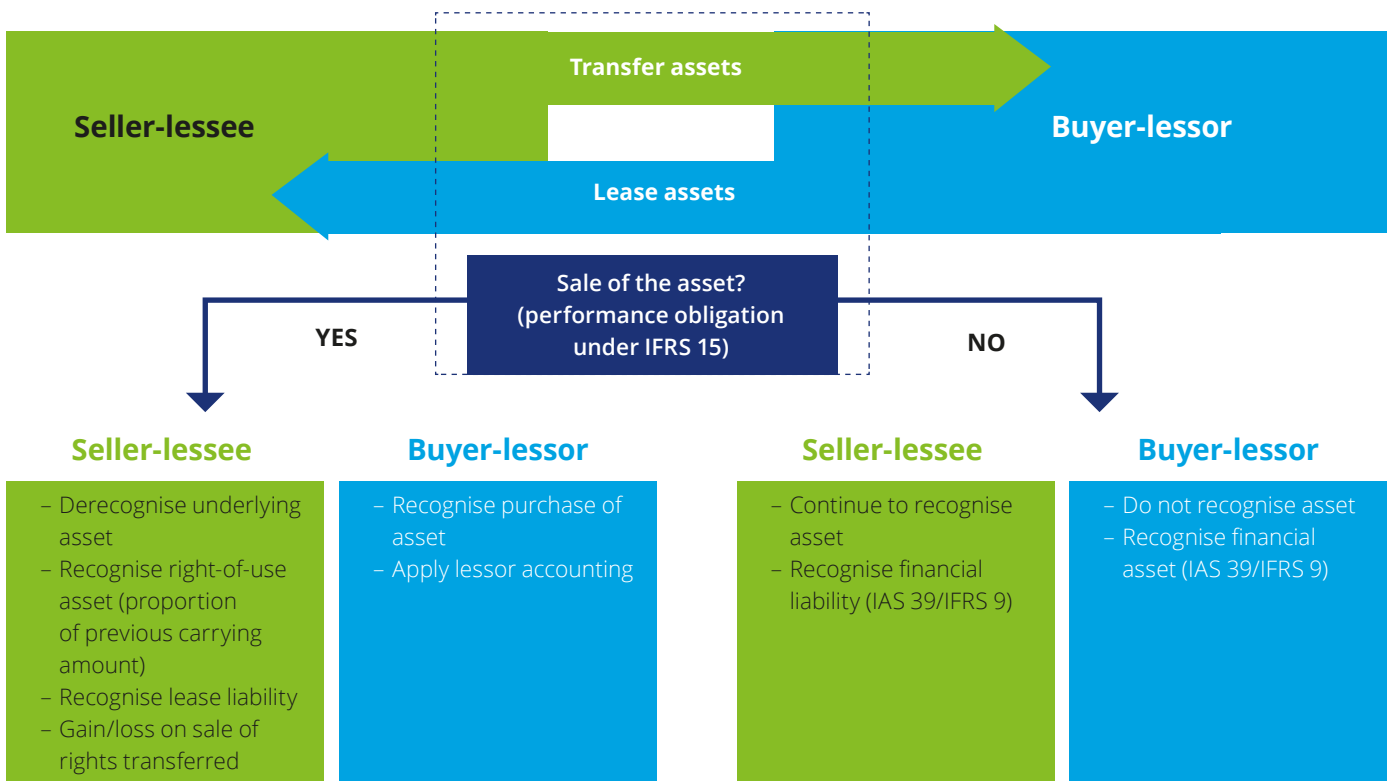
10.1 Sale and leaseback transactions – general

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 are required to account for the transfer contract and the lease applying IFRS 16:99 to 103 (see **10.2** to **10.4**). [IFRS 16:98]

In considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback (e.g. a sale and leaseback transaction may be structured in the form of a lease and leaseback). [IFRS 16:BC261]

Sale and leaseback

Lessee and lessor accounting



10.2 Assessing whether the transfer of the asset is a sale

An entity should apply the requirements for determining when a performance obligation is satisfied in IFRS 15 *Revenue from Contracts with Customers* to determine whether the transfer of an asset is accounted for as a sale of that asset. [IFRS 16:99]

IFRS 16 provides no additional application guidance regarding the determination as to whether there is a sale in a sale and leaseback transaction (i.e. regarding how to apply the IFRS 15 requirements relating to the satisfaction of performance obligations to sale and leaseback transactions). This is because the IASB considers that the principles in IFRS 15 can be applied appropriately and consistently to sale and leaseback transactions without any further guidance. [IFRS 16:BC264]

10.3 Transfer of the asset is a sale

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:

[IFRS 16:100]

- the seller-lessee should 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 should recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor; and
- the buyer-lessor should account for the purchase of the asset applying applicable IFRSs, and for the lease applying the lessor accounting requirements in IFRS 16.



Thinking it through

For a sale and operating leaseback under IAS 17, the seller-lessee would have recognised the full profit on sale at fair value. Therefore, from an accounting perspective, IFRS 16's restriction of the gain to those rights of the asset transferred may not seem as attractive. However, whether this will affect the volume of such transactions in future is likely to depend on whether the primary driver was the accounting result or improved cash flows.

If either (1) the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or (2) the payments for the lease are not at market rates, the following adjustments are required to measure the sale proceeds at fair value:

[IFRS 16:101]

- any below-market terms should be accounted for as a prepayment of lease payments; and
- any above-market terms should be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

The entity should measure any potential adjustment required by IFRS 16:101 (see above) on the basis of the more readily determinable of:

[IFRS 16:102]

- 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.

The following example, reproduced from the illustrative examples accompanying IFRS 16, illustrates the application for the requirements in IFRS 16:99 to 102 for a seller-lessee and a buyer-lessor.



Example 10.3 Sale and leaseback transaction

[IFRS 16: Illustrative example 24]

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) × 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 × CU1,259,200) relates to the right to use the building retained by Seller-lessee; and
- (b) CU240,355 (CU800,000 ÷ CU1,800,000 × (CU1,800,000 – CU1,259,200)) relates to the rights transferred to Buyer-lessor.



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 (18 payments of CU16,447, discounted at 4.5 per cent per annum)	CU200,000	
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.

10.4 Transfer of the asset is not a sale

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:

[IFRS 16:103]

- the seller-lessee should continue to recognise the transferred asset and should recognise a financial liability equal to the transfer proceeds. It should account for the financial liability applying IFRS 9 *Financial Instruments* (or, for entities that have not yet adopted IFRS 9, IAS 39 *Financial Instruments: Recognition and Measurement*); and
- the buyer-lessor should not recognise the transferred asset and should recognise a financial asset equal to the transfer proceeds. It should account for the financial asset applying IFRS 9 (or, for entities that have not yet adopted IFRS 9, IAS 39).

In such circumstances, no sale is recognised by the seller-lessee and no purchase is recognised by the buyer-lessor. Instead, the seller-lessee and buyer-lessor are required to account for any amounts received or paid relating to the leaseback as a financial asset or a financial liability applying IFRS 9 (or IAS 39). This is because such a transaction represents, in substance, a financing arrangement. [IFRS 16:BC265]



Section 11 Effective date and transition

11.1 Effective date

IFRS 16 is required to be adopted for annual reporting periods beginning on or after 1 January 2019. An entity is permitted to apply IFRS 16 in advance of that date provided that it also:

[IFRS 16:C1]

- discloses that fact; and
- applies IFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of IFRS 16.

The 'date of initial application' is the beginning of the annual reporting period in which an entity first applies IFRS 16. [IFRS 16:C2]

Therefore, for example, for an entity adopting IFRS 16 for the first time in the year beginning 1 January 2019, the date of initial application is 1 January 2019 irrespective of whether the Standard is applied with full retrospective effect (see **11.5**).

11.2 Transition – overview

The IASB is conscious of the significant costs that entities could incur on transition to IFRS 16. The Standard includes a number of transition reliefs and practical expedients designed to allow an entity to minimise those costs without significantly compromising the quality of the financial information reported.

Both lessees and lessors are permitted to grandfather assessments regarding whether a contract existing at the date of initial application contains a lease (see **11.3**). If an entity decides not to use this practical expedient, it may incur significant costs in re-examining all of its contracts to determine if they contain a lease.

For lessors, apart from one specific exception in respect of subleases, no adjustments are required on transition from IAS 17 to IFRS 16 because lessor accounting under IFRS 16 is largely consistent with the requirements of IAS 17 (see **11.4**).

The situation is more complex for lessees, who need to focus on a number of key decisions. The most significant choices available to a lessee on transition (i.e. in addition to the choice regarding whether it will reassess its contracts, as discussed at **11.3**) are set out below.



1	Whether to apply IFRS 16 to all of its leases retrospectively in accordance with IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> or using the cumulative catch-up approach.	<p>If the lessee opts for full retrospective application, all of its leases (both finance and operating under IAS 17) will be required to be restated in accordance with IFRS 16. No further reliefs are available. See 11.3 for further discussion.</p> <p>If the lessee opts for the cumulative catch-up approach, it does not restate amounts previously reported and it applies specific rules for measuring right-of-use assets and lease liabilities (see 11.6.2 for leases previously identified as finance leases and 11.6.3 for leases previously identified as operating leases). It also has the option to apply specific transition reliefs and practical expedients in respect of leases previously identified as operating leases (see following points).</p>
2	Under the cumulative catch-up approach, whether to apply the practical expedient for leases previously classified as operating leases and ending within 12 months of the date of initial application.	On a lease-by-lease basis, the practical expedient permits such leases to be accounted for as short-term leases, irrespective of whether the original lease term was for more than 12 months (see 11.6.3.2).
3	Under the cumulative catch-up approach, whether (on initial recognition) to apply the practical expedients permitted in respect of the measurement of lease liabilities arising from leases previously classified as operating leases.	<p>On a lease-by-lease basis, an entity can choose to:</p> <ul style="list-style-type: none"> • apply a single discount rate to a portfolio of leases with reasonably similar characteristics; and/or • use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease. <p>See 11.6.3.4 for details.</p>
4	Under the cumulative catch-up approach, whether (on initial recognition) to apply the practical expedients permitted in respect of the measurement of right-of-use assets arising from leases previously classified as operating leases.	<p>On a lease-by-lease basis, an entity can choose to:</p> <ul style="list-style-type: none"> • adjust the right-of-use asset by the amount of any provision for onerous leases recognised under IAS 37 so as to approximate impairment; and/or • exclude initial direct costs from the measurement of the right-of-use asset. <p>See 11.6.3.4 for details.</p>

IFRS 16 also specifies disclosure requirements for lessees applying the cumulative catch-up approach (see 11.6.3.8), requirements for sale and leaseback transactions (see 11.7) and requirements for assets or liabilities previously recognised by a lessee in a business combination relating to favourable or unfavourable terms of an operating lease (see 11.8).

11.3 Transition – definition of a lease (both lessees and lessors)

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:

[IFRS 16:C3]

- to apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease*. The entity should apply the transition requirements in IFRS 16:C5 to C18 (see 11.4 to 11.7) to those leases; and
- not to apply IFRS 16 to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

If an entity chooses to apply this practical expedient, it is required to:

[IFRS 16:C4]

- disclose that fact;
- apply the practical expedient to all of its contracts; and
- consequently, apply IFRS 16's requirements regarding the identification of leases (see section 3) only to contracts entered into (or modified) on or after the date of initial application.



This relief applies for both lessees and lessors. It permits an entity to retain its existing assessment as to whether a contract contains a lease for all ongoing contracts entered into before the date of transition. The entity assumes that existing leases continue to be leases under IFRS 16 and existing service contracts continue to be service contracts – it is only required to apply the IFRS 16 definition of a lease to contracts entered into on or after the date of transition. The IASB has allowed this practical expedient so that entities are not required to incur the costs of detailed reassessments when it is expected that the determination will not change for the vast majority of contracts.

If the practical expedient is applied, it is required to be applied to all of the entity's contracts – no 'cherry-picking' is permitted.

If an entity does not apply this expedient, it is required to examine all of its contracts in the context of IFRS 16 to determine whether they contain a lease. This may be a costly exercise and entities will need to consider whether the benefits of identifying potential differences in assessment under IFRS 16 justify the cost. The IASB's view is that, although IFRS 16 contains more detailed guidance on the identification of a lease, there are not many contracts where the lease versus service contract assessment will differ under the new Standard.

Whether this practical expedient is applied or not does not restrict a lessee's ability to choose between retrospective application of IFRS 16 or the cumulative catch-up approach (see **11.5**).

11.4 Transition for lessors

Except as described in IFRS 16:C15 (see below), a lessor is not required to make any adjustments on transition for leases in which it is a lessor and should account for those leases applying IFRS 16 from the date of initial application. [IFRS 16:C14]

As described in **section 9**, the accounting requirements for lessors under IFRS 16 are substantially unchanged from those in IAS 17. Consequently, a lessor is not generally required to make any adjustments on transition to IFRS 16.

An intermediate lessor should:

[IFRS 16:C15]

- reassess subleases that were previously classified as operating leases 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 IFRS 16. The intermediate lessor should 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; and.
- for subleases that were classified as operating leases under IAS 17, but finance leases under IFRS 16, account for the sublease as a new finance lease entered into at the date of initial application.

IFRS 16 requires an intermediate lessor to evaluate the classification of a sublease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset as was required under IAS 17. As a result, in some cases, subleases that were classified by an intermediate lessor as operating leases applying IAS 17 may be classified as finance leases applying IFRS 16. If an intermediate lessor were to continue to apply previous operating lease accounting to such subleases, it would recognise the right-of-use asset arising from the head lease, despite the fact that, in effect, it no longer has a right to use the underlying asset. To avoid this misleading outcome, IFRS 16:C15 requires an intermediate lessor to reassess a sublease that was classified as an operating lease applying IAS 17 at the date of initial application to determine whether the sublease should be classified as an operating lease or a finance lease applying IFRS 16, and to account for it accordingly. [IFRS 16:BC289 – BC291]



11.5 Transition for lessees – choice between full retrospective application and ‘cumulative catch-up approach’

A lessee can choose to apply IFRS 16 to its leases either:

[IFRS 16:C5]

- a) retrospectively to each prior reporting period presented, applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (**see below**); or
- b) using the cumulative catch-up approach – under which the Standard is applied retrospectively with the cumulative effect recognised at the date of initial application in accordance with IFRS 16:C7 to C13 (**see 11.6**).

Whichever option is selected under IFRS 16:C5 should be applied consistently to all leases in which the entity is a lessee. [IFRS 16:C6]

If a lessee chooses under IFRS 16:C5 to apply IFRS 16 retrospectively in accordance with IAS 8, it is required to apply the requirements of that Standard in full to all of its leases. This means that it is required to:

- prepare its financial statements as if IFRS 16 had always been applied;
- restate comparative information for all periods presented, potentially requiring a third statement of financial position; and
- disclose the effect of applying IFRS 16 on a line-by-line basis.

Under the general requirements for retrospective application in IAS 8, an entity is required to adjust the opening balances in the earliest period presented for the cumulative effect of applying IFRS 16 up to that date. Therefore, if an entity applies IFRS 16 for the first time in an annual period beginning 1 January 2019, and it presents one year of comparative information, it is required to determine and recognise the cumulative effect of applying the new Standard at 1 January 2018 and also to restate the amounts reported for the year ended 31 December 2018, which will originally have been reported under IAS 17. In accordance with the requirements of IAS 1 *Presentation of Financial Statements*, this will potentially require inclusion of a third statement of financial position. This means that the entity will need to run parallel systems for 2018 in order to capture the required information, which is likely to be very costly. It is for this reason that the IASB decided to permit the cumulative catch-up approach (see **11.6**).

Lessees opting for full retrospective application are not permitted to take advantage of any of the reliefs described in **11.6** (so, for example, right-of-use assets and lease liabilities must be measured in accordance with the general requirements described in **7.4** and **7.5**). However, such entities are permitted to ‘grandfather’ assessments made under IAS 17 and IFRIC 4 regarding whether a contract contains a lease (i.e. they are permitted to apply the practical expedient described in **11.3**).

11.6 Transition for lessees – the cumulative catch-up approach

11.6.1 Cumulative catch-up approach – general

Rather than apply IFRS 16 retrospectively in accordance with IAS 8, lessees are permitted to apply IFRS 16:C5(b) under which comparative information is not restated. If this approach is selected, the 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.

[IFRS 16:C7]



If a lessee opts to use the cumulative catch-up approach:

- it recognises the cumulative effect of initial application at the date of initial application (i.e. if an entity applies IFRS 16 for the first time in an accounting period beginning 1 January 2019, it recognises the cumulative effect of application by adjusting balances at 1 January 2019);
- it does not restate comparative information – if there is a difference between the assets and liabilities introduced, an adjustment is made to opening retained earnings;
- it carries forward amounts previously recognised in respect of leases classified as finance leases (see **11.6.2**);
- it is permitted to apply a number of additional transition reliefs and practical expedients for leases previously classified as operating leases (see **11.6.3**); and
- it is required to disclose the effect of applying the cumulative catch-up approach (see **11.6.3.8**).

Importantly, the lessee is not required to run parallel systems at any point; information in comparative periods is reported on an IAS 17 basis and reporting moves to the IFRS 16 basis on the first day of the first accounting period in which the new Standard is applied.

11.6.2 Cumulative catch-up approach – leases previously classified as finance leases

For lessees applying the cumulative catch-up approach, for leases that were previously classified as finance leases, the carrying amounts of the right-of-use asset and the lease liability at the date of initial application are the carrying amounts of the lease asset and lease liability immediately before that date measured applying IAS 17. IFRS 16 is applied to such right-of-use assets and lease liabilities from the date of initial application. [IFRS 16:C11]

Note that the treatment set out in IFRS 16:C11 for finance lease assets and liabilities is mandatory – unless a lessee has opted for full retrospective application of IFRS 16 (see **11.5**), it is not permitted to restate such assets and liabilities on transition to IFRS 16.

The lessee accounting model in IFRS 16 is similar to the accounting requirements for finance leases in IAS 17. The availability of the practical expedient in IFRS 16:C3 to avoid reassessing whether a contract contains a lease (see **11.3**) and the requirement to carry forward balances previously recognised under IAS 17 as set out in IFRS 16:C11 mean that lessees in finance leases are unlikely to encounter significant issues on transition.

11.6.3 Cumulative catch-up approach – leases previously classified as operating leases

11.6.3.1 Leases of low-value assets

The recognition exemption available to lessees under IFRS 16 in respect of leases of low-value assets is discussed in detail at **7.2**. In making its assessment regarding the effect of transition, a lessee will need to determine the extent to which it will use this exemption (the choice is available on a lease-by-lease basis). To the extent that the recognition exemption is selected, no adjustments are required on transition for leases previously classified as operating leases. The requirements of IFRS 16 should be applied from the date of initial application. [IFRS 16:C9(a)]

11.6.3.2 Leases ending within 12 months of the date of initial application – practical expedient

As a practical expedient, available on a lease-by-lease basis, lessees applying the cumulative catch-up approach are permitted not to recognise right-of-use assets or lease liabilities in respect of leases previously classified as operating leases for which the lease term ends within 12 months of the date of initial application. When this option is taken, the lessee:



[IFRS 16:C10(c)]

- accounts for such leases in the same way as short-term leases as described in IFRS 16:6 (see **7.2**); and
- includes 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.

This additional relief is a pragmatic measure introduced to allow lessees to avoid incurring costs for little benefit. The relief effectively extends the short-term recognition exemption generally available for lease terms of 12 months or less to lease terms expected to end within 12 months of the date of initial application irrespective of when the lease term commenced. On a lease-by-lease basis, a lessee can choose to continue to account for such leases as it did under IAS 17.

Note that, if this relief is taken, so that the expense in relation to such leases is included in the amount disclosed for the short-term lease expense under IFRS 16:53(c), this may trigger the disclosure requirement in IFRS 16:55.

11.6.3.3 Recognition and measurement of lease liabilities

Lessees applying the cumulative catch-up approach are required to recognise a lease liability at the date of initial application in respect of leases previously classified as operating leases. The lease liability should be measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application. [IFRS 16:C8(a)]

When applying the cumulative catch-up approach for leases previously classified as operating leases, therefore, the lessee:

- ignores lease payments already made. The lease liability is measured by reference to the lease payments for the remainder of the lease term; and
- ignores any information it has regarding the interest rate implicit in individual leases or the lessee's incremental borrowing rate at the commencement of individual leases. The lessee's incremental borrowing rate at the date of initial application is not necessarily a single discount rate; it will vary among leases according to the term of the lease and the nature of the security held (see **7.4.2.2**). However, lessees are permitted to use a single rate for a portfolio of leases with reasonably similar characteristics (see **11.6.3.4**).

11.6.3.4 Lease liabilities for leases previously classified as operating leases – practical expedients

On a lease-by-lease basis, an entity can choose to use one or both of the following practical expedients in respect of the measurement of lease liabilities relating to leases previously classified as operating leases:

- 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); [IFRS 16:C10(a)] and/or
- use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease. [IFRS 16:C10(e)].

For example, consider an entity that entered into a lease a number of years before the date of initial application of IFRS 16 and that determined at the commencement of the lease that it was not reasonably certain to exercise an extension option. If, at the date of initial application, the entity has become reasonably certain to exercise the extension option, under IFRS 16:C10(e) it is permitted to measure the lease liability based on its assessment at the date of initial application (i.e. it is not required to reconstruct the accounting on the basis of its original assessment).



11.6.3.5 Recognition and measurement of right-of-use assets

Lessees applying the cumulative catch-up approach are required to recognise a right-of-use asset at the date of initial application in respect of leases previously classified as operating leases. Such assets should be measured either:

[IFRS 16:C8(b)]

- i) retrospectively, as if IFRS 16 had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or
- ii) at 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.

The selection of measurement basis for right-of-use assets under IFRS 16:8(b) is made on a lease-by-lease basis.

Entities are free to determine which measurement basis to apply to which leases. If a lessee elects retrospective measurement of a right-of-use asset under IFRS 16:C8(b)(i), it needs to have the necessary historical information to arrive at the carrying amount of the asset at the commencement of the lease and to calculate depreciation from that date, although it will use the incremental borrowing rate at the date of initial application. It may be costly to reconstruct such information. However, it is anticipated that entities will be willing to incur such costs for high-value items so as to avoid the recognition of higher lease-related costs in profit or loss in the years after transition (normally, because the lease liability falls more slowly under amortised cost accounting than the right-of-use asset, setting the asset equal to the liability part-way through the lease will mean that the carrying amount of the asset is higher than it would otherwise be, thus producing a higher depreciation expense post-transition). It is expected that lessees will generally apply IFRS 16:C8(b)(ii) for high-volume low-value leases for which the costs of applying a more accurate transition approach outweigh the benefit of achieving a 'correct' post-transition income statement. [IFRS 16:BC283 – BC286]

IAS 36 *Impairment of Assets* should also be applied to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient in IFRS 16:C10(b) (see **11.6.3.7**). [IFRS 16:C8(c)]

11.6.3.6 Specific requirements regarding investment property leases

Notwithstanding the requirements in IFRS 16:C8, as set out in **11.6.3.3** and **11.6.3.5**, for leases previously classified as operating leases, a lessee is:

[IFRS 16:C9(b) & (c)]

- 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 right-of-use asset and the lease liability arising from those leases should be accounted for under IAS 40 and IFRS 16 from the date of initial application; and
- required to measure the right-of-use asset at fair value at the date of initial application for leases previously accounted for as operating leases 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's right-of-use asset and the lease liability arising from those leases are required to be accounted for under IAS 40 and IFRS 16 from the date of initial application.



11.6.3.7 Right-of-use assets – practical expedients

On a lease-by-lease basis, an entity can choose to use one or both of the following practical expedients in respect of the measurement of right-of-use assets arising from leases previously classified as operating leases:

[IFRS 16:C10]

- rely on its assessment as to 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, it should 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; and

In accordance with IFRS 16:C8(c) (see **11.6.3.5**), lessees are required to consider whether right-of-use assets are impaired at the date of initial recognition. This practical expedient offers lessees a simplified approach based on the fact that if a right-of-use asset is impaired at the date of initial application, the equivalent operating lease will have been an onerous lease under IAS 37. IFRS 16 therefore permits a lessee to adjust the right-of-use asset on transition by the amount of any previously recognised onerous lease provision; this expedient is not expected to have a significant effect on reported information. [IFRS 16:BC287]

- exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

As discussed in **7.4.1.2**, initial direct costs are incremental costs that a lessee would not have incurred if it had not entered the lease contract. Such costs are generally included in the initial measurement of a right-of-use asset. This practical expedient permits a lessee to exclude such costs from right-of-use assets recognised for the first time when IFRS 16 is first applied; the choice is available on a lease-by-lease basis. It allows an entity to avoid the costs of identifying initial direct costs which may have been incurred several years previously.

11.6.3.8 Disclosure requirements for lessee's applying the cumulative catch-up approach

Lessees applying the cumulative catch-up approach are required to disclose information about initial application required by paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* except for the information specified in paragraph 28(f) of IAS 8. Instead of the information specified in IAS 8:28(f), the lessee is required to disclose:

[IFRS 16:C12]

- 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
- an explanation of any difference between:
 - 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 IFRS 16:C8(a) (see **11.6.3.3**); and
 - lease liabilities recognised in the statement of financial position at the date of initial application.

If a lessee uses one or more of the specified practical expedients in IFRS 16:C10 (see **11.6.3.2**, **11.6.3.4** and **11.6.3.7**), it is required to disclose that fact. [IFRS 16:C13]



11.7 Sale and leaseback transactions before the date of initial application

An entity should 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 *Revenue from Contracts with Customers* to be accounted for as a sale. [IFRS 16:C16]

If a sale and leaseback transaction was previously accounted for as a sale and a finance lease, the seller-lessee should:

[IFRS 16:C17]

- 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
- continue to amortise any gain on sale over the lease term.

If a sale and leaseback transaction was accounted for as a sale and an operating lease under IAS 17, the seller-lessee should:

[IFRS 16:C18]

- 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
- 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.

The transition provisions for sale and leaseback transactions are consistent with the general transition requirements for all leases. A seller-lessee should not perform any retrospective accounting specific to the sale element of a sale and leaseback transaction on transition to IFRS 16. A seller-lessee is required to account for the leaseback on transition to IFRS 16 in the same way as it accounts for any other lease that is in existence at the date of initial application.

A seller-lessee should apply the approach to gain or loss recognition on sale and leaseback transactions in IFRS 16 (see **section 10**) only to sale and leaseback transactions entered into after the date of initial application of IFRS 16. The IASB concluded that the costs of applying a retrospective approach would outweigh the benefits in terms of reported information. [IFRS 16:BC292 – BC294]

11.8 Assets or liabilities previously recognised by a lessee relating to favourable or unfavourable terms of an operating lease

If a lessee previously recognised an asset or a 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 should 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. [IFRS 16:C1]



Appendix 1

Illustrative examples – identification of a lease

The illustrative examples accompanying IFRS 16 include 10 examples of how an entity determines whether a contract is, or contains, a lease. These examples are summarised in a tabular format below, in each case highlighting the key determinants as to whether the contract is, or contains, a lease. Please refer to the full text of the illustrative examples accompanying IFRS 16 for complete details in each case.

Example	Identified asset?	Substantive substitution rights?	Customer has a right to control the use of the identified asset?	Lease?
1A – Contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail cars of a particular type for five years.	Yes. Specific rails cars identified in contract.	No. Can only be substituted for repairs or maintenance.	Yes. Customer has exclusive use of rails cars during the contract period so that it has the right to substantially all of the economic benefits from use of the rail cars. Customer has the right to change how and for what purpose the cars are used – it directs when and where the cars are used, and which goods are transported. Supplier's rights (restrictions on specified types of cargo) are protective only. Supplier's control of engines required to transport the rail cars does not give it the right to control the use of the cars.	Yes – lease of rail cars (not engines).
1B – Contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for five years.	No. Supplier has large pool of similar items and none are specified in the contract.	Yes. Alternatives are readily available at minimal cost. Supplier benefits economically by using its pool of available rolling stock in the most efficient manner.	No. Supplier selects which are used for each delivery and obtains substantially all of the economic benefits from use of the rail cars.	No. Customer is purchasing freight capacity (service).
2 – Coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period.	No. Many areas available for Customer to locate its kiosk and none specified in the contract.	Yes. Alternatives are readily available at minimal cost. Supplier benefits economically by using its retail space in the most efficient manner.	No. Supplier selects which space is allocated to Customer and obtains substantially all of the economic benefits from use of the concession space.	No. Customer is purchasing space, which can be changed at the discretion of the supplier, and is a service.



Example	Identified asset?	Substantive substitution rights?	Customer has a right to control the use of the identified asset?	Lease?
3A – Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use three specified, physically distinct dark fibres within a larger cable connecting Hong Kong to Tokyo.	Yes. Fibres are specifically identified in the contract and are physically distinct from other fibres within the cable.	No. Can only be substituted for repairs or maintenance.	Yes. Customer has exclusive use of fibres during the contract period so that it has the right to substantially all of the economic benefits from use. Customer has the right to change how and for what purpose the fibres are used – it decides when and whether the fibres are connected and the type and volume of data transported.	Yes – lease of specified fibres.
3B – Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo.	No. Customer is purchasing capacity, equivalent to its having the use of three fibres, but specific fibres are not identified. Capacity purchased is not physically distinct and does not represent substantially all the capacity of the cable.	Yes. Alternatives are readily available Supplier benefits economically by using fibres in the most efficient manner.	No. Supplier makes all of the relevant decisions and has the right to substantially all of the economic benefits from use of the fibres.	No. Customer is purchasing transmission capacity (service).
4 – Customer enters into a contract with a property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.	Yes. Specific retail unit identified in the contract.	No. Although Supplier has the practical ability to substitute another retail unit, it would be required to pay relocation expenses and the circumstances in which it would benefit economically (major new tenant) are, at the inception date, not considered likely to arise.	Yes. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the retail unit during the contract period (notwithstanding the requirement to make variable payments based on retail sales to the Supplier). Customer makes all of the relevant decisions regarding what to sell and prices. Supplier's inputs (cleaning, security, advertising) do not give it the right to decide how and for what purpose the retail space is used.	Yes – lease of specific retail unit.
5 – Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco.	Yes. Specific truck identified in the contract.	No.	Yes. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the truck during the contract period. Although how and for what purpose the truck is used is predetermined, Customer operates the truck and, therefore, has the right to direct the use of the truck (see 3.4.3.3).	Yes – lease of truck. Because the duration of the lease is one week, it is a short-term lease (see 7.2.2).



Example	Identified asset?	Substantive substitution rights?	Customer has a right to control the use of the identified asset?	Lease?
6A – Customer enters into a contract with a ship owner (Supplier) for the transportation of cargo from Rotterdam to Sydney on a specified ship.	Yes. Specific ship identified in the contract.	No	No. Customer occupies substantially all of the capacity of the ship and therefore has the right to substantially all of the economic benefits from use of the ship during the contract period. However, how and for what purpose the ship is used is predetermined and Supplier operates the ship. Therefore, Customer does not have the right to direct the use of the ship (see 3.4.3.3).	No. Customer is purchasing transport service.
6B – Customer enters into a contract with Supplier for the use of a specified ship for a five-year period.	Yes. Specific ship identified in the contract.	No	Yes. Customer occupies substantially all of the capacity of the ship and therefore has the right to substantially all of the economic benefits from use of the ship during the contract period. Customer makes the relevant decisions about whether, where and when the ship sails (subject to contractual restrictions designed to protect Supplier's investment and personnel). Although Supplier operates the ship, it is in accordance with Customer's decisions regarding how and for what purpose the ship is used.	Yes – lease of ship for the contract period.
7 – Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.	Yes. Specific aircraft identified in the contract.	No. Although Supplier has the right to substitute another aircraft, the costs of outfitting any substitute to the standard specified in the contract mean that Supplier would not be expected to benefit economically from substitution.	Yes. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the aircraft during the contract period. Contractual and legal restrictions define the scope of Customer's right of use. Within that defined scope, Customer makes the relevant decisions about how and for what purpose the aircraft is used. Although Supplier operates the aircraft, it is in accordance with Customer's decisions regarding whether, where and when the aircraft travels.	Yes – lease of aircraft for the contract period.



Example	Identified asset?	Substantive substitution rights?	Customer has a right to control the use of the identified asset?	Lease?
8 – Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality and quantity of shirts for a three-year period.	Yes. Factory implicitly specified because Supplier can fulfil the contract only through the use of its one factory.	No. No alternative factory available.	No. Customer does not have the right to obtain all of the economic benefits from use of the factory during the contract period because its output does not represent substantially all of the output of the factory and Supplier can use spare capacity to supply other customers. Also, Supplier directs the use of the factory (Customer has the same rights as other customers).	No. Customer is purchasing shirts (goods).
9A – A utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years.	Yes. Specific solar farm identified in the contract.	No	Yes. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the solar farm during the contract period (Supplier's benefits in the form of tax credits are economic benefits from ownership rather than use). Although how and for what purpose the solar farm is used is predetermined, Customer's design of the farm has given it the right to direct the use of the farm (see 3.4.3.3).	Yes – lease of solar farm for the contract period.
9B – Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years.	Yes. Specific power plant identified in the contract.	No	No. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the power plant during the contract period. However, how and for what purpose the plant is used is predetermined and Customer did not design the plant and Supplier operates the plant. Therefore, Customer does not have the right to direct the use of the plant (see 3.4.3.3).	No. Customer is purchasing a power supply (service).
9C – Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years.	Yes. Specific power plant identified in the contract.	No	Yes. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the power plant during the contract period. Customer makes the relevant decisions about how and for what purpose the plant is used. Although Supplier operates the plant, it is in accordance with Customer's decisions regarding the timing and quantity of power produced.	Yes – lease of power plant for the contract period.



Example	Identified asset?	Substantive substitution rights?	Customer has a right to control the use of the identified asset?	Lease?
10A – Customer enters into a contract with a telecommunications company (Supplier) for network services for two years.	Not considered	Not considered	No. Customer does not control the use of the servers. Supplier is the only party that can make relevant decisions about the servers during the period of use – it decides how data is transported using the services, whether to reconfigure the servers and whether to use the servers for another purpose.	No. Customer is purchasing network services.
10B – Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years.	Yes. Specific server identified in the contract.	No. Server can only be substituted if it malfunctions.	Yes. Customer has exclusive use and has the right to obtain all of the economic benefits from use of the server during the contract period. Customer makes the relevant decisions about how and for what purpose the server is used.	Yes – lease of the server for the contract period.



Appendix 2

Presentation and disclosure checklist – lessees

Reference	Presentation/disclosure requirement
	PRESENTATION
	Presentation – statement of financial position
IFRS 16:47	A lessee should either present in the statement of financial position, or disclose in the notes: <ul style="list-style-type: none"> • right-of-use assets separately from other assets; and • lease liabilities separately from other liabilities.
IFRS 16:47	If right-of-use assets are not presented separately in the statement of financial position, the lessee should: <ul style="list-style-type: none"> • 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.
IFRS 16:47	If lease liabilities are not presented separately in the statement of financial position, the lessee should disclose which line items in the statement of financial position include those liabilities.
IFRS 16:48	The requirement for separate presentation of right-of-use assets does not apply to right-of-use assets that meet the definition of investment property, which should be presented in the statement of financial position as investment property.
	Presentation – statement of profit or loss and other comprehensive income
IFRS 16:49	In the statement of profit or loss and other comprehensive income: <ul style="list-style-type: none"> • the interest expense on the lease liability should be presented separately from the depreciation charge for the right-of-use asset; and • the interest expense on the lease liability is a component of finance costs which, in accordance with paragraph 82(b) of IAS 1 <i>Presentation of Financial Statements</i> (, is required to be presented separately in the statement of profit or loss and other comprehensive income.
	Presentation – statement of cash flows
IFRS 16:50	In the statement of cash flows, a lessee should classify: <ul style="list-style-type: none"> • cash payments for the principal portion of the lease liability within cash flows from financing activities; • cash payments for the interest portion of the lease liability applying the requirements in IAS 7 <i>Statement of Cash Flows</i> 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 cash flows from operating activities.



Reference	Presentation/disclosure requirement
	<p>DISCLOSURE</p> <p><i>Notes:</i></p> <p>IFRS 16:51 1. The objective of IFRS 16's disclosure requirements for lessees is that sufficient information is disclosed in the notes, taken together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, to provide 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. IFRS 16:52 to 60 (see below) specify requirements designed to meet this objective.</p> <p>IFRS 16:52 2. A lessee should disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.</p>
	<p>Disclosure of amounts reflected in financial statements</p> <p>IFRS 16:53 The following amounts are required to be disclosed for the reporting period:</p> <ul style="list-style-type: none"> 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 under IFRS 16:6 (see 7.2). 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 IFRS 16:6 (see 7.2). This expense should not include the expense relating to short-term leases of low-value assets reported under (c) above; e) the expense relating to variable lease payments not included in the measurement of lease liabilities (see 7.5.2.3); 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.
	<p><i>Notes:</i></p> <p>IFRS 16:54 1. The disclosures specified in IFRS 16:53 should be reported in a tabular format, unless another format is more appropriate.</p> <p>2. The amounts disclosed under IFRS 16:53 should include costs that a lessee has included in the carrying amount of another asset during the reporting period.</p>
	<p>Disclosure of lease commitments for short-term leases</p> <p>IFRS 16:55 Disclosure is required of the amount of a lessee's lease commitments for short-term leases accounted for applying IFRS 16:6 (see 7.2) if the portfolio of short-term leases to which the lessee 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 under IFRS 16:53(c) (see above) relates.</p>



Reference	Presentation/disclosure requirement
	<p><i>Note:</i> <i>This disclosure requirement may be triggered in the year in which IFRS 16 is applied if an entity applies the practical expedient allowed for lease terms expected to end within 12 months of the date of initial application (see 11.6.3.2).</i></p>
IFRS 16:56	<p>Right-of-use assets meeting the definition of investment property If right-of-use assets meet the definition of investment property, the disclosure requirements of IAS 40 <i>Investment Property</i> should be applied. In that case, a lessee is not required to provide the disclosures in IFRS 16:53(a), (f), (h) or (j) (see above) for those right-of-use assets.</p>
IFRS 16:57	<p>Right-of-use assets measured at revalued amounts under IAS 16 If a lessee measures right-of-use assets at revalued amounts applying IAS 16 <i>Property, Plant and Equipment</i>, it should disclose the information required by IAS 16:77 for those right-of-use assets.</p>
[IFRS 16:58]	<p>Maturity analysis for lease liabilities Lessees are required to present a maturity analysis of lease liabilities applying paragraphs 39 and B11 of IFRS 7 <i>Financial Instruments: Disclosures</i>. This analysis should be presented separately from the maturity analyses of other financial liabilities.</p>
IFRS 16:59	<p>Additional information regarding the scope of lease activities General requirement to disclose additional information In addition to the disclosures required under IFRS 16:53 to 58 (see above), a lessee is required to disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in IFRS 16:51 (see above). This additional information may include, but is not limited to, information that helps users of financial statements to assess:</p> <ul style="list-style-type: none"> • the nature of the lessee's leasing activities; • 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: <ul style="list-style-type: none"> – variable lease payments (see below for further details); – extension options and termination options (see below for further details); – residual value guarantees (see below for further details); and – leases not yet commenced to which the lessee is committed; • restrictions or covenants imposed by leases; and • sale and leaseback transactions (see below for further details).



Reference	Presentation/disclosure requirement
IFRS 16:B48	<p>In determining whether additional information about leasing activities is necessary to meet the disclosure objective in IFRS 16:51 (see above), a lessee should consider:</p> <ul style="list-style-type: none"> • whether that information is relevant to users of financial statements. A lessee should provide additional information as specified in IFRS 16:59 (see above) 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: <ul style="list-style-type: none"> – the flexibility provided by leases (e.g. if a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions); – restrictions imposed by leases (e.g. if the entity is required to maintain particular financial ratios); – sensitivity of reported information to key variables (e.g. to future variable lease payments); – exposure to other risks arising from leases; and – deviations from industry practice (e.g. unusual or unique lease terms and conditions that affect a lessee's lease portfolio); and • 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.
IFRS 16:BC225	<p><i>Note:</i></p> <p><i>IFRS 16 therefore requires a lessee to disclose any material entity-specific information that is necessary in order to meet the disclosure objective and is not covered elsewhere in the financial statements. IFRS 16 supplements this requirement with a list of user information needs that additional disclosures should address, and with illustrative examples of disclosures (see illustrative examples 22 and 23 accompanying IFRS 16) that a lessee might provide in complying with the additional disclosure requirements. These examples are not exhaustive. Nonetheless, the IASB thinks that the illustrative examples are useful in demonstrating that judgement should be applied in determining the most useful and relevant disclosures, which will depend on a lessee's individual circumstances. In the IASB's view, this approach facilitates the provision of more relevant and useful disclosures by:</i></p> <ul style="list-style-type: none"> • <i>discouraging the use of generic or 'boilerplate' statements; and</i> • <i>enabling a lessee to apply judgement to identify the information that is relevant to users of financial statements and focus its efforts on providing that information.</i>
IFRS 16:B49	<p>Additional information relating to variable lease payments (see illustrative example 22 accompanying IFRS 16)</p> <p>Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in IFRS 16:51 (see above) could include information that helps users of financial statements to assess, for example:</p> <ul style="list-style-type: none"> • the lessee's reasons for using variable lease payments and the prevalence of those payments; • the relative magnitude of variable lease payments to fixed payments; • key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and • other operational and financial effects of variable lease payments.



Reference	Presentation/disclosure requirement
IFRS 16:B50	<p>Additional information relating to extension options or termination options (see illustrative example 23 accompanying IFRS 16)</p> <p>Additional information relating to extension options or termination options that, depending on the circumstances, may be needed to satisfy the disclosure objective in IFRS 16:51 (see above) could include information that helps users of financial statements to assess, for example:</p> <ul style="list-style-type: none"> • the lessee's reasons for using extension options or termination options and the prevalence of those options; • the relative magnitude of optional lease payments to lease payments; • the prevalence of the exercise of options that were not included in the measurement of lease liabilities; and • other operational and financial effects of those options.
IFRS 16:B51	<p>Additional information relating to residual value guarantees</p> <p>Additional information relating to residual value guarantees that, depending on the circumstances, may be needed to satisfy the disclosure objective in IFRS 16:51 (see above) could include information that helps users of financial statements to assess, for example:</p> <ul style="list-style-type: none"> • the lessee's reasons for providing residual value guarantees and the prevalence of those guarantees; • the magnitude of a lessee's exposure to residual value risk; • the nature of underlying assets for which those guarantees are provided; and • other operational and financial effects of those guarantees.
IFRS 16:B52	<p>Additional information relating to sale and leaseback transactions</p> <p>Additional information relating to sale and leaseback transactions that, depending on the circumstances, may be needed to satisfy the disclosure objective in IFRS 16:51 (see above) could include information that helps users of financial statements to assess, for example:</p> <ul style="list-style-type: none"> • the lessee's reasons for sale and leaseback transactions and the prevalence of those transactions; • key terms and conditions of individual sale and leaseback transactions; • payments not included in the measurement of lease liabilities; and • the cash flow effect of sale and leaseback transactions in the reporting period.
IFRS 16:60	<p>Short-term leases or leases of low-value assets</p> <p>A lessee that accounts for short-term leases or leases of low-value assets in accordance with IFRS 16:6 (see 7.2) is required to disclose that fact.</p>



Appendix 3

Disclosure checklist – lessors

Reference	Disclosure requirement
IFRS 16:89	<p><i>Notes:</i></p> <p>1. The objective of the disclosure requirements for lessors 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. IFRS 16:90 to 97 (see below) specify requirements designed to meet this objective.</p>
IFRS 16:BC251	<p>2. The lessor disclosure requirements in IFRS 16 are more extensive than those in IAS 17 to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities. The disclosure requirements have been expanded to address the perception that the lessor accounting model in IAS 17 did not provide sufficient information relating to all elements of a lessor's leasing activities.</p>
IFRS 16:90(a)	<p>Disclosures – finance leases</p> <p>The following amounts should be disclosed for the reporting period for finance leases:</p> <ol style="list-style-type: none"> selling profit or loss; finance income on the net investment in the lease; and income relating to variable lease payments not included in the measurement of the net investment in the lease.
IFRS 16:91	<p><i>Note:</i></p> <p><i>These disclosures should be presented in a tabular format, unless another format is more appropriate.</i></p>
IFRS 16:93 & 94	<p>A lessor should also:</p> <ul style="list-style-type: none"> provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases; 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; and reconcile the undiscounted lease payments to the net investment in the lease. This reconciliation should identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value. <p><i>Note:</i></p> <p><i>Finance lease assets fall within the definition of financial instruments as set out in IAS 32 Financial Instruments: Presentation. Therefore, in addition to the specific disclosure requirements set out above, an entity must also meet the requirements of IFRS 7 Financial Instruments: Disclosures in respect of its finance lease arrangements.</i></p> <p><i>In particular, because the derecognition and impairment requirements of IFRS 9 Financial Instruments (or, for entities that have not yet adopted IFRS 9, IAS 39 Financial Instruments: Recognition and Measurement) apply to a lessor's net investment in a lease, the relevant requirements under IFRS 7 are also applicable. These are the disclosure requirements for transfers of financial assets in accordance with IFRS 7:42A and the disclosure requirements regarding credit risk under IFRS 7.35A et seq.</i></p>



Reference	Disclosure requirement
	Disclosures – operating leases
IFRS 16:90(b)]	For operating leases, a lessor should disclose its lease income for the reporting period, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.
IFRS 16:91	<i>Note:</i> <i>These disclosures should be presented in a tabular format, unless another format is more appropriate.</i>
IFRS 16:95	For items of property, plant and equipment subject to an operating lease, a lessor should apply the disclosure requirements of IAS 16 <i>Property, Plant and Equipment</i> . For this purpose, each class of property, plant and equipment should be segregated into assets subject to operating leases and assets not subject to operating leases (i.e. the disclosures required by IAS 16 should be provided separately for assets subject to an operating lease (by class of underlying asset) and owned assets held and used by the lessor.
IFRS 16:96	The disclosure requirements in IAS 36 <i>Impairment of Assets</i> , IAS 38 <i>Intangible Assets</i> , IAS 40 <i>Investment Property</i> and IAS 41 <i>Agriculture</i> should be applied for assets subject to operating leases.
IFRS 16:97	A lessor should 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.
	Additional qualitative and quantitative information
IFRS 16:92	A lessor should disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in IFRS 16:89 (see above). This additional information includes, but is not limited to, information that helps users of financial statements to assess: <ul style="list-style-type: none"> • the nature of the lessor's leasing activities; and • how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor should 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.



Appendix 4

Comparison with US GAAP

The FASB issued its new leasing standard, ASU 2016-02, in February 2016. Although the IASB and the FASB started the initiative to improve the accounting for leases as a joint project, with the aim of producing a fully converged standard, in the end there are a number of differences in approach between IFRS 16 and ASU 2016-02, the most significant of which are highlighted in the table below.

Key provision	IFRS 16	ASU 2016-02
Scope	Scope includes leases of all assets (with specified exceptions – see section 2). Also, lessees can elect to apply the guidance to leases of intangible assets.	Scope includes leases of all property, plant, and equipment and excludes: <ul style="list-style-type: none"> • leases of intangible assets; • leases to explore for or use non-regenerative resources; • leases of biological assets; • leases of inventory; and • leases of assets under construction.
Leases of low-value assets	A lessee may recognise the payments on leases of low-value assets on a straight-line basis over the lease term (in a manner similar to recognition of an operating lease under IAS 17) – see 7.2). When the exemption is applied, such leases are not reflected on the lessee's balance sheet.	No equivalent exemption under US GAAP. However, the FASB believes that an entity will be able to adopt a reasonable capitalisation policy under which the entity will not recognise lease assets and liabilities that are below a certain threshold.
Lessee accounting model	<p>All leases are 'on-balance sheet' (subject to exemptions for short-term leases and leases of low-value assets – see 7.2).</p> <p>No distinction between finance and operating leases.</p> <p>As of the lease commencement date, a lessee recognises:</p> <ul style="list-style-type: none"> • a liability for its lease obligation (initially measured at the present value of the future lease payments not yet paid over the lease term) (see 7.4.2); and • an asset for its right to use the underlying asset (equal to the lease liability, adjusted for lease payments made at or before lease commencement, lease incentives, and any initial direct costs) (see 7.4.1). <p>The lessee uses the effective interest rate method to subsequently account for the lease liability (see 7.5.2), and the right-of-use asset is generally amortised on a straight-line basis (see 7.5.1).</p>	<p>All leases are 'on-balance sheet' (subject to exemption for short-term leases).</p> <p>Distinction between finance (capital) and operating leases is retained.</p> <p>The accounting for finance leases is similar to the IFRS 16 approach. The right-of-use asset is generally amortised on a straight-line basis. This amortisation, when combined with the interest on the lease liability, results in a front-loaded expense profile in which interest and amortisation are presented separately in the income statement.</p> <p>For operating leases:</p> <ul style="list-style-type: none"> • the lease liability is measured as under IFRS 16 but without a requirement to reassess variable lease payments; and • the lease expense is generally recognised on a straight-line basis and is presented as a single line item in the income statement.



Key provision	IFRS 16	ASU 2016-02
Lessor accounting	Retains the current lessor accounting approach for operating and finance leases (see sections 8 and 9). A dealer's profit for a finance lease is recognised up-front without regard to the revenue guidance in IFRS 15 (see 9.1.2).	Retains the current lessor accounting approach for operating and capital (direct financing and sales-type) leases. However, the lease classification criteria will change, and the treatment of dealer's profit, if any, will be affected as follows: <ul style="list-style-type: none"> • a dealer's profit is recognised up-front if the arrangement is a sales-type lease; and • a dealer's profit resulting from a direct financing lease, if any, is deferred and recognised as interest income over the lease term. Leveraged lease accounting is eliminated going forward (existing leveraged leases are grandfathered).
Subleases	The intermediate lessor is required to classify a sublease as either an operating lease or a finance lease by reference to the right-of-use asset arising from the head lease (see 8.6).	The intermediate lessor is required to classify a sublease by reference to the underlying asset of the head lease.
Sale-and-leaseback arrangements	For transactions that qualify as a sale, the gain or loss recognised by a seller-lessee is limited to the amount of any gain or loss that relates to the rights transferred to the buyer-lessor (see section 10).	If the transaction qualifies as a sale, the entire gain on the transaction is recognised.



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Notes



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