IFRS 16 LEASES

GUIDE

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INTRODUCTION

IFRS 16 *Leases* became mandatorily effective for annual reporting periods beginning on or after 1 January 2019 and brought significant change to lease accounting for lessees as most leases now need to be recognised on a lessee's balance sheet in the form of right-of-use assets with corresponding lease liabilities.

In this six-part guide we break down IFRS 16 into digestible chunks, with each part focusing on a key aspect of the new standard – the definition of a lease, lease term, lease payments, discount rate, transition options, and modifications and reassessments.

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PART 1

DEFINITION OF A LEASE

IFRS 16 *Leases* became mandatorily effective for annual reporting periods beginning on or after 1 January 2019 and replaced IAS 17 *Leases*, IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, as well as two lease-related interpretations.

For many organisations, leasing is an important part of their commercial activities as it is a means of gaining access to assets and obtaining financing, while at the same time reducing exposure to the risks associated with ownership of the assets. The prevalence of leasing means that most organisations are required to apply IFRS 16 and the changes it introduced.

The new leases standard introduced a single model of lease accounting for lessees, removing the need to distinguish between operating and finance leases. Lessees now have to recognise most leases on the balance sheet as a right-of-use (ROU) asset with a corresponding liability. In terms of the income statement, depreciation (or amortisation) and interest expense replace operating lease expense.

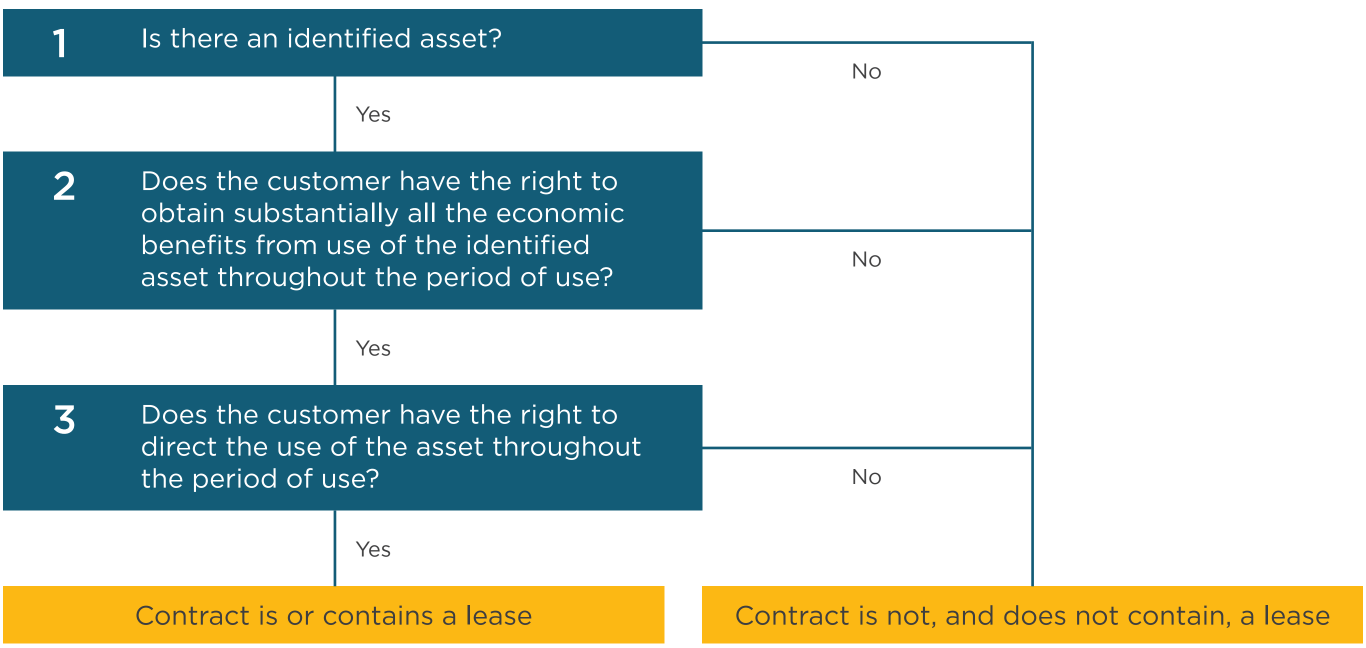
For lessors, accounting for leases has remained largely unchanged from IAS 17. Lessors still have to make a distinction between operating and finance leases depending on whether or not substantially all the risks and rewards of ownership of the underlying asset are transferred.

Identifying a lease

In many cases, identifying a lease is straightforward. However, where contracts are not in the legal form of a lease but involve the use of a specific asset, an analysis would need to be undertaken as these arrangements may now contain a lease under IFRS 16. This would apply to, for example, transportation agreements, IT outsourcing arrangements and power supply agreements where the focus of the analysis would be on whether the customer 'controls' the use of a specific asset.

Under IFRS 16, 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.

In assessing whether an arrangement is, or contains, a lease, three key assessments need to be made. These are presented diagrammatically below and examined individually in more detail thereafter.



1 - IDENTIFIED ASSET

In many instances, the asset that is being leased will be explicitly specified in the agreement and therefore will be easily identifiable.

Example: *A specific floor of an office building, or a specific piece of machinery identified by a serial number, being stipulated in the lease contract would be explicitly specified assets.*

An identified asset is also one that is implicitly specified by being identified at the time that the asset is made available for use by the customer (i.e. commencement date).

Example: *A delivery vehicle may be an implicitly specified asset where it is not yet built at inception (i.e. signing) of the contract, but the specifications (brand, model, colour, etc.) of the vehicle are detailed in the contract. In this case, the delivery vehicle will be identifiable at the commencement of the lease (i.e. when the vehicle is made available for use by the customer) and is therefore an identified asset.*

Another situation of an asset being implicitly specified is one in which the supplier can fulfil its obligations only by using a specific asset, either because it only has one such asset that suits the customer's particular needs, or it has alternative assets but due to, for example, geographical restrictions, only one of those assets can realistically be supplied to the customer.

Example: *A supplier owns several drilling rigs but there is only one drilling rig in the customer's required geographic area that is not already being used by another customer. The drilling rig is implicitly specified as the supplier must use it to fulfil the contract.*

Substantive substitution rights

Even if an asset is explicitly specified, a customer does not control the use of an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset throughout the period of use.

For supplier substitution rights to be substantive, the supplier must have the practical ability to substitute alternative assets throughout the period of use, and the supplier must also benefit economically from doing this.

A supplier has the practical ability to substitute alternative assets when the customer cannot prevent it from substituting the asset and the supplier has alternative assets either readily available or available within a reasonable period of time.

If the supplier has a right or 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.

A supplier would benefit economically from the exercise of its right to substitute the asset when the economic benefits associated with substituting the asset are expected to exceed the related costs.

The assessment of whether substitution rights are substantive is based on the facts and circumstances that exist at inception of the contract. Future events that are unlikely to occur are ignored. These include:

- 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 performance or customer's use of an asset, and the use or performance considered likely at inception of the contract; and
- a substantial difference between the actual market price of the asset during the period of use and the market price considered likely at inception of the contract.

A supplier's right or obligation to substitute the asset for repairs and maintenance, because the asset is not working properly (i.e. a 'warranty-type' obligation) or because a technical upgrade becomes available, is not a substantive substitution right.

Very often a customer would not have access to the necessary information to determine whether a supplier's substitution right is in fact substantive. IFRS 16 makes it clear that in such instances, customers are not required to expend undue effort in trying to make this assessment but should instead presume that the substitution right is not substantive.

Example: *A customer enters into a contract with a supplier to transport perishable goods using refrigerated trucks over a period of three years. The timetable and quantity of food stipulated equates to the customer having the use of eight trucks for three years. Under the agreement, the supplier makes available the trucks as well as the drivers. The supplier has a large fleet of these refrigerated trucks, and they are kept at the supplier's premises when they are not being used to transport food.*

In this case, the contract does not contain a lease of refrigerated trucks. There is no identified asset as the supplier has a substantive right to substitute the trucks. This is because:

- *the supplier has the practical ability to substitute the trucks as it deems fit throughout the three year period. Alternative trucks are readily available to the supplier and these can be substituted without the customer's approval; and*
- *the supplier would benefit economically from being able to deploy alternative trucks as needed to fulfil the customer's needs. The costs associated with doing this would be minimal as the trucks are kept at the supplier's premises and the supplier has a large fleet of these trucks.*

Capacity portions

The asset under lease will, in many cases, be the entire underlying asset and therefore be easy to identify. However, it is possible for a portion of an asset's capacity to be an identified asset if:

- it is physically distinct (e.g. a floor of an office building or two specified strands of a fibre optic cable); or
- it is not physically distinct, but the customer has the right to receive substantially all of the capacity of the asset (e.g. capacity portion of a gas pipeline that is not physically distinct but represents substantially all of the capacity of the pipeline).

'Substantially all' in the context of a lease is not defined in IFRS 16. Entities will have to apply judgement in interpreting this when developing accounting policies, ensuring they apply their interpretation on a consistent basis.

2 - RIGHT TO OBTAIN SUBSTANTIALLY ALL OF THE ECONOMIC BENEFITS FROM USE OF THE IDENTIFIED ASSET

Economic benefits from using the asset

The economic benefits from using an asset include its primary output, by-products and other economic benefits from using the asset that could be realised from a commercial transaction with a third party (e.g. sub-leasing the asset).

These economic benefits need to be assessed within the defined scope of a lessee's right to use an asset. For example, if a contract limits the use of a vehicle to only one particular territory during the period of use, then a company considers only the economic benefits derived from using the vehicle within that territory, and not beyond.

Example: *Company A leases a motor vehicle that it can drive up to a maximum of 150,000 kilometres during the three-year period. When assessing whether it has the right to obtain substantially all of the economic benefits from use of the vehicle, Company A considers only the economic benefits for the permitted mileage.*

Whether or not tax credits and similar items are 'economic benefits' when applying the lease definition will depend on whether the benefits arise from ownership or use of the asset.

A lease conveys a right to use the underlying asset. Accordingly, the International Accounting Standards Board (IASB) concluded that the benefits derived from ownership of the asset (such as income tax credits) are excluded when considering whether a customer has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use. Conversely, benefits such as renewable energy credits received from use of the asset are more akin to a by-product and so will be included in the analysis of economic benefits.

'Substantially all'

As mentioned previously, IFRS 16 does not define what 'substantially all' means. Fortunately, assessing whether a customer has the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use will be straightforward in many cases as the customer in a lease often has exclusive use of the asset.

This assessment becomes more challenging in cases where the economic benefits of an asset under lease are shared by more than one party. Where a contract provides a party other than the customer the right to more than an insignificant amount of the economic benefits from using the same asset, the entity will have to consider the complete population of economic benefits that can be derived from the asset in the scope of the entity's right to use.

Example: *Company B enters into a contract to lease an office. Company B does not require all the space being leased and so enters into a contract with Company C in which it sub-lets 20% of the office space to Company C. In this case, Company B receives substantially all the economic benefits of the asset through its own use and sub-letting (other economic benefits).*

Example: *Company F enters into a three year contract to lease a helicopter to transport its executives to and from project sites. Company F shares access and use of the helicopter with another party. Both parties have the right to use the helicopter at any time, subject to a limited number of hours per month and the other party not using it at the same time. In this case Company F does not receive substantially all the economic benefits throughout the three year period because it shares the use of the asset with another party.*

Variable lease payments based on a customer's use of an asset do not prevent a customer from obtaining substantially all the economic benefits from the use of that asset.

An example would be a retailer paying the landlord a percentage of sales in consideration for using a retail space. Granted, the retailer is transferring some of the benefits to the landlord through these variable payments, however the retailer is still the party that receives the economic benefits arising from use of the retail store, being the cash flows generated by sales made in the store. IFRS 16 is explicit on this point to reduce the risk that companies seek to avoid lease accounting by introducing variable payments into an arrangement that would otherwise be a lease.

3 - RIGHT TO DIRECT USE OF THE IDENTIFIED ASSET

A customer has the right to direct the use of an identified asset in either of the following situations:

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use; or
- the relevant decisions about how and for what purpose the asset is used are predetermined and certain conditions are met.

If neither of the conditions above are met, the supplier directs how and for what purpose the asset is used and, consequently, the arrangement does not contain a lease.

'How and for what purpose' decisions

A customer has the right to direct how and for what purpose the asset is used if, in the scope of its rights of use as defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. The focus is on whether the customer has decision-making rights that affect the economic benefits to be derived from use of the asset.

In assessing whether a customer has the right to direct the use of an asset, an entity considers only the rights to make decisions about the asset's use during the period of use. Decisions that are predetermined before the period of use (i.e. commencement date) are not taken into account.

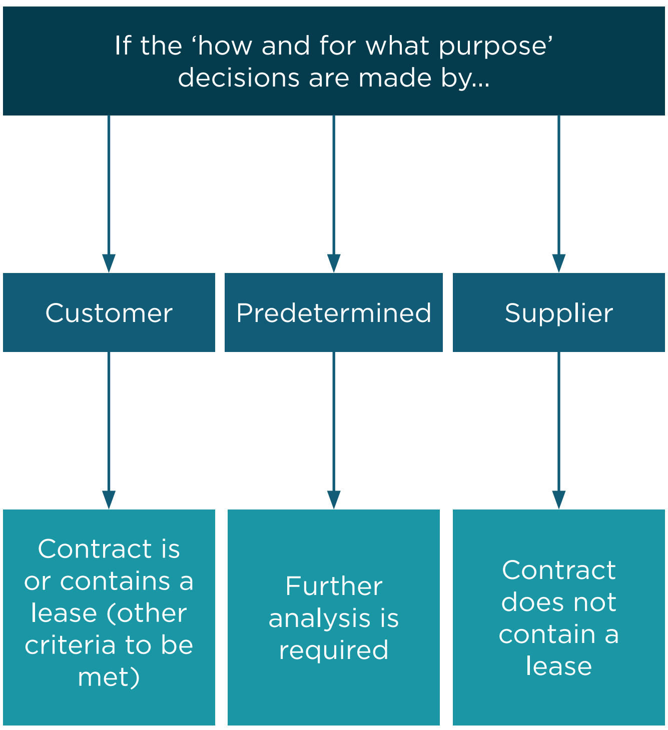
'Period of use' is defined in IFRS 16 as the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).

The decision-making rights that are most relevant to affecting the economic benefits to be derived from use of the asset are likely to be different from contract to contract, depending on the nature of the asset and the terms and conditions of the arrangement.

Depending on the circumstances, these could include:

- rights to change the type of output to be produced by the asset;
- rights to change when the output is produced;
- rights to change where the output is produced; and
- rights to change whether the output is produced and the quantity thereof.

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



Relevant predetermined decisions

The decisions about how and for what purpose an asset is used can be predetermined in many ways. For example, they could be agreed between the parties in negotiating the contract, with neither party being able to change them during the period of use of the asset. The decisions could also be predetermined by the design of the asset.

A customer has the right to direct the use of an identified asset when all the relevant decisions are predetermined and either:

- 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
- 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.

In either of the cases above, 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.

The IASB noted that situations in which how and for what purpose decisions are predetermined are expected to be rare.

Supplier's 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 protective rights and typically define the scope of a customer's right to use an asset, but do not, in isolation, prevent the customer from having the right to direct the use of an asset within that scope.

Examples of protective rights are those that:

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

Example: *Customer X enters into a contract with a shipping company to transport vehicles from Japan to Australia. The contract specifies the ship to be used, the dates of pick-up and delivery, and the vehicles to be transported which will utilise the ship's entire capacity. The shipping company operates and maintains the ship and is responsible for safe passage of the cargo. X cannot make any changes to the terms (destination or cargo) after signing the contract.*

The contract does not contain a lease. Customer X cannot direct how and for what purpose the ship is used and does not therefore control the use of the ship. The contract predetermines how and for what purpose the ship is to be used and the customer neither operates nor designed the ship.

Example: *Customer X enters into a four year contract with a shipping company to transport cargo. The contract specifies the ship to be used. X decides whether and what cargo will be transported and when and to which destinations the ship will sail throughout the period of use, subject to restrictions stipulated in the contract. These restrictions prevent X from sailing the ship into waters that have a high risk of piracy or carrying explosive materials. The supplier operates and maintains the ship and is responsible for safe passage.*

The contract contains a lease. In the scope of its right of use, Customer X has the right to direct the use of the ship. X determines how and for what purpose the ship is used throughout the four year period since it decides whether, where and when the ship sails, as well as what cargo it will transport. X can change these decisions throughout the period of use. The contractual restrictions are protective rights for the supplier that protect its investment in the ship and its personnel, and do not preclude the customer from having the right to direct the use of the ship within the defined scope of the customer's rights.

Assessing decision-making rights is an area that requires judgement. In summary:

- **how and for what purpose (relevant) decisions:** the allocation of these decisions to the supplier or customer determines whether the arrangement contains a lease, unless these are predetermined.
- **operating decisions:** these are ignored unless the how and for what purpose decisions are predetermined, in which case there is a lease if the customer makes the operating decisions and other criteria are met.
- **protective rights:** these typically define the scope of the customer's right to use an asset but do not, in isolation, prevent an arrangement from being a lease.

PART 2

LEASE TERM

The lease term is a key input in calculating the amount of the lease liability (and consequently the right-of-use asset). Assessing the lease term will often require judgement, especially when the lease contains features like rent renewal and termination options.

IFRS 16 defines the lease term as the non-cancellable period for which a lessee has the right to use an underlying asset, together with both:

- periods covered by a lessee's extension option if extension is reasonably certain; and
- periods covered by a lessee's termination option if the lessee is reasonably certain not to terminate.

The concept of 'reasonably certain' has been carried over from the superseded IAS 17 and remains unchanged. In applying this concept, entities are required to consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise, or not to exercise, the option.

Consideration of enforceability

A contract is an agreement between two or more parties that creates enforceable rights and obligations. In assessing the lease term, entities need to determine the period for which the lease agreement is enforceable.

A lease is not enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. The term 'penalty' includes all aspects of termination penalties, not only those that are contractual and financial. In other words, the meaning of 'penalty' in this context extends to the existence of any significant economic disincentives of exercising a termination option, taking into account all facts and circumstances.

Options to extend or terminate a lease are only taken into consideration when assessing the lease term when they are enforceable. Consequently, if a lessor has the right to decline a lessee's request to extend or terminate the lease, then the lessee's option is not enforceable and is ignored in assessing the lease term.

If only the lessor has a right to terminate the contract, the non-cancellable lease period includes the period covered by the option to terminate the lease. This is because 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.

When assessing the lease term, entities also need to consider whether local laws and regulations create enforceable rights and obligations that need to be included in the evaluation of the lease term.

Assessing the lease term

The lease term begins on the commencement date – the date on which the lessor makes the underlying asset available for use by the lessee – and includes any rent-free periods provided by the lessor to the lessee. It is from the commencement date that assets, liabilities, income and expenses resulting from a lease are recognised. The timing of when the lease payments begin under the contract does not affect the commencement date of the lease. It's all about when the lessee takes possession of, or is given control over, the use of the underlying asset.

In contrast to lessor termination options discussed above, 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 assessing the lease term. In making this assessment, the lessee considers all facts and circumstances (see examples of such facts and circumstances on the next page) that create an economic incentive for the lessee to exercise, or not to exercise, the option. It should include any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

Examples of relevant facts and circumstances

Contractual terms and conditions compared with market rates	For example: • Amount of payments for the lease in any optional period; • Amount of any variable payments for the lease or other contingent payments such as termination penalties and residual value guarantees; • 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	Significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit to the lessee when the option becomes exercisable.
Termination costs	These would include negotiation costs, relocation costs, costs of identifying another suitable underlying asset suited to the lessee's needs, integration costs, or termination penalties and similar costs, including costs associated with returning the underlying asset in a required condition and/or location.
Importance of the asset to the lessee	The importance of the leased asset to the lessee's operations, considering, for example, whether the underlying asset is specialised, its location, and the availability of suitable alternatives.
Conditions attached to exercising options	Whether certain conditions have to be met before an option can be exercised, and the likelihood that those conditions will exist.
Options and other contractual features	Where an option is combined with one or more other contractual features (e.g. 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, 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.
Length of non-cancellable period	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.
Lessee's past practice	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.

Reassessing the lease term

After lease commencement, IFRS 16 requires lessees to monitor leases for significant changes that could trigger a change in the lease term. A lessee reassesses whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of a significant event or a significant change in circumstances that:

- is within the control of the lessee; and
- affects whether the exercise, or non-exercise, of the option is reasonably certain.

Examples of significant events or changes in circumstances that could trigger a reassessment include:

- substantial leasehold improvements not anticipated at lease commencement that are expected to have significant economic benefit for the lessee when the option becomes exercisable;
- significant modifications to, or customisation of, the leased asset that were not anticipated at 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, the option. For example, deciding to extend the lease of a complementary asset, to dispose of an alternative asset, or to dispose of a business unit in which the right-of-use asset is employed.

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

- the lessee exercises an option not previously included in the determination of the lease term;
- the lessee exercises an option not previously included in the determination of the lease term;
- the lessee does not exercise an option previously included in the lease term;
- an event occurs that contractually obliges the lessee to exercise an option not previously included in the lease term;
- an event occurs that contractually prohibits the lessee from exercising an option not previously included in the lease term.

If the reassessment of the lease term results in a change, lessees would remeasure the lease liability using revised inputs (such as the discount rate) at the reassessment date. A corresponding adjustment would be made to the right-of-use asset.

The examples below demonstrate some of the principles discussed relating to the lease term:

Scenario 1:

Lessee A enters into a contract with Lessor B to lease an office for a period of six years. The contract includes an option to extend the lease for a further two years if both the lessee and lessor agree to the two-year extension. There is no penalty for either party if they do not agree to extend. Company A is certain it will exercise its option to extend the lease.

Under the contract, the lease term is six years. Both the lessee and the lessor could unilaterally elect not to extend the arrangement without more than an insignificant penalty meaning neither party has enforceable rights beyond the initial non-cancellable lease period of six years.

Scenario 2:

Lessee X enters into a contract to lease a warehouse for eight years. The lessor has the option to terminate the lease after five years. A lessor's right to terminate a lease is ignored in determining the lease term. Lessee X is obliged to pay rent under the contract for eight years unless the lessor chooses to terminate early. In other words, the lessor can enforce the contract for the full eight-year period. Accordingly, the lease term is eight years.

Scenario 3:

Lessee P enters into a non-cancellable lease agreement with Lessor Q to lease a commercial building. The lease is for five years initially, and P has the option to extend the lease by another five years at the same rental.

To determine the lease term, P considers the following factors:

- *it is P's intention to stay in business in the same area for at least ten years.*
- *the location of the building is ideal for relationships with customers and suppliers.*
- *market rentals for a similar building in the same area are expected to increase by 12% over the ten- year period of the lease.*
- *at inception of the lease, rentals are in accordance with current market rates.*

P concludes that it has a significant economic incentive to extend the lease. Therefore, for lease accounting purposes, P uses a lease term of ten years.

Scenario 4:

A retailer enters into a lease for a specific retail space in a shopping centre for three months a year, being October, November and December, for a non- cancellable term of seven years. The contract states that the same space will be provided to the retailer every year over the seven-year period.

Under the contract, the retailer has the right to use the space for three months every year for seven years, thus the lease term is 21 months. The emphasis is on the period the lessee has the right to use the underlying asset, rather than the contractual term.

PART 3

LEASE PAYMENTS

Under IFRS 16, lessees are required to recognise most leases on balance sheet as a right-of-use asset with a corresponding lease liability. The lease liability is measured at the present value of the lease payments, which begs the question: which lease payments should be included in determining the lease liability, both initially and subsequently?

At the commencement of a lease, a lessee measures the lease liability at the present value of lease payments that have not been paid as at that date. Determining which payments to include, and how changes in those payments are accounted for, may require the use of judgement.

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, and comprise the following:

- fixed payments (including in-substance fixed payments) less any lease incentives receivable
- variable lease payments that depend on an index or rate
- amounts expected to be payable under a residual value guarantee
- the exercise price of an option to purchase the underlying asset that the lessee is reasonably certain to exercise
- payments for terminating the lease unless it is reasonably certain that early termination will not occur.

In contrast, the following payments are excluded from the lease liability:

- variable lease payments that depend on sales or usage of the underlying asset
- payments for non-lease components unless the lessee elects to combine lease and non-lease components.

Let's explore some of the more complicated aspects of lease payments.

In-substance fixed payments

In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable.

In-substance fixed lease payments exist where payments are structured as variable lease payments but there is no genuine variability in those payments.

These payments contain variable clauses that lack real economic substance, for example:

- payments that must be made only if an event occurs that has no genuine possibility of not occurring;
- payments that must be made only if an asset is proven to be capable of operating during the lease;
- 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.

Further examples of in-substance fixed lease payments include those payments where:

- there is more than one set of payment options described in the lease but only one set of those payments is realistic. In this case, an entity considers the realistic set of payments to be the lease payments; or
- there is more than one realistic set of payments described in the lease, but the lessee must select 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).

Example: *A retailer leases a retail space in an established shopping mall. The lease terms state that the retailer is required to operate the store during normal trading hours and that the store cannot be sub-let. The retailer has been operating for a number of years and has a well-established business.*

Annual rentals payable under the contract are:

- *1,000 if the retailer makes no sales at the store; or*
- *1,000,000 if the retailer makes any sales at the store during the lease term.*

The retailer concludes that the lease contains in- substance fixed payments of 1,000,000 per annum on the basis that there is no realistic possibility that the retailer will make no sales at the store. The retailer has an established retail business and has agreed to operate during normal trading hours.

Lease incentives

Lease incentives are those payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee. Such incentives may take the form of an up-front cash payment to the lessee, payment of costs for the lessee such as relocation costs or the assumption by the lessor of the lessee's pre-existing lease with a third party.

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

Variable lease payments

Variable lease payments include payments linked to a consumer price index, payments linked to a benchmark interest rate (such as EURIBOR) or payments that vary to reflect changes in market rental rates. In measuring the lease liability, lessees do not estimate how future changes in the index or rate will impact future lease payments. Rather the lessee assumes that the initial lease payment will remain constant during the lease term.

Despite the measurement uncertainty associated with changes to index- or rate-based payments, the payments meet the definition of a liability for a lessee because they are unavoidable and do not depend on any future activity of the lessee.

Lessees subsequently remeasure the lease liability when there is a change in the cash flows for future payments resulting from a change in the index or rate used to determine the lease payments (i.e. when the adjustment to the lease payments takes effect).

In remeasuring the carrying amount of the lease liability, the lessee uses an unchanged discount rate unless the change in lease payments results from a change in floating interest rates. In that case, the lessee revises the discount rate to reflect the change in the interest rate.

Example: *Entity X enters into a six-year lease of a warehouse. The lease payment for the first year is 1,000. Lease payments are linked to the consumer price index (CPI) and are updated at the end of every second year. CPI at commencement of the lease is 100. This changes to 105 at the end of year one and 108 at the end of year two.*

At lease commencement, the lease payments are 1,000 per year for six years. Entity X does not take into account potential future changes in the index in calculating the initial lease liability. At the end of year one the payments have not changed thus the liability is not remeasured. At the end of year two, when the lease payments are updated for the change in CPI, Entity X updates the remaining four lease payments to 1,080 (1,000 / 100 x 108) and does not change its discount rate to remeasure the liability (and right-of-use asset).

Market rent reviews

Increases in lease payments resulting from market rent reviews are considered to be variable payments based on an index or rate.

When a lease contract includes the potential for rent reviews, the lease payments included in the measurement of the lessee's lease liability at the commencement date will be the payments agreed at inception, without consideration of future rent reviews. That is, any increase or decrease as a result of subsequent rent reviews will be accounted for (via remeasurement of the lease liability) when the rent review occurs and adjustment to the lease payments takes effect.

Payments that depend on sales or usage

Variable lease payments that depend on sales or usage of the underlying asset are excluded from the lease liability. Instead, these payments are recognised in profit or loss in the period in which the event or condition that triggers those payments occurs.

Example: *Lessee Q enters into a five-year lease of retail space in a shopping centre. There are no minimum lease payments. Lease payments are 5% of annual sales. In negotiating the contract with the lessor, the lessee demonstrates that it generates at least 100,000 per annum at each location, and on average, 125,000.*

Although there is a high degree of certainty that the lessee will incur a lease expense of at least 5,000 (100,000 x 5%) per annum, variable lease payments that are linked to the future performance or use of an underlying asset are excluded from the definition of lease payments. Consequently, no liability is recognised for those variable lease payments. Instead, they are recognised as an expense in profit or loss when incurred.

Non-lease components

In practice, contracts may contain a lease coupled with an agreement to purchase other goods or services (non-lease components). For example, a contract for a lease of a vehicle may require the lessee to make additional payments for maintenance every year. The maintenance is considered a separate (albeit non-lease) component because it provides the lessee with an additional service.

Non-lease components are identified and accounted for separately from the lease component in accordance with other accounting standards (i.e. they are not included as lease payments in determining the lease liability). Using our vehicle and maintenance example in the preceding paragraph, the maintenance costs would be recognised as an expense as and when incurred.

It should be noted that IFRS 16 offers a practical expedient whereby lessees may elect not to separate non-lease components. This election is applied consistently by class of underlying asset. A lessee making this election accounts for the lease and non-lease components together as a single lease component. While taking advantage of this practical expedient may simplify the accounting for contracts containing a lease, it will increase the amount of assets and liabilities recognised on the balance sheet.

Charges for administrative tasks or other costs incurred associated with the lease that do not transfer a good or service to the lessee do not give rise to a separate component. However, they are part of the total consideration that the lessee allocates to the identified components.

When a contract contains a lease component and one or more non-lease components, and the lessee has opted not to use the practical expedient, the lessee allocates the consideration in the contract to each lease component based on the relative stand-alone prices of the lease components and the aggregate standalone price of the non-lease components.

Lessees determine the relative stand-alone prices of lease and non-lease components based on the price that a supplier would charge an entity for a similar component separately. Such information may not always be available, and in these cases, lessees are allowed to estimate the stand-alone price by using as much observable information as possible.

Example: *Lessee P enters into a five-year contract with Lessor Q to use a long-reach excavator, including a person to operate the vehicle. The contract includes maintenance services provided by Lessor Q. Q obtains its own insurance for the excavator. Annual payments are 20,000, including 3,000 for maintenance services and 500 for administrative costs. Lessee P is able to determine that similar maintenance services are offered by third parties for 2,000 a year. P is also able to determine that similar leases for long-reach excavators without an operator are offered by third parties for 15,000 a year and, using a cost-plus calculation, P estimates the annual cost of operator hire to be 5,000. Payments are made at the end of each year. Assume a discount rate of 5%.*

In this case, P estimates the stand-alone price of the lease component as follows:

Observable stand-alone price: maintenance	A	2,000
Estimated stand-alone price: operator	B	5,000
Observable stand-alone price: lease of excavator	C	15,000
Total	**D=A+B+C**	**22,000**
Lease component as a % of total observable and estimated prices	E=C/D	68%
Allocation of consideration (20,000) to lease	E x 20,000	13,600

The lease liability at commencement date would be calculated as the present value of the five lease payments of 13,600, discounted at 5%. The maintenance and operator costs (non-lease components) of 6,400 are recognised as expenses as and when incurred.

The administrative costs do not transfer a separate good or service to Lessee P and are therefore not a separate component. However, they are part of the total consideration that Lessee P allocates to the identified components.

PART 4

DISCOUNT RATE

Under the new leases standard, lessees are required to bring most leases onto the balance sheet in the form of right-of-use assets with corresponding lease liabilities. These assets and liabilities are initially measured at the present value of the future lease payments. But at what discount rate?

The definitions of discount rates remained unchanged from the superseded leases standard, however applying these concepts in bringing leases on-balance sheet requires judgement and can prove to be one of the more practical challenges of IFRS 16 for lessees.

A lessee discounts the lease payments using the interest rate implicit in the lease (IRIL) if this can be readily determined. Otherwise, the lessee uses its incremental borrowing rate (IBR). In terms of transition, entities using one of the modified transition approaches will be required to use the IBR at the date of initial application.

Interest rate implicit in the lease	Incremental borrowing rate
The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.	The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

Based on the definitions, it can be seen that the two rates are conceptually different: the IRIL is specific to the lessor and is really a measure of the lessor's minimum return on the lease. The IBR, on the other hand, is specific to the lessee and is the rate at which the lessee could borrow over a similar term and with a similar security on the right-of-use asset.

Let's explore the two rates in more detail.

Interest rate implicit in the lease

The definition of IRIL is the same for both lessees and lessors. From the perspective of the lessee, however, it will often be difficult or impossible to make a reliable estimate of the IRIL due to the lack of available information that is specific to the lessor. For example, the IRIL hinges on the initial fair value of the underlying asset as well as the lessor's expectation of the residual value of the asset at the end of the lease term. Very often, lessees will not have the information at their disposal to determine these amounts.

It may be as simple as asking the lessor for the relevant information when negotiating the lease, however lessors may be unwilling to disclose specific pricing information so as not to give away commercially-sensitive information.

In other cases, the lessee may be able to reliably estimate the initial fair value and the residual value of the underlying asset as well as the lessor's initial direct costs (if these are expected to be significant) by reference to external sources. These estimates may be challenged by regulators and auditors so evidence supporting them, and documentation of considerations would be critical.

Where a lessee does go down the path of calculating the IRIL, it must be remembered that lease payments are defined differently in IFRS 16 for lessees and lessors. Differences arise in the treatment of residual value guarantees and non-lease components. Since the IRIL is a company-specific rate that is specific to the lessor, it seems appropriate that lessees should use lease payments as defined for lessors in determining the IRIL.

Under IFRS 16, lessees are required to use the IRIL if it is 'readily determinable'. Generally speaking, the expectation is that lessees will not be able to readily determine the IRIL for reasons outlined above and will therefore have to use their IBR.

Incremental borrowing rate

The IBR is an interest rate specific to the lessee that reflects:

- the credit risk of the lessee
- the term of the lease
- the nature and quality of the 'security' given
- the amount 'borrowed' by the lessee, and
- the economic environment in which the transaction takes place.

Considering the number of factors above, determining the IBR will require judgement and will most likely be a practical challenge for entities, especially those that do not have direct borrowings with banks and other financiers.

For those entities that do have direct borrowings, it may be appropriate to use the interest rate on these borrowings as a starting point in determining the IBR. This would then have to be appropriately adjusted to take into consideration all the factors listed above.

Other sources of data that can be used as starting points in determining the IBR are property yields (for property leases), government and corporate bond rates. Again, these would need to be quantitatively adjusted to arrive at an appropriate IBR that satisfies the requirements of IFRS 16.

A lessee's weighted average cost of capital (WACC) is not a suitable proxy for its IBR. WACC includes the cost of equity which is unsecured and ranks behind other creditors, meaning it is generally more expensive than debt. Furthermore, an entity's WACC is not specific to a lease and does not factor in the lease term, security and value of the underlying asset.

Lessees are required to determine a separate IBR for each lease except in the following cases:

- where the lessee chooses to apply the practical expedient that allows for lease accounting on a portfolio basis. IFRS 16 allows this practical expedient if the effect is expected to be materially the same as a lease-by-lease approach; and
- on transition where the lessee uses the modified retrospective approach and applies 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).

Reassessment of discount rate

In most cases, a lessee does not reassess the discount rate during the lease term, including when there is a change in future lease payments due to a change in an index (such as CPI). However, a lessee remeasures the lease liability at the date of reassessment using a revised discount rate when there is a change in:

- the lease term;
- the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset; or
- floating interest rates that result in a change in future lease payments.

The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term, unless it cannot be readily determined, in which case the lessee's incremental borrowing rate at the date of reassessment is used.

Factors impacting IBR

Factor	Impact on IBR
↑ Credit risk of lessee	↑
↑ Term of the lease	↑
↑ Quality of security	↓
↑ Amount 'borrowed'	↑

PART 5

TRANSITION OPTIONS

For many entities, adopting IFRS 16 will be a challenging task: one that will require entities to think about systems and processes, data collection, communication with stakeholders, and the impact on key financial metrics, debt covenants and remuneration schemes. A smooth transition requires an understanding of the many transition options and practical expedients that the new standard has to offer.

Choosing a transition strategy is important as it can have a significant impact on reported as well as future financial results. Entities will therefore have to decide carefully which approach best suits their needs, bearing in mind that the options and expedients aimed at simplifying transition often make the resulting financial information less comparable.

This part of our leases guide focuses on the transitional reliefs that are available to make the first- time adoption of the new standard simpler. Details of the transitional provisions that are available can be found in Appendix C of IFRS 16.

Identifying leases

The first transition decision to be made is which lease definition to apply when identifying leases. This is a critical decision as it essentially determines the scope of the work to be done under the implementation project.

For contracts that exist on date of initial application, entities can choose to apply either:

- IFRS 16's new definition of a lease; or
- IAS 17 / IFRIC 4's definition of a lease as a practical expedient.

Date of initial application is the beginning of the annual reporting period in which an entity first applies the standard. Thus, for an entity with a 30 June balance date, date of initial application will be 1 July 2019.

The practical expedient to 'grandfather' assessments of leases before date of initial application offers substantial relief on transition. This is because entities do not have to incur the costs of detailed reassessments when it is likely that the assessment will not change for many contracts.

Applying the practical expedient means:

- IFRS 16 is applied to leases previously assessed in accordance with IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease;*
- IFRS 16 is not applied to contracts previously identified as not containing leases in accordance with IAS 17 and IFRIC 4; and
- the new definition of a lease under IFRS 16 is applied to contracts entered into on or after the date of initial application to assess whether the arrangement is, or contains, a lease.

The practical expedient is applied on an 'all or nothing basis'. That is, it is an accounting policy choice that, if applied, must be applied to all contracts.

Making use of the practical expedient does not permit entities to 'grandfather' errors or omissions in previous assessments of which arrangements are, or contain, leases. Errors identified during the implementation of IFRS 16 should be corrected in the usual way, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

Optional recognition exemptions

Lessees may elect not to bring the following leases on balance sheet, both on transition and subsequently:

- short-term leases; and
- leases of low-value assets.

The recognition exemptions impact the population of contracts that need to be restated on date of initial application. There will be no adjustments needed on transition for those leases that were classified as operating leases under IAS 17 and to which one of the recognition exemptions is applied.

Where either of the above exemptions is applied, the lease payments are recognised as an expense over the lease term.

Short-term leases

A short-term lease is one that has a lease term of 12 months or less. A lease that has a purchase option cannot be classified as a short-term lease, irrespective of the probability that the option will be exercised.

The short-term leases exemption is an accounting policy choice by class of underlying asset. This means entities will need to develop an accounting policy and apply the exemption consistently on transition and subsequently.

For example, consider an entity that has several items of IT equipment under lease, some with terms of less than 12 months and some with terms longer than 12 months.

If the entity chooses to use the short-term lease exemption, it must do so for all the IT equipment leases with terms of less than 12 months. The leases that are longer than 12 months will be accounted for using the general recognition and measurement requirements of IFRS 16.

Leases of low-value assets

'Low-value' is not explicitly defined in IFRS 16, however the Basis for Conclusions refers to US$ 5,000 or less when the asset is new (i.e. the age of the leased asset is disregarded). The exemption is aimed at items such as tablet and personal computers, small items of office furniture and telephones.

The low-value assessment is performed on an absolute basis meaning the exemption can apply even if the lease is material to the lessee. The assessment is not affected by the size, nature or circumstance of the lessee.

The low-value exemption is available on a lease-by- lease basis. In order to apply the exemption, entities will have to develop policies for identifying leases of low-value assets and apply these consistently on transition and subsequently.

There is no need to consider the aggregate of the leases identified as relating to low-value assets to determine if the overall effect is material. Each 'lease' is assessed separately, subject to the requirements relating to the combination of interdependent contracts and the specific requirements regarding assets that are highly interdependent or highly interrelated.

Example: *A school enters into a contract for a large number of iPads. Each iPad within the contract constitutes an identified underlying asset and the other conditions for identification of a lease are met. The value of an individual iPad would be considered to be 'low' even though the contract for all the iPads is not. The school can benefit from the use of an individual iPad together with other readily available resources, and each individual iPad does not require other assets to make it functional for students. As such, each iPad qualifies as a low-value asset and the exemption can be applied to all iPads.*

Transition methods

The next key decision for lessees relates to the transition approach that will be followed in adopting IFRS 16. The new standard provides for two methods for first-time adoption:

- full retrospective application; or
- modified retrospective application.

The election is applied consistently to all leases.

Full retrospective method

Under this approach, right-of-use (ROU) assets and lease liabilities are measured as if IFRS 16 had always applied. Comparative financial information will be restated and any adjustment to equity will be recognised at the beginning of the earliest period presented in the financial statements (i.e. 1 July 2018 for 30 June 2020 balance dates).

The only transitional relief available under this approach relates to the choice to grandfather previous assessments made under IAS 17 and IFRIC 4, as discussed earlier in this section. No other practical expedients can be used, and the retrospective application is made in accordance with IAS 8.

To apply this method, lessees will require extensive information about their leasing transactions. This will include historical data about lease payments and discount rates, as well as information relating to past judgements made about lease terms (including assessments made about options to extend and terminate), amounts expected to be paid under residual value guarantees, and amortisation and impairment of ROU assets.

The benefit of this approach is that comparability of financial information will be maintained in the financial statements as both prior and current year numbers would be calculated under IFRS 16.

Modified retrospective method

Using the modified retrospective approach means applying the new standard from the beginning of the first year of application. This would entail:

- calculating lease assets and liabilities at date of initial application (i.e. 1 July 2019 for 30 June 2020 year ends) using special rules provided by the standard;
- not restating prior period information;
- recognising an adjustment to equity at the date of initial application; and
- making additional disclosures required by the new standard.

The lease liability is measured at the present value of the remaining lease payments from, and discounted using the lessee's incremental borrowing rate (IBR) at, the date of initial application.

The ROU asset can be measured in one of two ways:

- an amount equal to the lease liability, adjusted by any prepaid or accrued lease payments relating to that lease at date of initial application; or
- an amount equal to the carrying value of the ROU asset calculated as if IFRS 16 had applied since commencement of that lease, but using the lessee's IBR at the date of initial application to discount the lease payments in working out the ROU asset.

The main advantage of using a modified retrospective approach is the cost savings involved due to not having to restate prior period information and the practical expedients available that offer relief on transition (see below for more detail on these practical expedients). The trade-off is that comparability of financial information is lost.

Practical expedients available under modified retrospective approach

Also making the modified approach easier and less cost- and time-intensive are the number of practical expedients available under IFRS 16 that simplify the calculations involved in applying the new standard for the first time.

The practical expedients can be applied independently of each other and on a lease-by-lease basis.

If lessees opt to make use of any of the practical expedients discussed below, they should disclose this information in the financial statements.

Discount rate

This practical expedient permits a lessee to apply a single discount rate to a portfolio of leases with reasonably similar characteristics. Thus, a single discount rate could be applied to leases with similar remaining lease terms for similar classes of assets in similar economic environments.

Impairment and onerous leases

On transition, ROU assets are required to be assessed for impairment. This can be done by either:

- applying the impairment provisions of IAS 36 *Impairment of Assets* on transition; or
- adjusting the ROU asset by the amount of any previous onerous provision calculated under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

Leases with less than 12 months to go

Lessees can elect to account for leases with a term of less than 12 months from date of initial application as short-term leases. This means such leases would be accounted for in the same manner as IAS 17, with payments recognised as an expense over the lease term.

Initial direct costs

This practical expedient allows entities to choose whether to include or exclude initial direct costs when measuring the ROU asset at the date of initial application. This practical expedient would only be of benefit when applying the modified approach that measures the ROU asset as if IFRS 16 had always applied.

Use of hindsight

Under this transitional relief, entities are permitted to use hindsight when applying the standard for the first time. For example, determining the lease term if the contract contains options to extend or terminate the lease. Again, this practical expedient would only be of benefit when applying the modified approach that measures the ROU asset as if IFRS 16 had always applied.

Summary of key options and expedients

Option/ Expedient	Scope
Option to 'grandfather' previous lease assessments	Accounting policy choice
Recognition exemption: short-term leases	Class of underlying asset
Recognition exemption: low-value assets	Lease-by-lease
Retrospective vs modified retrospective approach	Accounting policy choice
Modified retrospective: measurement of ROU asset	Lease-by-lease
Modified retrospective: practical expedients	Lease-by-lease

PART 6

REASSESSMENTS & MODIFICATIONS

Lease modifications have always been common, however accounting for these changes is more involved under the requirements of the new leases standard. Thankfully, clear guidance on accounting for modifications has been included in IFRS 16, so while lease modifications come in many different forms, an understanding of just a few key principles will address the accounting for all of them.

Unfortunately, the new leases standard is not a 'set and forget' kind of standard, thus it is important to understand how to account for ongoing changes to leases, which can be many in number over the life of a lease.

IFRS 16 addresses various scenarios where the initial terms or related assumptions underlying the lease may change and what the related accounting for any remeasurements would be. Generally, there are two situations when an entity may need to remeasure an existing lease asset and lease liability. These are:

- reassessment of the estimates used in the initial lease accounting; and
- lease modifications.

The accounting is different for reassessments and modifications.

Reassessments

Reassessments of leases occur when there are changes in the lease payments (cash flows) based on contractual clauses that were part of the original terms and conditions of the lease.

Changes to the original assessment of the following would trigger reassessments for lessees:

- lease term
- an option to purchase the underlying asset
- expected amount payable under a residual value guarantee
- future lease payments due to a change in the index or rate used to determine those payments.

In the above situations, lessees are required to remeasure the lease liability to reflect the changes to the lease payments. This is done by adjusting the carrying amount of the ROU asset for the remeasurement of the lease liability. If the carrying amount of the ROU asset has already been reduced to zero, then any remaining amount of the remeasurement is recognised in profit and loss.

As a reminder, when remeasuring the lease liability due to a reassessment, a revised discount rate is used for the first two types of reassessments above, while the original discount rate is used for the third and fourth scenarios.

Take note that the above guidance on reassessments pertains to lessees only. There is no equivalent guidance for lessors.

Modifications

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions. Essentially, changes that result from renegotiations and changes to the original terms and conditions of a lease contract are lease modifications.

Examples of lease modifications include:

- increasing the scope of the lease by:
  - adding the right to use one or more underlying assets, or
  - extending the contractual lease term;
- decreasing the scope of the lease by:
  - removing the right to use one or more underlying assets, or
  - shortening the contractual lease term;
- changing the consideration of the lease by increasing or decreasing the lease payments.

In terms of timing, lease modifications are accounted for on the effective date of the modification, which is when both parties (lessee and lessor) agree to the change.

Lessees must use a new discount rate whenever there is a lease modification. The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term unless this cannot be readily determined. If the implicit rate is not readily determinable, then the revised discount rate is the lessee's incremental borrowing rate at the effective date of the modification.

A critical assessment that drives the accounting for a lease modification is whether or not the modification creates a separate lease. Let's consider this in more detail.

Separate lease

A modification gives rise to a separate lease if both of the following conditions are met:

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

If both the above conditions are met, the lease modification results in two separate leases – the original lease and a separate new lease. No accounting adjustment is made to the original lease, while the separate new lease is accounted for in the same manner as any other new lease.

Not a separate lease

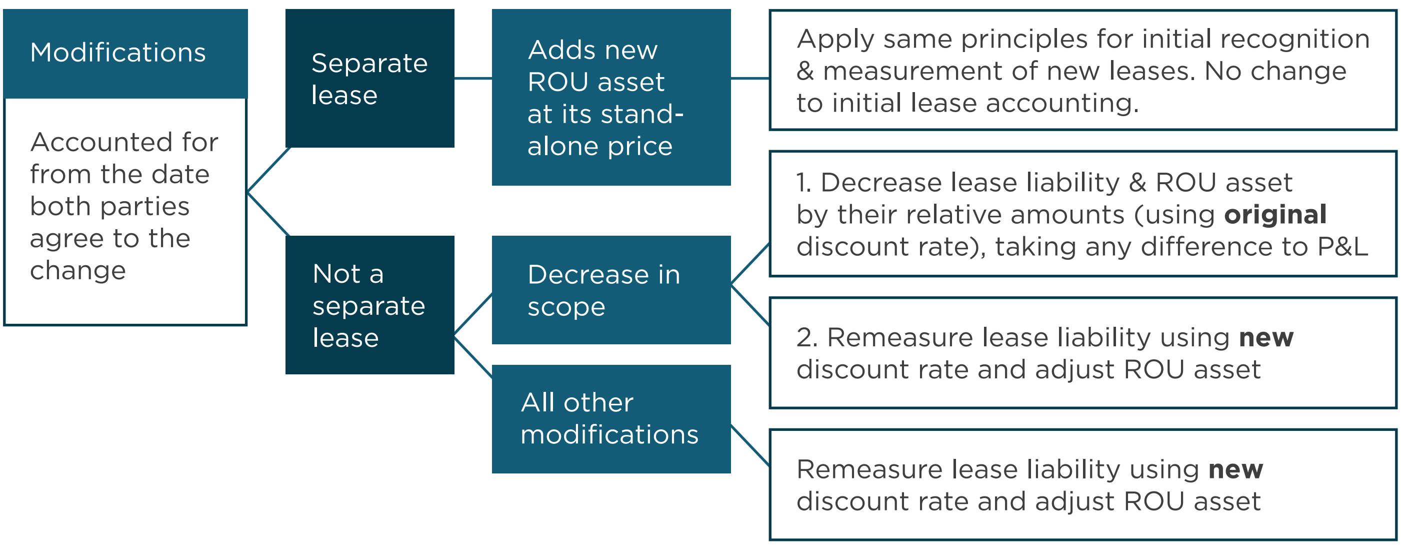
If either of the conditions set out above are not met, the modified lease is not accounted for as a separate lease. The accounting for the modification will depend on whether there is a decrease in the scope of the lease or not.

Accounting for modifications that decrease the scope of a lease involves two steps. Firstly, the lessee reduces the carrying amounts of the ROU asset and lease liability by their relative amounts to reflect the partial or full termination of the lease. Any difference between the decrease in the ROU asset and the decrease in the lease liability is recognised in profit and loss.

The second step requires that the lease liability be adjusted again by remeasuring the future lease payments under the modified contract using the discount rate on the date of the modification (i.e. a revised discount rate). A corresponding adjustment is made to the ROU asset, and not profit and loss.

For all other modifications, the lease liability is remeasured on the date of the modification using a revised discount rate, with a corresponding adjustment to the ROU asset.

Summary of the accounting for lease modifications



IFRS 16 contains several illustrative examples relating to lease modifications which readers may find useful. The cases below are based on some of these examples.

Example 1 – Modification that is a separate lease

Lessee enters into a lease for two floors in an office building for a term of 10 years. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to grant Lessee the right to use an additional floor of office space. The additional floor is made available for use by Lessee at the end of the second quarter of Year 6. The lease payments for the new office space are commensurate with market rentals for office space of that size and nature, except for a discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the space to a new tenant (such as marketing costs).

Analysis:

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 new right is commensurate with its stand-alone price. In this example, the additional underlying asset is the additional floor of office space for the remaining three and half years. At the commencement date of the new lease (i.e. at the end of the second quarter of Year 6), Lessee recognises a ROU asset and a lease liability relating to the lease of the additional floor. No adjustments are made to the ROU asset and lease liability relating to the original lease of two floors.

Example 2 – Modification that increases the scope by extending lease term

Lessee enters into a 10-year lease for 5,000 square meters of office space. Annual lease payments are CU100,000 payable at the end of each year. Lessee's incremental borrowing rate of 6% is used to discount lease payments as the rate implicit in the lease cannot be readily determined. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending it by an additional four years. Annual lease payments remain unchanged. Lessee's incremental borrowing rate at the beginning of Year 7 is 7%. The lease liability immediately prior to the modification is CU346,511.

Analysis:

As the modification does not convey the right to use additional assets (as the lease is for the same underlying premises), it is not accounted for as a new lease. As a result, the lease is remeasured using the discount rate as determined on the effective date of modification, being at the beginning of Year 7.

Present value of CU100,000 a year for 8 years (for Years 7 to 14) using a discount rate of 7% = CU597,130

Since the lease liability was CU346,511 immediately prior to the modification, it is increased with the difference of CU250,619 (CU597,130 - CU346,511) and a corresponding debit adjustment is made to the ROU asset. There is no impact to profit and loss.

Example 3 – Modification that decreases the scope

Lessee is party to a 10-year lease for 5,000 square meters of warehouse space. The annual lease payments are CU50,000 payable at the end of each year. The rate implicit in the lease cannot be determined readily thus Lessee's incremental borrowing rate of 6% is used. At the beginning of Year 6, Lessee and Lessor agree to halve the space being leased (i.e. to 2,500 square meters) for the remainder of the lease. As a result, the remaining lease payments reduce to CU30,000 per annum. At the beginning of Year 6, Lessee's incremental borrowing rate is 5%. Immediately prior to the lease modification, the lease liability is CU210,618 and the ROU asset is CU184,002.

Analysis:

Step 1: *Lessee determines the proportionate decrease in the carrying amount of the ROU asset. In this case, the leased warehouse space has reduced from 5,000 to 2,500 square meters resulting in a 50% reduction in space. Consequently, the carrying amounts of the ROU asset and lease liability are reduced by the relative amounts compared to their pre-modification carrying amounts. This entails reducing the ROU asset and the lease liability by CU92,001 (CU184,002 x 50%) and CU105,309 (CU210,618 x 50%) respectively. The difference between the decrease in the ROU asset and the decrease in the lease liability of CU13,308 (CU105,309 - CU92,001) is recognised as a gain in profit and loss on the date of the modification.*

Step 2: *Lessee remeasures the lease liability based on 5 years remaining, annual payments of CU30,000 and an updated incremental borrowing rate of 5%. The result is a lease liability of CU129,884. Lessee therefore increases the lease liability of CU105,309 determined in step 1 above by CU24,575 (CU129,884 - CU105,309) and increases the ROU asset with the same amount. This effectively accounts for the change in the consideration paid for the lease and the revised discount rate.*

GET IN TOUCH

We hope you found this guide helpful in navigating IFRS 16 Leases. If you would like to learn more, please contact your HLB advisor or visit https://www.hlb.global/location/ to find the nearest HLB office.

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