BDO

NEED TO KNOW

IFRS 16 *Leases*

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1. INTRODUCTION

IFRS 16 *Leases* brings significant changes in accounting requirements for lease accounting, primarily for lessees. It has been developed by the International Accounting Standards Board (IASB) to replace the existing suite of standards and interpretations on leases:

– IAS 17 *Leases*
– IFRIC 4 *Determining whether an Arrangement contains a Lease*
– SIC 15 *Operating Leases – Incentives*
– SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease.*

The IASB completed IFRS 16 in January 2016 by publishing a final standard, with significant modifications from the 2013 Exposure Draft ('ED').

This *Need to Know* sets out the final requirements in relation to the classification and measurement of leases from the perspective of lessees and lessors and compares those requirements to the previous standards, primarily IAS 17. It should be noted that the guidance relating to lessor accounting remains largely unchanged from IAS 17, therefore, the focus of this publication primarily relates to lessees, who are more broadly affected.

Those requirements are summarised as:

Lessees

All leases are recognised in the statement of financial position as a 'right of use' asset and a financial liability. There are narrow exceptions to this recognition principle for leases where the underlying asset is of low value and for leases classified as short-term in nature.

The asset is subsequently accounted for in accordance with the cost or revaluation model in IAS 16 *Property, Plant and Equipment* or as Investment Property under IAS 40 *Investment Property*. The liability is unwound over the term of the lease using an appropriate discount rate.

Lessors

The guidance relating to lessors remains substantially unchanged from IAS 17. Lessors continue to account for leases as either operating or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset.

Operating leases continue to be recorded as assets in the statement of financial position and lease income is recognised on a straight line basis over the lease term. For finance leases, a lessee is required to derecognise the underlying asset (and recognise a corresponding gain/loss on sale) and record a receivable equal to the net investment in the lease. Finance income is subsequently recognised based on a pattern reflecting a constant periodic rate of return on the remaining balance of the lease liability.

Effective date

The effective date of IFRS 16 is for annual reporting periods beginning on or after 1 January 2019. There is a choice of full retrospective application, or retrospective application without restatement of prior year comparatives with the cumulative impact of the adoption being recorded in the opening balance of equity.

Early adoption of IFRS 16 is permitted, but entities electing to do so must also apply IFRS 15 *Revenue from Contracts with Customers* at the same time.

IFRS 16 has not been endorsed for use in the European Union (EU) and therefore cannot be early adopted by entities that report in accordance with EU-endorsed IFRS. The European Financial Reporting Advisory Group (EFRAG) is currently scheduled to issue its endorsement advice in the second half of 2016, with EU-endorsement during 2017.

2. BACKGROUND

Research projects by the IASB regarding revisions to lease accounting date back to 1996, but the most relevant research into the standard setting process that would ultimately yield IFRS 16 commenced in 2006.

Research done by the IASB and their US counterpart, the FASB, determined that the current standards for leasing (particularly for lessees) drew arbitrary lines between operating ('off balance sheet') and finance/capital ('on balance sheet'), as the existing guidance was interpreted as creating 'bright line' rules that lessees and lessors used to structure leases.

To avoid recognition in financial statements, lease agreements were being written to avoid finance lease classification by lessees. This resulted in situations where two leases were nearly identical in every way except one was for an insignificantly longer period of time than the other, but resulted in a different accounting treatment.

Additionally, off balance sheet treatment created significant differences in financial reporting for entities that opted to purchase assets as opposed to entities that leased them, when both situations yielded common financial realities; the conveyance of the use of an asset in exchange for consideration.

In the boards' research, they also determined that many users of financial statements were already making adjustments to IFRS compliant financial statements to capitalise off balance sheet lease commitments. For example, many lending institutions were adjusting property plant and equipment and financial liabilities by an approximate figure using the lease commitments as disclosed in an entity's financial statements. This practice illustrated to the boards the need to reconsider lease accounting standards, especially considering that based on the boards' review of this estimation technique, financial statement users were generally overstating financial liabilities.

The IASB and FASB decided to initiate a joint project to develop improvements to lease accounting. In 2010, the boards issued a joint exposure draft, which proposed significant changes, many of which are similar in principle to the final standard, but contained additional operational complexity.

The boards received significant comments from constituents about the (lack of) practicality of certain aspects of the proposed standard, and therefore issued a revised exposure draft in 2013. The exposure draft aimed to simplify some of the operational complexity found in the 2010 ED by introducing Type A and B lease classifications and also included material changes to the lessor model, however, this was criticised by constituents as creating arbitrary distinctions between leases and becoming too distant from the underlying goal of improving consistency in lease accounting. Furthermore, the comments received indicated that the existing lessor model was satisfactory and did not need to be changed.

In January 2016, the IASB issued the final version of IFRS 16, which retains certain aspects of both the 2010 and 2013 EDs.

While this project was started as a harmonised process between the IASB and the FASB, ultimately the FASB's standard diverged from the IASB's in that the FASB's standard retains a distinction for leases from the perspective of the lessee, classifying them into distinct categories with different accounting requirements.

3. SCOPE

The scope of IFRS 16 is broadly similar to IAS 17 in that it applies to contracts meeting the definition of a lease (see Section 4.), except for:

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

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

(c) Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*;

(d) Licences of intellectual property granted by a lessor within the scope of IFRS 15 *Revenue from Contracts with Customers*; and

(e) Rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

3.1. Recognition Exemptions

Notwithstanding the scoping defined above, a lessee can elect not to apply the initial and subsequent recognition and measurement requirements discussed in subsequent sections to:

(a) Short-term leases; and

(b) Leases for which the underlying asset is of low value ('low value leases').

The short-term lease exemption must be applied consistently by class of underlying asset (ie similar classes of leased assets must use the short-term exemption if it is elected by an entity), but the low value lease exemption may be applied on a lease-by-lease basis.

If an entity applies either exemption, it must disclose that fact and certain information to make the effect of the exemption known to financial statement users (see Section 8. – Disclosure).

Short-term Leases

Short-term leases are defined as '*leases that, at the commencement date, have a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.*'

BDO comment

This exemption simplifies the application of the standard for short-term leases significantly.

It is important to note that the definition of a short-term lease uses the defined concept of 'lease term' within IFRS 16 (see Section 5. for detailed discussion of this term). That is, the lease term must include reasonably certain options to extend or terminate a lease. This means that it is not possible to, say, design a lease contract with an 11 month, 29 day term, with subsequent 11 month, 29 day term extensions and achieve 'off balance sheet' treatment if the extension terms are reasonably certain to be executed by the lessee.

The assessment of 'low value' for a lease is to be made on the basis of when the asset itself is new, regardless of whether the actual asset being leased is new. Additionally, the assessment is to be made regardless of whether the lease is material to the particular lessee. This guidance is meant to achieve the goal that different lessees should reach the same conclusions relating to underlying assets, regardless of their size, nature or circumstances.

An underlying asset in a lease can be of low value only if:

(a) The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and

(b) The underlying asset is not highly dependent on, or highly interrelated with, other assets.

IFRS 16 provides examples of low value leases, which include tablets and personal computers, and small items of office furniture and telephones.

BDO comment

The standard itself does not provide much in way of guidance to assist in assessing what 'low value' means. Examples are provided to allow preparers to analogise the relative cost of potential assets against those disclosed, but this may become problematic in the future as assets become more or less expensive due to technological advancement, which may increase the functionality of equipment and/or decrease its cost. The Basis for Conclusions to the standard notes the value of $5,000 US as being an amount the IASB had in mind when finalising IFRS 16 towards the end of 2015, but this was not included in the standard itself.

It's important to note that the intention of IFRS 16 is that this definition be applied consistently to assets, regardless of the lessee's size and nature. This fact is illustrated in the following two examples.

Example 1 – Low Value Lease Assessment

Entity A is a large, multi-national technology company with approximately CU 10 billion in its annual operating budget. It enters into a contract to lease one floor of an office building in a major city in Central America for total lease cost of CU 50,000 a year for five years. The operations of the facility and the lease cost are immaterial to Entity A.

Assessment

Despite the fact that the lease is clearly immaterial to Entity A (it represents 0.0005% of the annual operating budget), a floor of an office building is not generally considered to be of 'low value' on an absolute basis. Additionally, analogising its cost to the cost of items provided in IFRS 16 as items meeting 'low value' criteria such as telephones and laptops, shows that the cost is clearly much more significant. Therefore, the lease does not meet the low value lease exemption.

Example 2 – Low Value Lease Assessment

A lessee in the pharmaceutical manufacturing and distribution industry 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.

Assessment

The 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.

The lessee elects to account for these leases using the low value exemption.

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. The lessee would not lease the modules without also leasing the servers.

4. IDENTIFYING A LEASE

As all leases (except for the limited exceptions described in Section 3.) will be recorded 'on balance sheet', a key test for contracts is now whether they meet the definition of a lease in IFRS 16:

> **'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.'**

* *Note: a period of time may also be described in terms of an amount of use of an asset (e.g. Number of production units that a piece of machinery will produce).*

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

Separation of Lease Components

For contracts that are themselves leases or contain a lease component, an entity is required to account for each lease component within the contract as a lease separately from non-lease components.

A lessee may apply a practical expedient by class of underlying asset, and ignore the requirement to separate non-lease and lease components and account for the entire contract as a single lease component (for example, the lease of an item together with its maintenance during the lease term). This practical expedient cannot be applied to embedded derivatives within the scope of IFRS 9.

If this practical expedient is not utilised, a lessee must allocate consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components.

Combining Contracts

It may be necessary to combine two or more contracts together to assess whether the combined transaction constitutes a lease. Multiple legal agreements may be entered into at or near the same time with the same counterparty or related parties of the counterparty. Combination of contracts is required when:

(a) The contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together;

(b) The amount of consideration to be paid in one contract depends on the price or performance of the other contract; or

(c) The rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component.

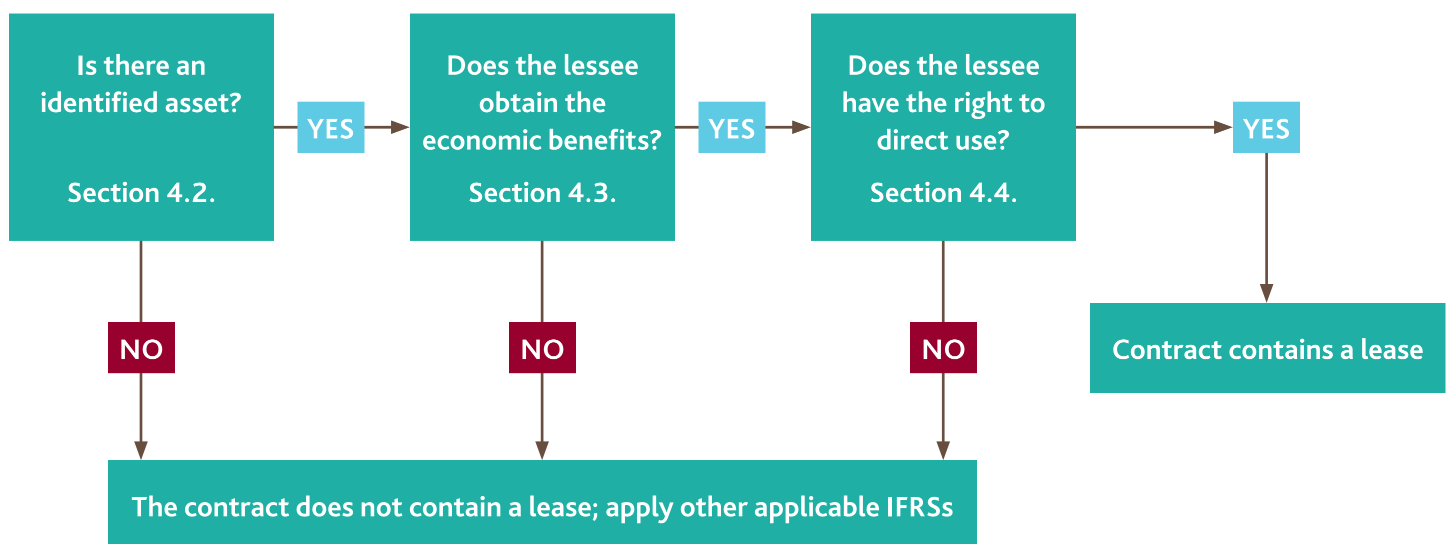
Portfolio Practical Expedient

IFRS 16 is written in the context of accounting for an individual lease. However, as a practical expedient, an entity may apply IFRS 16 to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the standard to the portfolio would not differ materiality from applying the standard to the individual leases within the portfolio. If it accounts on a portfolio basis, an entity must make estimates and assumptions that reflect the size and composition of the portfolio.

4.1. Applying the Definition of a Lease

IFRS 16 provides new guidance on the evaluation of a contract to determine whether it contains a lease. This replaces guidance previously found in IAS 17, IFRIC 4 and SIC 27. In most cases, the determination of whether contracts give rise to a lease will remain consistent upon adoption of IFRS 16, but entities must perform an analysis of the relevant facts and circumstances as IFRS 16 contains more guidance than the previous standards.

In applying the definition of a lease, there are several criteria that must be met, as illustrated below (refer to the referenced section of this *Need to Know* for further discussion):



4.2. Identified Asset

Substitution Rights

In many situations, it may be clear that a lease contains an identified asset. An asset can also be implicitly specified at the time it is made available for use by the lessee.

It is also possible for a contract to specify an asset, while at the same time the lessor retains a **substantive right to substitute** the asset throughout the period of use. In such cases, the 'specified asset' criterion would not be met and the contract would not contain a lease. A supplier's right to substitute an asset would be substantive if both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use; and
- The supplier would benefit economically from the exercise of its right to substitute the asset.

BDO comment

It is important to note that both of the above criteria must be satisfied for a supplier's substitution right to be substantive. Some contracts contain clauses where a lessor has the right to substitute an asset, but unless the lessor has a compelling reason to exercise this right, it is not substantive. In such a case, the substitution right may be protective in nature to ensure the supplier's interest in the asset is maintained.

In situations where the asset is located at the lessee's premises or elsewhere away from the lessor, the cost to substitute the asset may outweigh any perceived benefit to the lessor.

In addition, it is noted that a supplier's right to substitute an asset for the purposes of repairs or maintenance, if the asset is not operating properly, or is to be upgraded when a technical update becomes available, does not eliminate the lessee from having a right to an identified asset.

In situations where it is not readily determinable whether a supplier has substantive substitution rights, a lessee is required to presume that any substitution right is not substantive.

BDO comment

The requirement in the standard that requires lessees to conclude that substitution rights are non-substantive in situations where it is unclear can be seen as an indication that in many situations, substitution rights will not be substantive in nature.

Example 3 – Lease of Rail Cars

A 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 a period of five years. The timetable and quantity of goods specified are equivalent to customer having the use of 10 rail cars for five years. Supplier provides the rail cars, driver and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods). Supplier has a large pool of similar cars that can be used to fulfil the requirements of the contract. Similarly, supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored at supplier's premises when not being used to transport goods.

Assessment

The supplier's substitution rights in this example are substantive because:

(a) The supplier has the practical ability to substitute the rail cars;

(b) The supplier would benefit economically from substituting the cars because there is a large pool of them available and they are stored at the supplier's premises. Potential benefits to the supplier are deploying the cars to a nearby location as they are stored on premises or to use cars that are sitting idle because they are not currently being used by the customer.

Portions of Assets

A capacity portion of an asset may be an identified asset if it is physically distinct (e.g. a floor of a building). A capacity portion of an asset that is not distinct (e.g. a specified capacity of fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset. In this latter situation, the customer in essence has the right to obtain substantially all of the benefit from the underlying asset itself.

Example 4 – Fibre Optic Cable

A customer enters into a 15-year contract with a supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong and Tokyo. The specified amount is equivalent to the lessee having the full capacity of three fibre strands within a 15 strand cable. The supplier makes decisions about the transmission of data (i.e. Which fibres are used to transmit the lessee's traffic).

Assessment

The contract does not contain a lease as the capacity specified is not physically distinct and it does not represent substantially all of the underlying asset as the capacity is 20% of the total capacity of the cable. If the contract specified an amount of capacity equivalent to say, 90% of the total cable, the contract would contain a lease since the lessee would be obtaining substantially all of the benefit from the underlying asset.

BDO comment

The requirement that a portion of an asset can meet the identifiability requirements can be seen as a potential 'anti-avoidance' provision of the standard. Without this provision, a contract could be written to specify a portion of use of an asset that is so significant that it essentially transfers the entire usage of the asset, but (absent the 'portion' requirement) it would not meet identifiability criteria.

4.3. Obtaining Economic Benefits

The next element analysed in determining whether a customer controls the use of an identified asset is whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use.

Ways that this may be demonstrated include having exclusive use of the asset throughout the period of the contract or by sub-leasing the asset.

Economic benefits from use of the asset include its primary outputs (e.g. finished goods for a manufacturer to sell) and by-products, including potential cash flows that derive from these items.

Example 5 – Obtaining Economic Benefits with Outputs Flowing to Supplier

A customer enters into a contract with a supplier for the lease of retail space in a shopping centre for 5 years. The lease payments are based on a 20% of the gross sales of the store. The customer has the right to determine which products are to be sold, the design of the store, etc.

Assessment

A requirement for a customer to provide a portion of the output of the asset (e.g. In this case, cash flows derived from the operations of the retail space) does not mean that the customer is not obtaining substantially all of the economic benefits associated with the asset. Such requirements are common in retail real estate. In this case, such cash flows are considered economic benefits that the customer obtains and then uses to pay the supplier as consideration for the right to use the asset. The customer is obtaining these benefits, despite the obligation to pay them to the supplier, because the cash flows are derived from activities that the customer controls.

When determining whether a contract conveys the right to obtain substantially all of the economic benefits from an asset, a quantitative assessment may be required. In assessing a customer's right to receive economic benefits from an underlying asset, the assessment should be made based on the asset's use within the defined scope of the contract. For example:

- If a contract limits the use of a vehicle to only a particular geographic area, an entity assesses only the economic benefits from use of the motor vehicle within that territory.
- If a contract specifies a machine can only be utilised during specific times of the day, an entity assesses only the economic benefits from use of the machinery during that time of the day.

Example 6 – Obtaining Economic Benefits

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. That the energy must be produced from this particular facility is specified in the contract and the supplier does not have substantive substitution rights. The supplier received tax incentives from various levels of government for building the facility as it produces clean, renewable energy.

Assessment

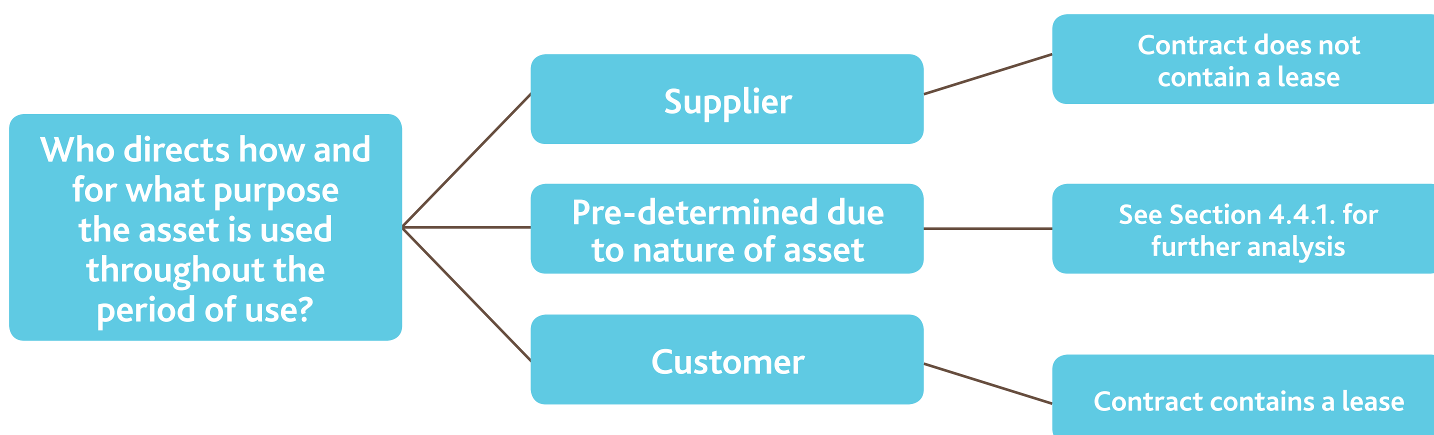
The contract transfers to the customer the right to obtain substantially all of the economic benefit from use of the underlying asset (the power plant) because:

- The power plant is specified in the contract and there are no substitution rights; and
- The customer has exclusive use of the primary product of the facility (i.e. the electricity).

Note that while the supplier realises benefits in the form of tax incentives, these are based on the ownership of the asset from a legal perspective, and not its use. Therefore, these tax incentives should be disregarded.

4.4. Right to Direct Use of the Asset

In assessing whether a customer has the right to direct the use of an asset throughout the period of use, further analysis needs to be carried out:



A customer has the right to direct how and for what purpose an asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. Certain decision making rights are clearly more relevant than others. Those that affect the economic benefits (as earlier outlined in Section 4.3.) derived from use of the asset are the most relevant.

Examples of decision-making rights that may grant a customer the right to change how and for what purpose an asset is used (depending on the circumstances), include:

- Rights to change the type of output that is produced by the asset (e.g. What type of food certain food processing equipment produces);
- Rights to change when the output is produced (e.g. the regular operating hours for equipment);
- Rights to change where the output is produced (e.g. the physical location of machinery or destinations and routes for transport equipment); and
- Rights to change whether the output is produced, and the quantity of the output (e.g. to decide whether to produce energy from a power plant and how much energy to produce).

Decision-making rights relating solely to maintenance or operational activities are generally not substantive.

BDO comment

The guidance on determining who has the right to direct the use of the asset is focused on control. This is consistent with the IASB's continued focus in its more recent standards on control being a primary element in determining whether transactions qualify for recognition under various standards and situations such as subsidiaries under IFRS 10 and revenue recognition under IFRS 15.

Example 7 – Supplier Directs Use

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. That the energy must be produced from this particular facility is specified in the contract and the supplier does not have substantive substitution rights. The supplier received tax incentives from various levels of government for building the facility as it produces clean, renewable energy. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer. Customer had no involvement in that design.

Assessment

The contract does not contain a lease. There is an identified asset (the power plant), the supplier does not have substitution rights, and the customer will obtain substantially all of the economic benefit from the asset over the contract term as it is acquiring 100% of the electricity produced. However, the customer does not have the right to control the use of the power plant because it does not have the right to direct its use during the contract term. The supplier is the only party able to make relevant decisions about the underlying asset and the customer had no part in designing the asset.

See Example 8 for an illustration of the effect that a customer having designed the underlying asset has in this assessment.

4.4.1. Relevant Decisions are Pre-Determined

Based on the nature of an asset, many relevant decisions about how and for what purpose an asset will be used are pre-determined.

For an asset where the relevant decisions are pre-determined, the contract contains a lease if:

(a) 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

(b) 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.

BDO comment

Assets that may fall into this situation are those that are:

- *Technologically advanced such that they are designed for highly specific purposes;*
- *Costly to modify or repurpose for other functions or uses; and/or*
- *Restricted based on regulation or law.*

An entity is only permitted to include in its analysis decision-making ability that will occur during the term of the lease, except in the situation described in (b) above where the customer designed the asset itself. In such a situation, an entity would consider what elements were essentially pre-determined by the decisions made prior to the asset being completed.

Example 8 – Pre-determined Functionality

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. That the energy must be produced from this particular facility is specified in the contract and the supplier does not have substantive substitution rights. The supplier received tax incentives from various levels of government for building the facility as it produces clean, renewable energy. The customer designed the bio-mass facility before it was constructed by hiring experts in the field to assist in determining the location of the facility and the engineering of the equipment to be used. The supplier is responsible for building the facility to the customer's specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

Assessment

In assessing the 'right to direct use of asset' criterion, the functionality of the facility is predetermined based on its design, and those predeterminations were made by the customer, therefore, the criterion is met.

5. DETERMINING THE LEASE TERM

In determining the period over which to account for a lease, the lease term needs to be determined.

The lease term includes the following:

(a) The non-cancellable period of the lease (Section 5.1.);

(b) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option (Section 5.2.); and

(c) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option (Section 5.2.).

The lease term begins at the commencement date (i.e. the date on which the lessor makes the underlying asset(s) available for use by the lessee) and includes any rent-free or reduced rent periods provided to the lessee by the lessor.

The meaning of these components of the lease term is elaborated below.

5.1. Non-cancellable Period

The non-cancellable period of a lease is as defined in the contract. It is the period under which the terms of the contract are enforceable until both the lessee and lessor each have the right to terminate the contract or the term ceases.

Only extension and termination options held by the lessee are considered when determining the lease term. If a lessor has termination rights, the non-cancellable period of the lease includes the period of time covered by this lessor termination option.

BDO comment

The standard requires a lessee to assume that a lessor will continue to enforce a contract over a period of time in which the lessor has the sole, unilateral right to terminate the contract. Requiring a lessee to make assumptions concerning the likelihood of having the lease contract terminated early by the lessor would require an entity to make significant assumptions surrounding the intentions and economic conditions of lessors, for which lessees often have limited information available to them.

5.2. Extension and Termination Options

A lessee must assess the likelihood of it either exercising or failing to exercise options that exist in a lease contract, which are common in many types of leases. Factors that would be considered in this assessment include, but are not limited to:

(a) Contractual terms and conditions for the optional periods compared with market rates, such as:
   i. The amount of payments for the lease in any optional period;
   ii. The amount of any variable payments for the lease or other contingent payments;
   iii. The terms and conditions of any options that are exercisable after initial option periods (e.g. example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

(b) Significant leasehold improvements or other improvements made to underlying assets that are expected to have a significant benefit to the lessee when options become exercisable;

(c) Costs relating to the termination of the lease (e.g. negotiation, relocation, and search costs, installation and setup costs for new assets, termination penalties or costs to return an underlying asset at the end of the lease term);

(d) The importance of an underlying asset to the lessee's operations (e.g. whether the underlying asset is highly specialised, the location of the asset and the available of suitable alternatives); and

(e) Conditionality associated with the exercise option (i.e. when the option can be exercised only if one or more conditions are met) and the likelihood that those conditions will be met.

A lessee's past practice with leases, particularly leases of similar assets, should be considered in determining the likelihood of options being utilised. The reason for a lessee utilising options may not be apparent from any single criterion, but may relate to synergies and a weighting of several reasons that must be considered in aggregate.

Example 9 – Assessment of Lease Term

Customer is considering entering into a lease for a piece heavy machinery to manufacture widgets.

The lease has a 5 year term, with 2 optional terms to extend the lease for an additional 2 years each at the option of the lessee. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation is included over the optional extension term.

Customer operates in a remote location where the cost of shipping and installation for pieces of equipment are significant.

Assessment

Customer lacks a direct, contract-specific incentive to extend the lease given that lease payments are at a market rate throughout the period of the lease, however, entity specific factors must be considered. Customer operates in a remote location, which inherently increases the cost of not extending the lease for a key piece of equipment that it needs to operate its business due to installation and transportation costs (see factor (c) above).

To conclude on the assessment of the lease term, Customer should also consider its past experience with these types of leases and other factors. This Example illustrates that entity-specific factors must be considered in determining the lease term, such that two lessees may determine different lease terms on identical lease contracts.

5.3. Revisions to the Lease Term

See Sections 6.6. and 6.7. for discussion of the measurement implications for reassessments to leases that have already been recognised in an entity's financial statements. This may be required if the entity's estimate of original lease term changes or if the underlying contract term is modified.

Reassessment of Original Estimate

Changes in the originally assessed lease term may occur due to unforeseen circumstances such as a change in an entity's intentions, the entity's business practice, unforeseen modifications or customisations to underlying lease assets, etc.

A lessee is required to reassess the likelihood of it exercising or failing to exercise options upon the occurrence of an event or a change in circumstances that:

(a) Is within the control of the lessee; and

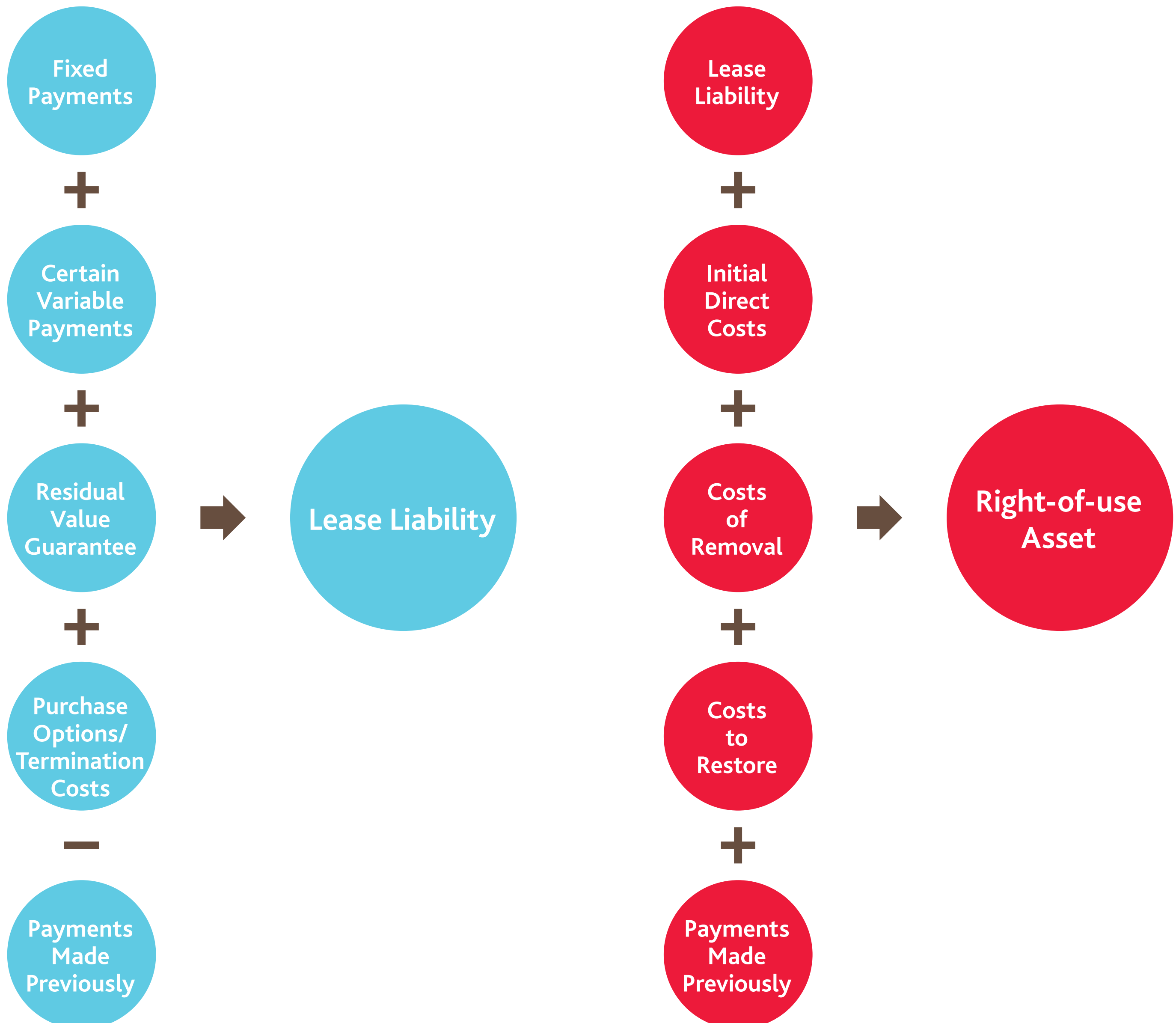
(b) Affects whether the lessee is reasonably certain to exercise an option not previously included in the determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

Remeasurements due to Revisions to the Lease Contract

The lease term may be modified if the lessee and lessor agree to amend it legally in the underlying contract. This also requires remeasurement of the lease liability and right-of-use asset.

6. RECOGNITION AND MEASUREMENT

At the commencement date of a lease, the lease liability and right-of-use asset comprise:



6.1. Lease Liability – Initial Recognition

As outlined in the illustration above, the initial measurement of the lease liability has several components. All components of the liability are added together and discounted at an appropriate rate (see Section 6.2.). The following components are included, to the extent that they arise over the lease term (as defined in Section 5.):

Fixed Payments

These include the set payments outlined in the lease contract, less any lease incentives receivable from the lessor. Some payments may be structured in a way such that they appear to have variability, but based on their nature or circumstance, are unavoidable and therefore are 'in-substance fixed lease payments'.

In-substance fixed lease payments may take several forms:

- Payments being based on a presumed underlying assumption (e.g. that a leased asset will have to operate during the period);
- Payments structured as containing bona fide variable components, where the variable component will be resolved during the term of the lease (e.g. payments that becomes fixed once the lessee's base level of use of the asset has been established in the first year). Such payments become in-substance fixed payments when the variability is resolved;
- There is more than a single set of potential payments a lessee may have to make, but only one option is realistic;
- There is more than a single set of potential payments, but at least one must be made. In this case, the minimum (on a discounted basis) payments are the fixed lease payments.

Variable Payments

Variable lease payments can take multiple forms. They may be indexed to a rate such as inflation, LIBOR or the consumer price index, or be linked to the performance of the asset itself (e.g. a percentage of store sales for a retail space lease in a shopping centre).

The treatment of variable lease payments is summarised as:

Variable payments that depend on an index or a rate	– Include in the initial measurement of the lease using the index or rate as at the commencement date. – Remeasure lease in the period the rate or index changes (see Section 6.6.).
In-subtance fixed payments	– Include in the initial measurement of the lease. – Remeasure the lease in the period in-substance fixed payments are changed or are resolved (see Section 6.6.).
Other variable payments	– Do not include in the initial measurement of the lease. – Recognise in profit or loss (or in the carrying value of another asset as required by another Standard) when the event or condition that triggers the payments occur.

Example 10 – Variable Lease Payments that Depend on an Index or Rate

Year One – Beginning of Lease

Lessee enters into a 10-year lease of property with annual lease payments of CU 50,000, 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. The rate implicit in the lease is not readily determinable. (Note: This example ignores any initial direct costs.)

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 CU 50,000, discounted at the interest rate of 5 per cent per annum, which is CU 355,391.

Assessment

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

Dr		Right-of-use asset	CU 405,391		
	Cr	Lease liability		CU 355,391	
	Cr	Cash		CU 50,000	(lease payment for the first year)

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.

Dr		Interest expense	CU 33,928		
	Cr	Lease liability		CU 33,928	
Dr		Depreciation charge	CU 81,078		(CU 405,391 ÷ 10 × 2 years)
	Cr	Right-of-use asset		CU 81,078	

Example 10 – Variable Lease Payments that Depend on an Index or Rate (continued)

Year Three

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 CU 339,319 (the present value of eight payments of CU 50,000 discounted at the interest rate of 5 per cent per annum = CU 355,391 + CU 33,928 (interest for years 1 and 2) – CU 50,000 (lease payment made at the start of year 2)).

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 CU 54,000 (CU 50,000 × 135 ÷ 125).

Assessment

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 CU 54,000.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of CU 54,000 discounted at an unchanged discount rate of 5 per cent per annum, which is CU 366,464. Lessee increases the lease liability by CU 27,145, which represents the difference between the remeasured liability of CU 366,464 and its previous carrying amount of CU 339,319. The corresponding adjustment is made to the right-of-use asset, recognised as follows:

Dr		Right-of-use asset	CU 27,145	
	Cr	Lease liability		CU 27,145

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

Dr		Lease liability	CU 54,000	
	Cr	Cash		CU 54,000

BDO comment

The Basis for Conclusions to IFRS 16 notes that the IASB considered whether the standard should require entities either to forecast an estimate of what the index or rate will be over the life of the lease or to use the index or rate in effect as of the commencement date as a benchmark for the life of the lease if the lease contained an inflationary clause (e.g. 1.5% inflation assumed each year if that was the inflation rate as of the commencement date). Ultimately, the IASB rejected both of these proposals as they could require lessees to make estimates using macroeconomic data that may not be available and the costs may outweigh the benefits to users of the statements. Therefore, the final standard does not require a lessee to estimate future rates (e.g. inflation) but, instead, it requires the lessee to measure lease liabilities using lease payments that assume no inflation over the remainder of the lease term.

Changes in the underlying rate used to index lease payments could result in significant remeasurements to lease contracts and this remeasurement may need to occur annually. Long-term real estate leases often contain lease escalations linked to indexes such as the consumer price index or inflation rates posted by government agencies.

The lease liability and right-of-use asset may need to be remeasured if rates change.

Under current standards, changes in underlying rates and indexes are often reflected in profit or loss as they occur, therefore, this will be a significant change for many entities.

See Section 6.6. for the requirements relating to remeasurement regarding changes to variable lease payments.

Example 11 – Variable Lease Payments not included in the Initial Measurement of the Lease

Assume the same facts as Example 10 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.

Lessee prepares financial statements on an annual basis. During the first year of the lease, Lessee generates sales of CU 800,000 from the leased property.

Assessment

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in Example 10. This is because the additional variable lease payments are linked to future sales and, thus, do not meet the definition of lease payments (i.e. they are not linked to a rate or index as required by the standard). Consequently, those payments are not included in the measurement of the asset and liability.

Dr		Right-of-use asset	CU 405,391		
	Cr	Lease liability		CU 355,391	
	Cr	Cash		CU 50,000	(lease payment for the first year)

Lessee incurs an additional expense related to the lease of CU 8,000 (CU 800,000 × 1 per cent), which Lessee recognises in profit or loss in the first year of the lease.

Dr		Profit or loss	CU 8,000	
	Cr	Accounts payable		CU 8,000

Residual Value Guarantees

Some leases contain requirements for a lessee to guarantee the value of an asset at the time it is returned to the lessor. These are included to create incentive for the lessee to maintain the asset properly and provide regular maintenance and upkeep. Any amounts that a lessee expects to be required to pay for residual value guarantees are included in the lease liability.

Purchase and Termination Options

Amounts that a lessee expects to pay to either purchase an underlying asset or to terminate a lease by exercising a termination option included in the lease term assessment are included in the lease liability.

BDO comment

Determining whether a lessee will exercise a purchase option at the end of a lease term may have a significant impact on the lease liability and right-of-use asset recognised in the financial statements.

The amount of judgement involved in this assessment is especially high for lease contracts with a significant period, as uncertainties and assumptions inherently increase when the period of time covered by forecasts increases.

6.2. Discount Rate on Initial Recognition

All the components of the lease liability as described in Section 6.1. are required to be discounted to reflect the expected timing of the payments. The rate is required to be the rate implicit in the lease, unless it cannot readily be determined, in which case the lessee's incremental rate of borrowing is to be used.

BDO comment

The rate implicit in the lease would be the rate that would cause the present value of the lease payments and unguaranteed residual to equal the sum of the fair value of the underlying asset(s) and initial direct costs incurred. Using the implicit rate presents the true financing cost of leasing an asset as opposed to paying for it up-front or buying it outright without financing.

The implementation simplification of allowing the incremental rate of borrowing to be used if the implicit rate cannot readily be determined acknowledges the fact that the implicit rate is often not determinable to a lessee. A lessor often does not disclose the rate in the contract, or may offer a rate as being promotional (e.g. below market interest rates, when the lessor ultimately charges above-market lease rates instead).

Many lessees may end up using their internal rate of borrowing for a wide variety of leases as the rate is likely to be relatively easy to obtain. In this case, the rate used should reflect the incremental rate of borrowing for a lessee in the same currency, with similar terms such as collateral and for a similar period of time.

6.3. Right-of-Use Asset – Initial Recognition

The right-of-use asset's value is initially linked to the calculated value of the financial liability with several additional adjustments.

Initial Direct Costs

These are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained. These might include costs such as finder's fees, commissions to agents for establishing the lease and up-front fees.

BDO comment

It is important to note that the standard emphasises that direct costs must be 'incremental'. This precludes an entity from making an allocation of administrative costs relating to obtaining a lease, such as a portion of finance and management salaries. Such costs would not be incremental as they would incurred regardless of whether an entity enters into a specific lease.

Removal and Restoration Costs

Some leases contain requirements for lessees to return assets in a specified condition, such that the lessee would be required to incur costs to restore it. Certain types of assets may also have significant transportation and removal costs to return them to the lessor as specified in the lease agreement.

These types of obligations may be incurred at the commencement date of a lease or as a consequence of using an underlying asset.

BDO comment

Leases of premises often require that lessees return them to a specified state upon the termination of the lease. For example, a manufacturing lessee may install significant amounts of equipment and customised leasehold improvements in a factory it leases, with these items being required to be removed at the end of the lease term.

Example 12 – Initial Recognition of a Lease

Entity Z (the lessee) enters into a 10-year lease of a floor of a building, with an option to extend for 5 years. Lease payments are CU 50,000 a year during the initial term and CU 55,000 per year during the optional period, all payable at the beginning of each year. To obtain the lease, lessee incurs initial direct costs of CU 20,000 (CU 15,000 to the former tenant occupying the floor and CU 5,000 for real estate commissions). The lessor agrees to reimburse the lessee the real estate commission of CU 5,000 and provide CU 7,000 for leasehold improvements.

At the commencement date, the lessee concludes that it is not reasonably certain to exercise the option to extend the lease. Therefore the lease term is 10 years.

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

Assessment

The entries required to record this transaction are as follows (see corresponding superscripts for notes reconciling each component of the entry):

To record the initial value of the lease asset and liability:

Dr		Right-of-use asset	CU 405,391[1]		
	Cr	Lease liability		CU 355,391[2]	
	Cr	Cash		CU 50,000	(cash paid up front)

[1] PV of 9 payments at CU 50,000, discounted at 5% + CU 50,000 (initial payment made up front).

[2] PV of 9 payments at CU 50,000, discounted at 5%.

To record the initial direct costs:

Dr		Right-of-use asset	CU 20,000		(cash paid)
	Cr	Cash		CU 20,000	

To record lease incentive relating to the lease:

Dr		Cash	CU 5,000		(cash received)
	Cr	Right-of-use asset		CU 5,000	

Note that the CU 7,000 received for leasehold improvements is not included in the lease accounting because costs incurred on leasehold improvements by the lessee are not included within the cost of the right-of-use asset.

BDO comment

Under IAS 17 and SIC 15 Operating Leases – Incentives, the CU 7,000 provided to the lessee for leasehold improvements would have been accounted for as a leasehold inducement and therefore recognised over the lease period.

Under IFRS 16, since the leasehold improvements do not form part of the right-of-use asset, the payment received by the lessor to acquire them is not included as a component of the lease accounting.

6.4. Lease Liability – Subsequent Measurement

Interest on the lease liability is recognised in profit or loss, unless it is included in the carrying amount of an asset as required by another standard.

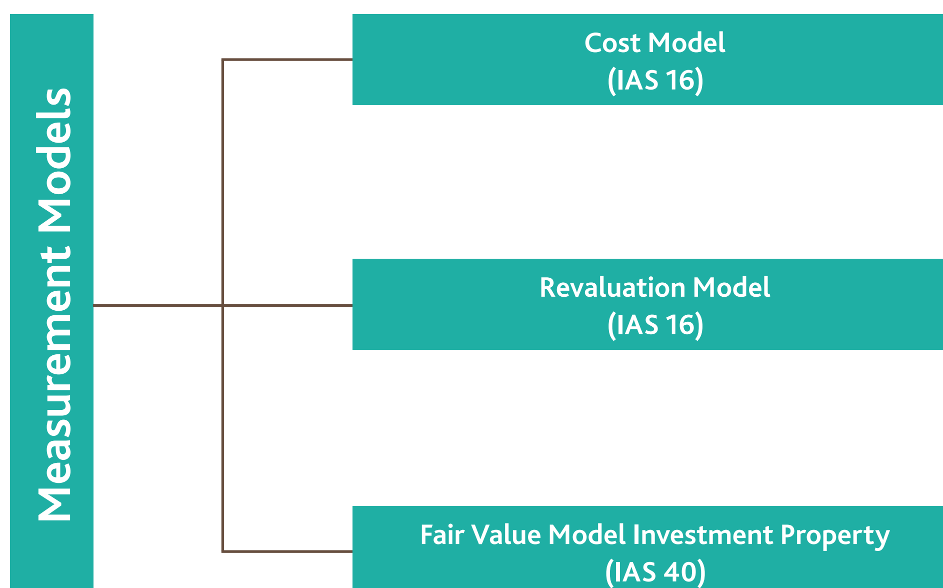
BDO comment

Situations where interest on lease liabilities may be capitalised into the cost of other assets include:

- *The production of inventory utilising leased equipment;*
- *The construction of property plant and equipment where leased assets are a component of the construction; and*
- *The development of intangible assets where leased assets are a component of the directly identifiable costs to obtain or develop intangible assets.*

6.5. Right-of-Use Asset – Subsequent Measurement

Subsequent to initial recognition, an entity may apply three potential models to account for right-of-use assets, depending on accounting policy choice and facts and circumstances:



BDO comment

It is important to note that while IFRS 16 references other standards for guidance on subsequent measurement (IAS 16 and IAS 40), it does not state or require that the underlying asset in the lease contract meets the definition of these standards (e.g. a right-of-use asset could be accounted for using the cost model in IAS 16 without meeting the definition of an item in the scope of IAS 16).

Right-of-use assets appear to be a distinct class of assets, however, they often exhibit similar characteristics to assets within the scope of other IFRSs.

Cost Model

To follow the cost model, an entity measures a right-of-use asset at cost:

(a) Less accumulated amortisation and accumulated impairment losses (recognised in accordance with IAS 36); and

(b) Adjusted for remeasurements (see Sections 6.6. and 6.7.)

In determining the relevant time period to calculate amortisation expense, an entity uses the lease term as determined in the initial recognition calculation, unless the initial recognition contemplates purchase options being utilised or the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. In those cases, the period of time to utilise is the useful life of the asset.

Revaluation Model

If right-of-use assets relate to a class of property, plant and equipment that an entity applies the revaluation model to under IAS 16, a lessee may elect to also apply the revaluation model to right-of-use assets of the same class. An entity must be consistent in its classification of a class of right-of-use assets.

BDO comment

The option to apply the revaluation model for right-of-use assets offers the potential for asymmetry in that an entity is not required to apply the model to leased assets of the same class; it is optional.

Therefore, an entity may have a group of owned assets (e.g. heavy machinery) where it applies the revaluation model, but a group of leased assets of the same type where it applies the cost model.

Fair Value Model

If an entity applies the fair value model in IAS 40 *Investment Property*, the same classification must also be applied to right-of-use assets that meet the definition of investment property.

BDO comment

In contrast to the revaluation model where its use is optional, the fair value model ***must*** *be applied to right-of-use assets meeting the definition of investment property where a lessee also applies the fair value model to owned investment property. Conceptually, this eliminates measurement inconsistencies on assets that are classified by their use (e.g. investment property), rather than the nature of the underlying asset itself (e.g. property, plant and equipment classes).*

6.6. Remeasurement of Leases

An entity's assessment of its lease liabilities and right-of-use assets may need to be revisited if certain events occur that modify the originally assessed assumptions used to calculate the lease balances upon initial recognition.

The situations set out below would result in remeasurement of lease liabilities and right-of-use assets. An entity recognises the effects of these remeasurements as an adjustment to the carrying value of the lease liability and right-of-use asset as at the time of remeasurement; prior period figures are not adjusted. If the carrying value of the right-of-use asset is less than the amount of an adjustment, the carrying value is reduced to zero with any further reductions being recognised in profit or loss.

Lease modifications arise when there is a change in the legal form of the lease agreement. The accounting for lease modifications is addressed in Section 6.7.

Situations requiring remeasurement and their impact are:

Situation	Impact
Change in original assessment of lease term or purchase/termination options	– Revise lease using new assumptions – Revised discount rate *
Change in estimate of residual guarantee	– Revise lease using new assumptions – Unchanged discount rate **
Change in index or rate affecting payments	– Revise lease using new assumptions – Unchanged discount rate **

* The implicit rate in the lease is to be used. If it cannot be readily determined, the lessee's incremental borrowing rate is to be used.

** The discount rate is unchanged, unless the change in lease payments results from a change in floating interest rates.

Example 13 – Remeasurement of a Lease due to Reassessment of an Option

In the sixth year of a 10-year lease, with an option to renew for another 5 years (this optional period has not been included in the initial assessment of the lease term), 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 of the combined companies. To minimise costs, Lessee (a) enters into a separate 8-year lease of another floor in the building it currently occupies 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. Entity A will then move into the new floor leased by Lessee.

Assessment

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. It accounts for the remeasurement consistently with the methodology in Example 15.

6.7. Lease Modifications

Lease modifications arise from changes to the underlying contract between the lessee and the lessor. The accounting for the modification is dependent on whether the modified terms increase or decrease the scope of the lease, and whether increases in scope require consideration commensurate with a 'standalone price' for the new scope of the lease.

Modifications – Separate Leases

A lease modification is accounted for as a separate lease if both:

(a) The modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessee would follow the previous guidance in this publication on the initial recognition and measurement of lease liabilities and right-of-use assets.

Example 14 – Lease Modification that is a Separate Lease

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

Assessment

Lessee accounts for the modification as a separate lease, in addition to 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.

BDO comment

The legal form of a lease agreement may be modified to add additional assets (eg. Additional floors of an office building being added to an existing lease contract for a single floor). In cases where the assets are added to the contract at a price commensurate with their standalone value, the modification is in essence a new lease contract and the modification is accounted for as a separate lease under IFRS 16.

Modifications – Not Separate Leases

If a lease modification fails the test above (e.g. additional assets are added, but not at a standalone price) or the modification is of any other type (e.g. a decrease in scope from the original contract), the lessee must modify the initially recognised components of the lease contract.

The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:

Decrease in scope	– Remeasure lease liability using revised discount rate * (1) – Decrease right-of-use asset by its relative scope compared to the original lease (2) – Difference between (1) and (2) recognised in P&L
All other lease modifications	– Remeasure lease liability using revised discount rate * – Remeasure right-of-use asset by same amount

* The implicit rate in the lease is to be used. If it cannot be readily determined, the incremental rate of borrowing is to be used.

The remeasurements above occur as of the effective date of the lease modification on a prospective basis.

BDO comment

IFRS 16 does not address how the adjustment to right-of-use assets should be recorded; that is, whether the adjustment should be recorded to the cost of the asset, the accumulated amortisation, or on a pro-rata basis.

However, paragraph 35 of IAS 16 Property, Plant and Equipment provides guidance on remeasurements related to the revaluation model of subsequent measurement. It provides a choice between:

(a) Adjusting the cost and accumulated amortisation on a pro-rata basis such that the difference (i.e. The carrying value of the asset) is equal to the revised carrying amount.

(b) Adjusting accumulated amortisation against the cost of the asset such that it equals the revised carrying value of the asset.

The method adopted by a lessee should be disclosed in its financial statements.

Example 15 – Lease Modification that Increases Scope

Entity A has a 10-year lease on 5,000 square metres of office space with annual payments of CU 100,000 payable at the end of each year. The rate used to discount the payments due in accordance with the lease is Entity A's incremental borrowing rate of 6% as the implicit rate is not readily determinable. At the beginning of Year 7, Entity A and the lessor amend the lease by extending it for an additional 4 years. The annual payments remain unchanged. At the beginning of Year 7, Entity A's incremental borrowing rate is 7%.

Assessment

The modification is not accounted for as a new lease as it does not convey additional assets; the area leased remains the same and it is for the same underlying property.

Therefore, the lease is remeasured using a revised discount rate (i.e. the incremental borrowing rate at the time of the modification; not the original discount rate).

The lease liability immediately prior to the modification is CU 346,511.

Present value of Years 7 - 14 (8 years), CU 100,000 a year, 7% discount = CU 597,130

Adjustment required = newly remeasured liability – previous carrying value of liability

Adjustment required = CU 597,130 – CU 346,511

Adjustment required = CU 250,619

Entry required to adjust the carrying balance:

Dr		Right-of-use asset	CU 250,619	
	Cr	Lease liability		CU 250,619

Example 16 – Lease Modification that Decreases Scope

Entity B has a 10-year lease on 5,000 square metres of office space with annual payments of CU 50,000 payable at the end of each year. The rate used to discount the payments due in accordance with the lease is Entity A's incremental borrowing rate of 6% as the implicit rate is not readily determinable. At the beginning of year 6, Entity B and the lessor agree to reduce the lease to 2,500 square metres and reduce the remaining payments to CU 30,000 a year. At the beginning of year 7, Entity A's incremental borrowing rate is 5%.

Assessment

The modification is a decrease in scope from the original contract so the lease liability and right-of-use asset must be remeasured.

The lease liability immediately prior to the modification is CU 210,618 and the right-of-use asset is CU 184,002.

The scope of the decrease in the right-of-use asset is 50%, as the leased space has decreased from 5,000 square metres to 2,500.

Present value of years 6 – 10 (5 years), CU 30,000 a year, 5% discount = CU 129,884

Entry required to adjust the carrying balances to reduce scope:

Dr		Lease liability	CU 105,309		(CU 210,618 original * 50%)
	Cr	Right-of-use asset		CU 92,001	(CU 184,002 original * 50%)
	Cr	Gain		CU 13,308	(remainder)

Entry required to adjust lease liability to ending balance:

Dr		Right-of-use asset	CU 24,575		(corresponds to liability adjustment)
	Cr	Lease liability		CU 24,575	(CU 129,884 calculated balance - CU 105,309 revised carrying value)

7. PRESENTATION

The requirements for the presentation of lease related balances and transactions are summarised as follows:

Statement of Financial Position	Statement of Profit and Loss	Statement of Cash Flows
– Right-of-use assets: separate from other assets or same line as underlying asset type and disclose. * – Lease liabilities separate from other liabilities or disclose line item.	– Interest cost with other finance costs per IAS 1. – Amortisation of right-of-use assets. **	– Cash payments of lease liabilities as financing activities. – Cash payments for interest in accordance with IAS 7's requirements for interest paid. – Short-term, low-value and variable lease payments within operating activities.

* Right-of-use assets that meet the definition of investment property are required to be grouped with investment property.

** The presentation requirements of IFRS 16 do not require separate presentation of amortisation expense of right-of-use assets in the statement of profit and loss; however, the disclosure provisions require amortisation of right-of-use assets by class, therefore, an entity may find it useful to disclose amortisation of right-of-use assets separately on the face of the primary statement.

BDO comment

The presentation requirements may shift key metrics for entities significantly. EBITDA (earnings before interest, taxes, depreciation and amortisation) is often a key measure of short-term profitability for many industries and entities.

The timing of overall expenses being recognised in profit and loss will also change. See the example below for the effect on an entity for a typical real estate lease.

Example 17 – Illustration of Effect on Profit and Loss for Leases Previously Classified as Operating

Entity C has a 5-year lease for the floor of an office building. It pays CU 75,000 a year and has an incremental borrowing rate of 5% (the rate implicit in the lease is not readily determinable). The table below illustrates the impact on net income and EBITDA depending on whether IAS 17 or IFRS 16 is used to account for the lease. Assume the entity has no other transactions other than CU 100,000 of sales in each year.

	IAS 17				IFRS 16			
	Amortisation	Interest	Lease Exp.	Net income	Amortisation	Interest	Lease Exp.	Net income
Year 1	-	-	75,000	25,000	64,942	16,235	-	18,823
Year 2	-	-	75,000	25,000	64,942	13,297	-	21,761
Year 3	-	-	75,000	25,000	64,942	10,212	-	24,846
Year 4	-	-	75,000	25,000	64,942	6,972	-	28,086
Year 5	-	-	75,000	25,000	64,942	3,571	-	31,487
Total	**-**	**-**	**375,000**	**125,000**	**324,711**	**50,289**	**-**	**125,000**

As illustrated, the net income for the entire 5 year period does not change, but the timing of expense recognition is faster in IFRS 16 since the financing element (interest) recognised higher expense at the beginning of the lease. The more significant difference is the calculation of EBITDA:

	IAS 17	IFRS 16
Year 1	25,000	100,000
Year 2	25,000	100,000
Year 3	25,000	100,000
Year 4	25,000	100,000
Year 5	25,000	100,000
Total	**125,000**	**500,000**

IFRS 16 results in significantly higher EBITDA than under IAS 17, as all components of the expenses relating to the leases (amortisation and interest expense) are added back.

Entities may need to revisit covenant and regulatory calculations, and financial statement users' methods of analysing results may need to be updated.

8. DISCLOSURE

IFRS 16 has extensive disclosure requirements for lessees in both qualitative and quantitative form. Quantitative disclosure requirements by related primary financial statement include:

Quantitative Disclosure Requirements		
Statement of Financial Position	**Statement of Profit and Loss**	**Statement of Cash Flows**
– Additions to right-of-use assets. – Carrying value of right-of-use assets at the end of the reporting period by class. – Maturity analysis of lease liabilities separately from other liabilities based on IFRS 7 requirements.	– Depreciation for assets by class. – Interest expense on lease liabilities. – Short-term leases expensed. * – Low-value leases expensed. * – Variable lease payments expensed. – Income from subleasing. – Gains or losses arising from sale and leaseback transactions.	– Total cash outflow for leases.

* These disclosures need not include leases with lease terms of one month or less.

The standard prescribes that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate. The prescribed disclosures must also include amounts included in the carrying amount of other assets (e.g. interest on lease liabilities capitalised into the cost of inventory).

Other disclosure requirements also include:

- Commitments for short-term leases if the current period expense is dissimilar to future commitments.
- For right-of-use assets that meet the definition of investment property, the disclosure requirements of IAS 40, with a few exclusions.
- For right-of-use assets where the revaluation model has been applied, the disclosure requirements of IAS 16.
- Entities applying the short-term and/or low-value lease exemptions are required to disclose that fact.

Qualitative Disclosure Requirements

– A summary of the nature of the entity's leasing activities;
– Potential cash outflows the entity is exposed to that are not included in the measured lease liability, including:
  – Variable lease payments;
  – Extension options and termination options;
  – Residual value guarantees; and
  – Leases not yet commenced to which the lessee is committed.
– Restrictions or covenants imposed by leases; and
– Sale and leaseback transaction information.

BDO comment – Disclosure Initiative

In line with the IASB's recent focus on requiring the most relevant information to be disclosed rather than simply a prescriptive list, the disclosure requirements of IFRS 16 contain an overarching requirement that the disclosed information provides users with a basis for understanding how leases affect an entity. The disclosure requirements as prescribed by the standard may not meet this objective by themselves. Determining the appropriate level of disclosure is a matter of judgment and may be complex for entities with significant or unusual leases.

In addition, the disclosure requirements should be viewed in light of the IASB's ***Disclosure Initiative*** *project (see BDO's publication on these amendments* ***here****). The initiative aims to reduce unnecessary disclosure and improve the overall quality of financial statements by highlighting the most relevant information to users and not disclosing information that is immaterial or irrelevant. An entity with very few, straightforward and relatively low value leases may consider certain of the disclosures above to be immaterial.*

9. LESSOR ACCOUNTING

IFRS 16 is substantially unchanged in most respects from IAS 17 for lessor accounting. Leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases; all other leases are operating.

BDO comment

The IASB acknowledged in its due process documentation that there is a fundamental asymmetry in lessee and lessor accounting under IFRS 16. For operating leases (from the perspective of the lessor), both the lessee and the lessor will recognise an asset relating to the underlying asset in their financial statements. However, the IASB noted that symmetry was not ultimately seen as a high priority in developing the new leasing standard.

The areas that may affect lessors are those where IFRS 16 expands guidance or provides guidance on issues not previously addressed, such as:

- The new definition of a lease (see Section 4.);
- Revised sale-and-leaseback guidance (see Section 10.);
- Separation of lease and non-lease components in a contract (see below);
- Sub-lease guidance (see below);
- Guidance on lease modifications (IAS 17 was silent on the issue, see below); and
- Enhanced disclosure requirements (see below).

9.1. Separation of Lease and non-Lease Components

Unlike lessees, lessors do not have an option to account for a contract that contains both a lease and non-lease component as a single lease. Lessors must use the principles within IFRS 15 for allocating consideration to the various components of a contract.

9.2. Sub-Leasing

A lessee may become an intermediate lessor if it sub-leases an asset it in turn leases from another lessor (the 'head lessor' who ultimately owns the asset from a legal perspective). An intermediate lessor assesses whether the sub-lease is a finance or operating lease in the context of the right-of-use asset being leased, not the actual underlying asset.

Example 18 – Sub-Lease Assessment

An intermediate lessor enters into a 5-year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).

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 sub-lessee.

Assessment

From the perspective of the intermediate lessor, at the time the sub-lease is entered into, the right-of-use asset has a 3 year remaining life, and it is being sub-leased for the entirety of that remaining period of time. As such, the sub-lease is for a major part of the useful life of the right-of-use asset and the lease is classified as a finance lease.

BDO comment

Sub-leasing may lead to right-of-use assets being classified as finance leases from the perspective of the lessor while being classified by the head lessor as operating leases. In the example above, the ultimate underlying asset is real estate, which would typically be classified as an operating lease since most real estate leases do not transfer substantially all of the risks and rewards of ownership.

However, since the asset held by the intermediate lessor is a right-of-use asset with a much more limited useful life, the assessment for the intermediate lessor may ultimately differ.

The assessment of whether a sub-lease is a finance lease may be more difficult in situations where the whole asset is not sub-leased (e.g. A portion of real estate for a portion of the head lease term).

Note that when a head lease is short-term and the related practical expedient is elected by the intermediate lessor (i.e. assets and liabilities arising from the lease are not recognised in the statement of financial position), the intermediate lessor must classify the sub-lease as an operating lease.

In summary, the accounting treatment required for a sub-lease depending on its classification by the intermediate lessor is as follows:

Finance leases	– Derecognise the right-of-use asset (1); – Recognise the net investment in the sub-lease (2); – The difference between (1) and (2) is recognised in P&L; and – Retain the recognised lease liability.
Operating leases	– Retain the right-of-use asset and lease liability already recognised; – Continue to recognise depreciation and interest; and – Recognise lease income from the sub-lease.

9.3. Lease Modifications

The accounting for lease modifications from the perspective of lessors mirrors the requirements for lessees.

Modifications – Separate Leases

A lease modification is accounted for as a separate lease if both:

(a) The modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessor would follow the existing lessor guidance on initial recognition and measurement.

Modifications – Not Separate Leases

If a lease modification fails the test above (e.g. additional assets are added, but not at a standalone price) or the modification is any other type (e.g. a decrease in scope from the original contract), the lessor follows the following guidance:

The lease would have been classified as operating with the modifications at the inception date	– **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.**
All other lease modifications	– **Apply the requirements of IFRS 9 *Financial Instruments*.**

The remeasurements above occur as of the effective date of the lease modification on a prospective basis.

9.4. Disclosure Requirements

Disclosure requirements for lessors are summarised as follows:

Quantitative Disclosure Requirements	
Finance leases	– Selling profit or loss; – Finance income on the net investment; – Income from variable lease payments; – Qualitative and quantitative explanation of changes in the net investment; and – Maturity analysis of lease payments receivable.
Operating leases	– Lease income, separately disclosing variable lease payments; – Disclosure requirements of IAS 16 for leased assets, separating leased assets from non-leased assets; – Other applicable disclosure requirements based on the nature of the underlying asset (eg. IAS 36, 38, 40, 41); and – Maturity analysis of lease payments.

The standard prescribes that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate.

Qualitative Disclosure Requirements

Similar to the lessee disclosure requirements, IFRS 16 requires a lessor to disclose additional qualitative and quantitative information about its leasing activities in order to provide users with a basis for assessing the leasing's impact on the financial statements.

This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including:

- Buy-back agreements;
- Residual value guarantees;
- Variable lease payments for excess use; and
- Any other risk management strategies.

10. SALE-AND-LEASEBACK TRANSACTIONS

As a result of virtually all leases coming 'on balance sheet' with IFRS 16, there are significant implications to the accounting for sale-and-leaseback transactions ('SALTs'). In a SALT, a lessee (seller) sells an asset to a lessor (buyer) who then leases it back to the lessee. SALTs are often entered into in situations where a lessee has real estate or other assets that contain significant equity that can be used to obtain additional funding.

By selling, a lessee can immediately receive the difference between the property's market value and any debt still outstanding on the asset, but still keep its right to utilise the asset through the lease.

IAS 17 required a lessee to defer the gain on a SALT if the resulting lease was classified as a finance lease, and to recognise the gain entirely if it was operating and at fair value. IFRS 16's requirements are significantly different.

In order to determine the appropriate accounting treatment, the sale must first be assessed as to whether it qualifies as a sale in accordance with the requirements of IFRS 15 *Revenue from Contracts with Customers* (please refer to BDO's *Need to Know* publication on IFRS 15 here).

	Lessee (seller)	Lessor (buyer)
Transfer to buyer-lessor qualifies as a sale	– Derecognise asset and apply lessee accounting requirements. – Measure right-of-use asset as the retained portion of the previous carrying value. – Recognise gain/loss on the rights transferred to the lessor.	– Apply lessor accounting requirements to asset.
Transfer to buyer-lessor does not qualify as a sale	– Continue recognition of asset. – Amounts received are recognised as a financial liability under IFRS 9 *Financial Instruments*.	– Asset is not recognised. – Amounts paid are recognised as a financial asset under IFRS 9 *Financial Instruments*.

Note: a presumption of the above accounting guidance is that both the sale and lease payments are at market rates. Adjustments are required for off-market terms. See the following illustrative example.

Example 19 – Sale-and-leaseback transaction where transfer is a sale (lessee)

A seller-lessee sells its building to a buyer-lessor for CU 2,000,000. Before the transaction occurs, the building had a carrying value of CU 1,000,000. Simultaneously, the seller-lessee leases the building back from the buyer-lessor for a period of 18 years with annual lease payments at the end of each year of CU 120,000. The sale meets the criteria of IFRS 15 to be accounted for as a sale. There are no initial direct costs in the transaction.

The fair value of the building at the time of sale is CU 1,800,000. Since the consideration does not equal fair value, adjustments must be made to measure the sale proceeds at fair value. The excess consideration of CU 200,000 (CU 2,000,000 – CU 1,800,000) is additional financing provided by the buyer-lessor to the seller-lessee.

The interest rate implicit in the lease is determined to be 4.5% per annum. The present value of the annual payments (18 payments of CU 120,000, 4.5% discount per annum) is CU 1,459,200, of which CU 200,000 relates to financing and CU 1,259,200 relates to the lease.

Example 19 – Sale-and-leaseback transaction where transfer is a sale (lessee) (continued)

Assessment

The entry to record this transaction is as follows (see corresponding superscripts for notes reconciling each component of the entry):

Dr		Cash	CU 2,000,000[1]	
Dr		Right-of-use asset	CU 699,555[2]	
	Cr	Building		CU 1,000,000[3]
	Cr	Lease liability		CU 1,459,200[4]
	Cr	Gain on rights transferred		CU 240,355[5]

[1] Cash recognised is consideration received from the buyer-lessor.

[2] The right-of-use asset is measured based on the retained right on the previous carrying value of the building. This calculation measures the proportion of consideration the lessee will pay to the lessor for the lease (CU 1,259,200) compared to the fair value (CU 1,800,000) times the present carrying value of the building (CU 1,000,000). This conceptually achieves the objective of the standard; the seller-lessee legally sold the entire building, but retains a portion of the previous carrying value through the lease contract. In summary, the calculation is:

Right-of-use asset = (CU 1,259,200 / CU 1,800,000 * CU 1,000,000)

[3] The previous carrying value of the building is derecognised as it has been sold.

[4] Present value of future lease payments of CU 1,459,200 (CU 120,000 per year for 18 years, 4.5% annual discount) which includes the difference between the consideration received and the fair value of the property of CU 200,000 (CU 2,000,000 – CU 1,800,000).

[5] The gain is the balancing entry in the transaction, but can be reconciled as follows:

Gain = total gain – gain on rights retained by seller-lessee

Gain = (fair value – carrying value) – (PV of lease liability / fair value of building * total gain)

Gain = (CU 1,800,000 – CU 1,000,000) – (CU 1,259,200 / CU 1,800,000 * CU 800,000)

Gain = CU 800,000 – CU 559,644

Gain = CU 240,354

The concept of the above formula becomes clear in a situation where the present value of the seller-lessee's lease of the building is exactly equal to the fair value of the building. If this occurs, then there is no gain whatsoever on the SALT because the seller-lessee has simply agreed to lease the building for its fair value. If this were the case, the gain would be calculated as such:

Gain = total gain – gain on rights retained by seller-lessee

Gain = (fair value – carrying value) – (PV of lease liability / fair value of building * total gain)

Gain = (CU 1,800,000 – CU 1,000,000) – (CU 1,800,000 / CU 1,800,000 * CU 800,000)

Gain = CU 800,000 – CU 800,000

Gain = Nil

No gain would be recognised in this case as the seller-lessee has essentially agreed to pay back to the lessor the entire fair value of the property sold, therefore, the entire apparent gain relates to the rights retained by the seller-lessee.

BDO comment

Similar to what it achieves in overall lessee accounting, IFRS 16 creates a consistent treatment for SALTs (assuming they qualify as sales). Previously, IAS 17 provided significantly varying accounting treatments depending on whether the lease qualified as a finance or operating lease.

Given that SALTs are common for real estate, which normally qualified as operating lease backs, this led to significant gains being recognised.

11. EFFECTIVE DATE AND TRANSITION

IFRS 16 is effective for periods beginning on or after **1 January 2019**. Entities may early adopt the standard, but if they elect to do so, they must also adopt IFRS 15 *Revenue from Contracts with Customers* as there can be significant interactions between the two standards.

Given the broad impact of IFRS 16, significant transitional exemptions and simplifications are available to entities.

BDO comment

IFRS 16 was issued in January 2016, therefore the IASB has allowed a 3 year period of time for implementation by entities. The amount of time between a standard being issued and its effective date can be viewed as a measure of several factors underlying the standard, including its:

- *Relative complexity;*
- *Overall effects on reported financial position, financial performance and cash flows;*
- *Importance to key financial statement users such as lenders, investors and regulators; and*
- *Cost of implementation and impact on systems and processes.*

A 3 year implementation is a significant period of time, therefore it would appear that the IASB anticipates that some entities may require significant resources to be dedicated to IFRS 16 adoption.

Additionally, IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers are also effective from 1 January 2018. Part of the IASB's long implementation period for IFRS 16 may relate to the similarly significant implementation implications of IFRS 9 and 15 for some entities.

Because of the interaction between IFRS 15 and IFRS 16, and the potential to avoid two significant changes in accounting in two successive years, entities might wish to consider adopting IFRS 16 early.

11.1. Retrospective Application Options – Lessees

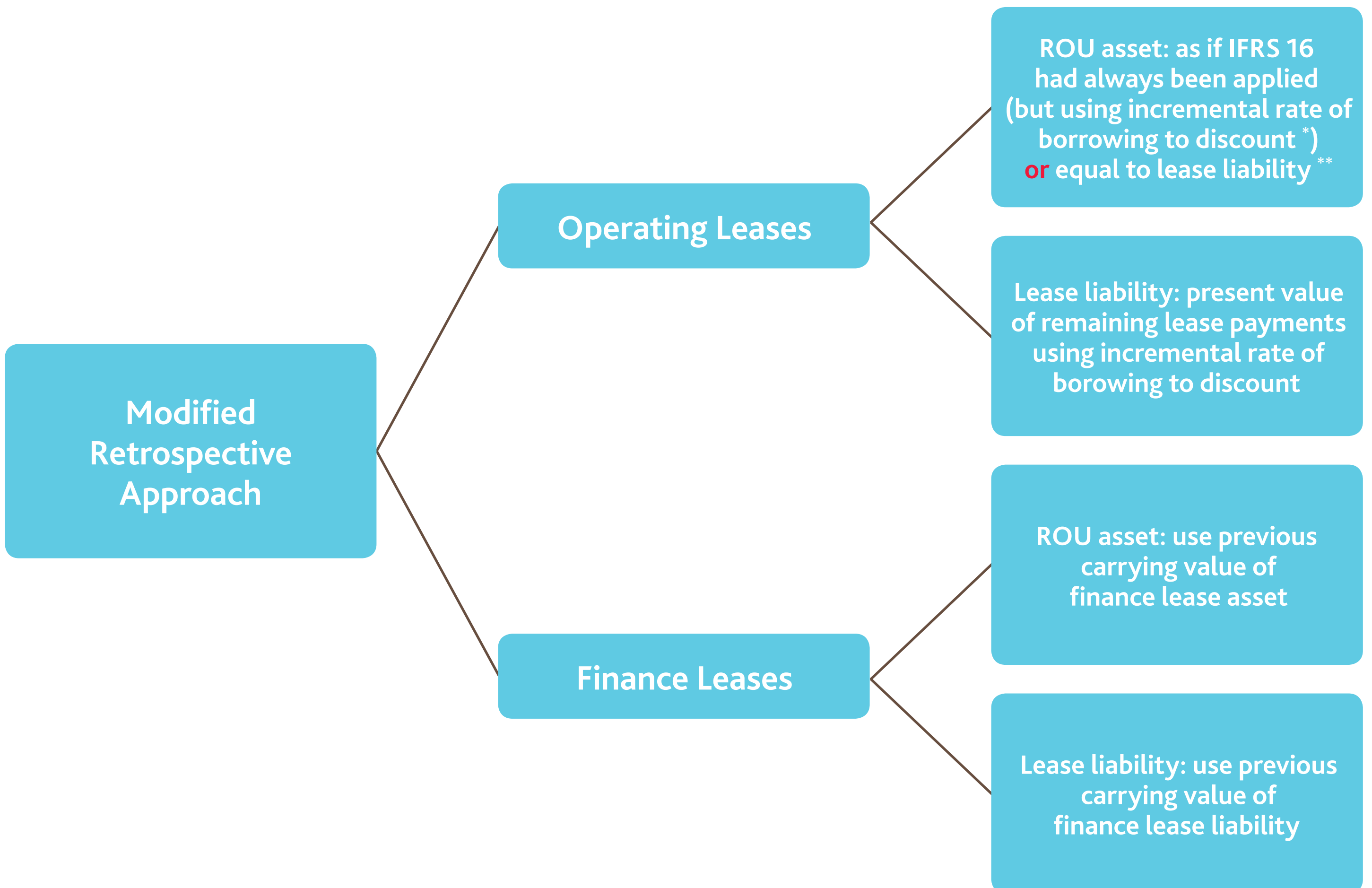
An entity is permitted to follow one of two approaches in adopting IFRS 16, the **retrospective approach** or the **modified retrospective approach**.

Full Retrospective Approach
This option results in an entity applying IFRS 16 to all periods presented as if it had always been applied, as well as meeting the disclosure requirements of IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, including: – A third statement of financial position as at the date of initial application of the standard (i.e. The first day of what would normally be the comparative period in the statement of financial position); – A reconciliation of all items affected by the adoption of the standard as well as the impact on earnings per share if an entity is required to follow IAS 33 *Earnings per Share*; – A description of the standard and its effects. Full retrospective application does not allow for any transitional relief and exemptions (except for relief in applying the definition of a lease as discussed in Section 11.2.), which may lead entities to follow the modified retrospective approach instead.

Modified Retrospective Approach

The modified approach does not require restatement of any comparative periods, except for reflecting the cumulative impact of applying IFRS 16 as an adjustment to the opening balance of equity at the date of initial application.

The modified retrospective approach is summarised as follows:



* The rate to be used is the incremental rate of borrowing as of the date of initial application of IFRS 16, not the commencement date of the lease.

** Note on operating leases ROU simplification: the option of retrospective IFRS 16 application or an amount equal to the lease liability may be made on a lease-by-lease basis. Additionally, no adjustment is required to leases previously accounted for as investment property under IAS 40. Such investment property is accounted for under IFRS 16 and IAS 40 subsequent to the date of initial application of IFRS 16.

BDO comment

The modified retrospective approach may initially seem significantly simpler than the full retrospective approach to transition, and while it does offer certain practical expedients (see below), in order to determine the cumulative effect of transition to record in opening equity a lessee still needs to undertake calculations that would affect prior periods.

Utilising the modified retrospective approach also makes financial statements less comparable to prior periods, therefore, potentially less relevant and useful. Preparers should consult with relevant financial statement users and those charged with governance to assist them in determining which method of transitioning to IFRS 16 is most suitable for their needs.

Practical Expedients – Modified Retrospective Approach

In applying the modified retrospective approach, several practical expedients are available to lessees accounting for leases that were previously categorised as operating leases under IAS 17. On a lease-by-lease basis, a lessee may:

- Apply a single discount rate to a portfolio of leases with reasonably similar characteristics;
- Rely on its assessment of whether leases are onerous by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as opposed to performing an impairment review;
- Not recognise leases whose term ends within 12 months of the date of initial application of IFRS 16. If this election is taken, these leases are accounted for as short-term leases;
- Exclude initial direct costs from the measurement of right-of-use assets at the date of initial application;
- Use hindsight, such as in determining the lease term for leases that contain options.

Other Disclosures – Modified Retrospective Approach

A lessee following the modified retrospective approach must also meet the disclosure requirements of IAS 8.28 (disclosure of earnings per share impact and line-by-line reconciliation prior periods), as well as disclosing:

- The weighted average lessee's incremental borrowing rate applied to lease liabilities in the statement of financial position at the date of initial application;
- An explanation of the difference between:
  - Operating lease commitments disclosed under IAS 17 at the end of the annual reporting period immediately preceding the date of initial application; discounted using the incremental borrowing rate at the date of initial application as described in paragraph C8(a); and
  - Lease liabilities recognised in the statement of financial position at the date of initial application.
- Disclosure of which, if any, practical expedients were utilised.

BDO comment

The number of options available to lessees on transition to IFRS 16 are extensive due to the two different approaches and the range of practical expedients that are available. For lessees with significant lease portfolios, if the modified retrospective approach is to be used it may take a significant amount of work, effort and time to determine:

- *Which practical expedients should be utilised;*
- *The calculated adjustments and amendments to systems and processes; and*
- *The required disclosures.*

11.2. Definition of a Lease

IFRS 16 offers entities an option on transition to assess the existence of a lease using either IFRS 16 or IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease* ('previous standards'). This option is available to all entities, regardless of which transition approach they apply. The accounting implications of each option are as follows (an entity must apply its choice consistently):

Option	Implications
IFRS 16	– **Reassess all leases using criteria in IFRS 16 as to whether they meet the definition of a lease within IFRS 16.**
Previous Standards	– **Apply IFRS 16 measurement guidance to contracts identified as leases under previous standards;** – **Do not apply IFRS 16 measurement guidance to contracts deemed to not meet the definition of a lease under previous standards;** – **Follow IFRS 16 guidance on the definition of a lease subsequent to the date of initial application.** *

* The **date of initial application** is the beginning of the annual period in which an entity first applies IFRS 16 (1 January 2019 for entities with calendar year-ends which do not early adopt IFRS 16).

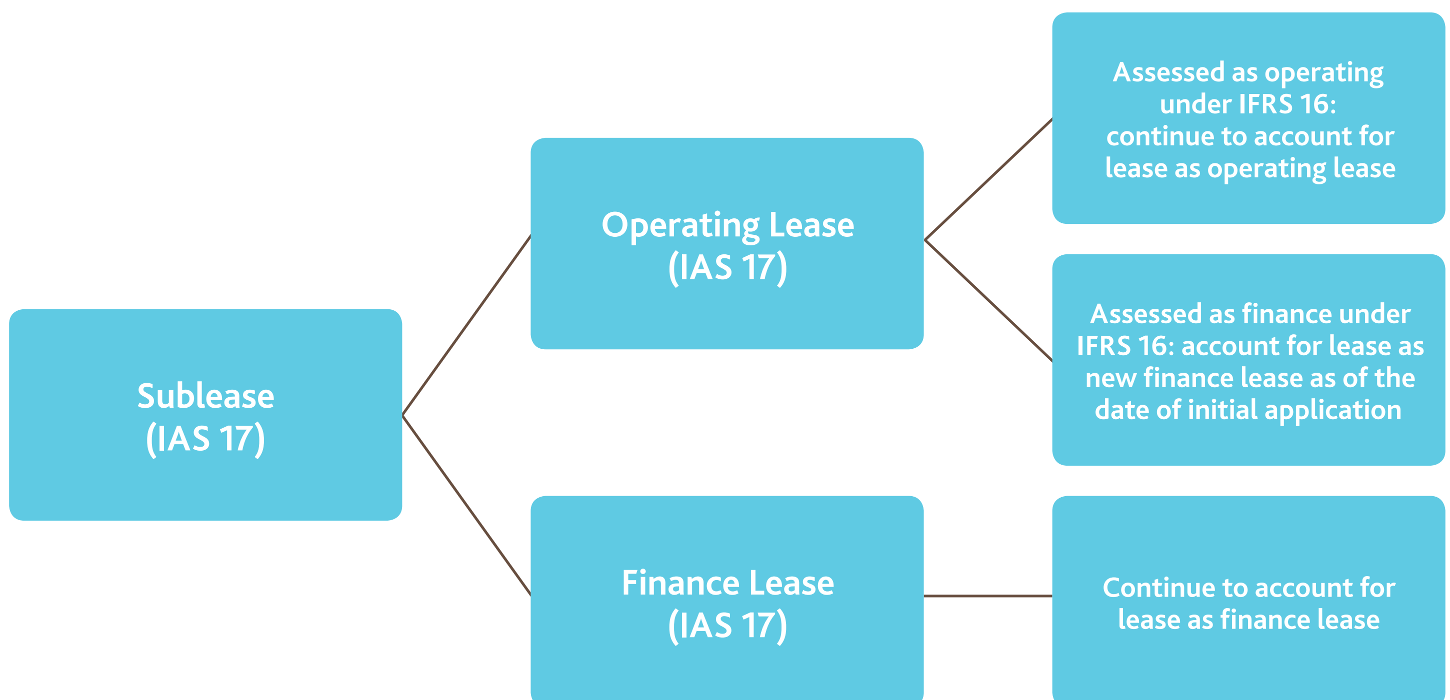
11.3. Transition – Lessors

As discussed in Section 8., the impact of IFRS 16 on lessors is significantly less than for lessees. IFRS 16's transitional provisions do not require a lessor to make any adjustments for leases in which it is a lessor. A lessor accounts for those leases applying IFRS 16 on a go forward basis, subsequent to the date of initial application.

Subleases

As IAS 17 contained limited guidance on subleases, transitional guidance is provided for intermediate lessors. An intermediate lessor must reassess subleases that were classified as operating leases applying IAS 17 that are ongoing at the date of initial application, to determine whether each sublease should be classified as operating or finance under IFRS 16. This assessment is made based on the remaining contractual terms as of the date of initial application; not the whole-life contractual term.

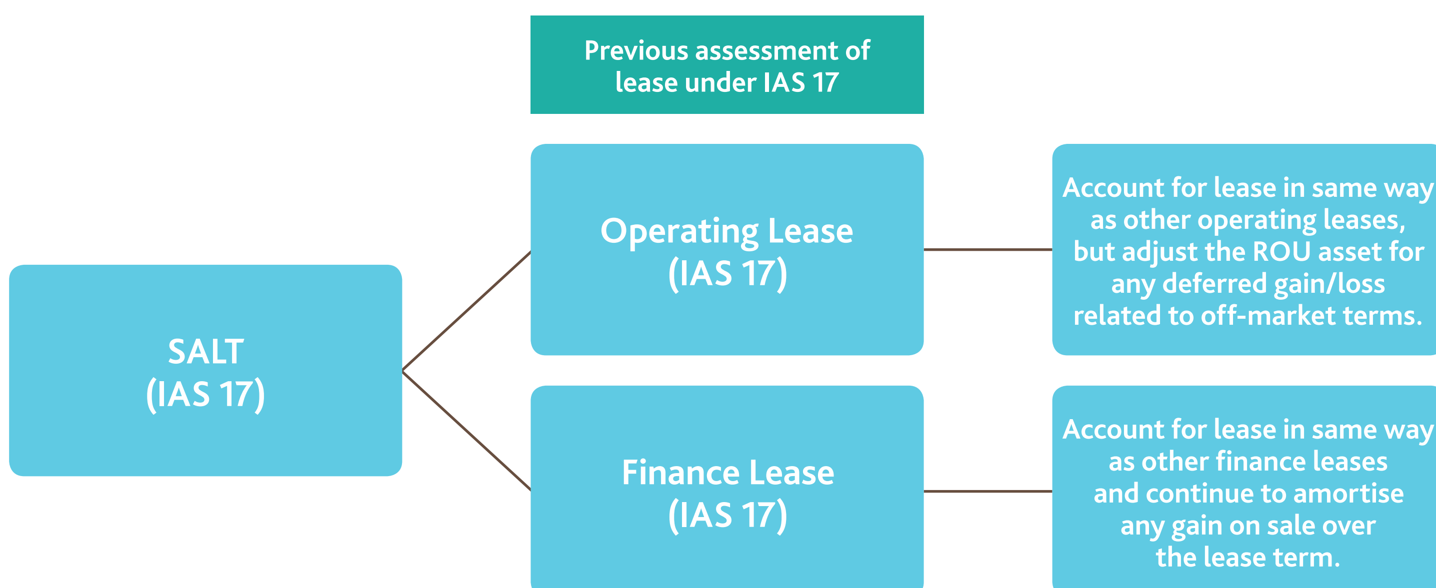
The implications of this assessment are summarised as follows:



11.4. Transition – Sale-and-Leaseback Transactions

The transitional provisions do not require entities to reassess whether a SALT entered into before the date of initial application would qualify as a sale under IFRS 15. However, depending on the treatment under IAS 17, transitional adjustments may be required.

The requirements are summarised as follows:



11.5. Transition – Business Combinations

For leases acquired in business combinations prior to the date of initial application, an entity would apply the same transitional provisions as for other leases. In some cases, prior to the adoption of IFRS 16, lessees with operating leases containing favourable or unfavourable terms at the time of acquisition previously had these terms recognised as assets or liabilities as part of the purchase price allocation in business combinations.

Upon adoption of IFRS 16, at the date of initial application, lessees are required to derecognise these assets and liabilities and adjust the carrying amount of right-of-use assets by the corresponding amount.

12. EFFECTS ON OTHER STANDARDS

Given how widespread leasing activities are, it is understandable that IFRS 16 resulted in several consequential amendments to other IFRSs. A summary of the more significant amendments are:

<table>
<tr><th>Standard</th><th>Effect of Amendments</th></tr>
<tr><td>IFRS 1 First-time Adoption of IFRS</td><td>
– The option to use fair value as deemed cost in an entity's opening statement of financial position upon adopting IFRS has been extended to right-of-use assets as well, along with property, plant and equipment, intangible assets and investment properties.
– If an entity elects to not apply IFRS 3 retrospectively to past business combinations upon adopting IFRS, it still must recognise leases based on the requirements of IFRS 16.
– In applying IFRS 16 upon adoption of IFRS, an entity may elect to follow several simplifications in initial measurement:
  – Measure the lease liability as the PV of remaining lease payments discounted using the lessee's incremental borrowing rate;
  – Measure the right-of-use asset at either (1) the value that it would have used if IFRS 16 had been applied since the commencement of the lease but discounted using the lessee's incremental borrowing rate or (2) an amount equal to the lease liability.
– A right-of-use asset for a lease that meets the definition of investment property and is measured using the fair value model would be measured at fair value on adoption of IFRS.
– A lessee may also use several other simplifications on a lease-by-lease basis:
  – Use a single discount rate to a reasonably similar portfolio of leases;
  – Elect not to measure leases that terminate within 12 months of the date of transition to IFRS;
  – Elect not to measure leases where the underlying asset is of low-value;
  – Exclude initial direct costs from the measurement of right-of-use assets;
  – Elect to use hindsight (e.g. in determining the lease term if options exist).
</td></tr>
<tr><td>IFRS 3 Business Combinations</td><td>
– Exclusion of requirement to use fair value as the measurement basis for lease liabilities.
– The lease liability is measured under the basis of it being a new lease at the time of acquisition of the business.
– The right-of-use asset is measured at the same amount as the lease liability, adjusted for favourable or unfavourable terms of the lease compared to market terms.
</td></tr>
<tr><td>IFRS 7 Financial Instruments – Disclosures</td><td>
– Extending the scope of an exclusion from requiring disclosure of fair values to lease liabilities.
</td></tr>
</table>

Standard	Effect of Amendments
IFRS 9 *Financial Instruments*	– Allowing lessors to choose to measure lease receivables using lifetime expected credit losses instead of the three-staged approach otherwise required by IFRS 9 for impairment of financial assets.
IFRS 13 *Fair Value Measurement*	– Extending the scope exemption for the measurement and disclosure requirements of the standard to leasing transactions within the scope of IFRS 16.
IAS 21 *The Effects of Changes in Foreign Exchange Rates*	– Clarification that lease liabilities are monetary liabilities and right-of-use assets are non-monetary assets.
IAS 40 *Investment Property*	– Significant editorial amendments to correspond with significant changes to leased right-of-use assets that may meet the definition of investment property.

13. APPENDIX A – DEFINITIONS

Commencement date of the lease (commencement date)	The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.
Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Economic life	Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.
Effective date of the modification	The date when both parties agree to a **lease modification**.
Fair value	For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Finance lease	A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.
Fixed payments	Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.
Gross investment in the lease	The sum of: (a) The **lease payments** receivable by a **lessor** under a **finance lease**; and (b) Any **unguaranteed residual value** accruing to the lessor.
Inception date of the lease (inception date)	The earlier of the date of a **lease** agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
Initial direct costs	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.
Interest rate implicit in the lease	The rate of interest that causes the present value of: (a) The **lease payments**; and (b) The **unguaranteed residual value** to equal the sum of: (i) The **fair value** of the **underlying asset**; and (ii) Any **initial direct costs** of the lessor.
Lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.
Lease incentives	Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.

Lease modification	A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).
Lease payments	Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, comprising the following: **(a)** **Fixed payments** (including in-substance fixed payments), less any **lease incentives**; **(b)** **Variable lease payments** that depend on an index or a rate; (c) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and (d) Payments of penalties for terminating the **lease**, if the lease term reflects the lessee exercising an option to terminate the lease. For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component. For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.
Lease term	The non-cancellable period for which a **lessee** has the right to use an **underlying asset**, together with both: (a) Periods covered by an option to extend the **lease** if the lessee is reasonably certain to exercise that option; and (b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
Lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.
Lessee's incremental borrowing rate	The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.
Lessor	An entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.

Net investment in the lease	The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.
Operating lease	A **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.
Optional lease payments	Payments to be made by a **lessee** to a **lessor** for the right to use an **underlying asset** during periods covered by an option to extend or terminate a **lease** that are not included in the **lease term**.
Period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
Residual value guarantee	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.
Right-of-use asset	An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.
Short-term lease	A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.
Sublease	A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.
Underlying asset	An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.
Unearned finance income	The difference between: (a) The **gross investment in the lease**; and (b) The **net investment in the lease**.
Unguaranteed residual value	That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.
Useful life	The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.
Variable lease payments	The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

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For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit **www.bdointernational.com/Services/Audit/IFRS/IFRS Country Leaders** where you can find full lists of regional and country contacts.

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