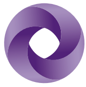

Grant Thornton
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# Insights into IFRS 16

June 2019

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## Contact us

We hope you find this publication provides helpful insight into some of the decisions you will face when applying IFRS 16. If you would like to discuss any of the points raised, please contact Grant Thornton's IFRS experts team at ifrs@gr.gt.com.

# Introduction

Grant Thornton "Insights into IFRS 16" is a publication designed to focus on key areas of the new Leasing Standard, which is effective for annual reporting periods beginning on or after 1 January 2019.

We have identified **7 key areas** of IFRS 16 and through this publication we aim to assist you in the application of the Standard and get through several challenges arising from the new requirements.

This guide starts with the **Definition of a lease** under IFRS 16, while it serves as a roadmap for **Understanding the discount rate's** determination, appropriateness and usage. It also aims to assist with the considerable judgement involved in **Lease payments'** treatment and the determination of the appropriate **Lease term**. Additionally, this guide clarifies the new concepts and provides a simplified example of the requirements concerning the issue of **Sale and leaseback**. Finally, it demonstrates how to treat a variable lease payment in the financial statements of an **Interim period** and sets out the **Transition choices** and practical expedients that are available, while highlights some of their practical implications.

# Definition of a lease

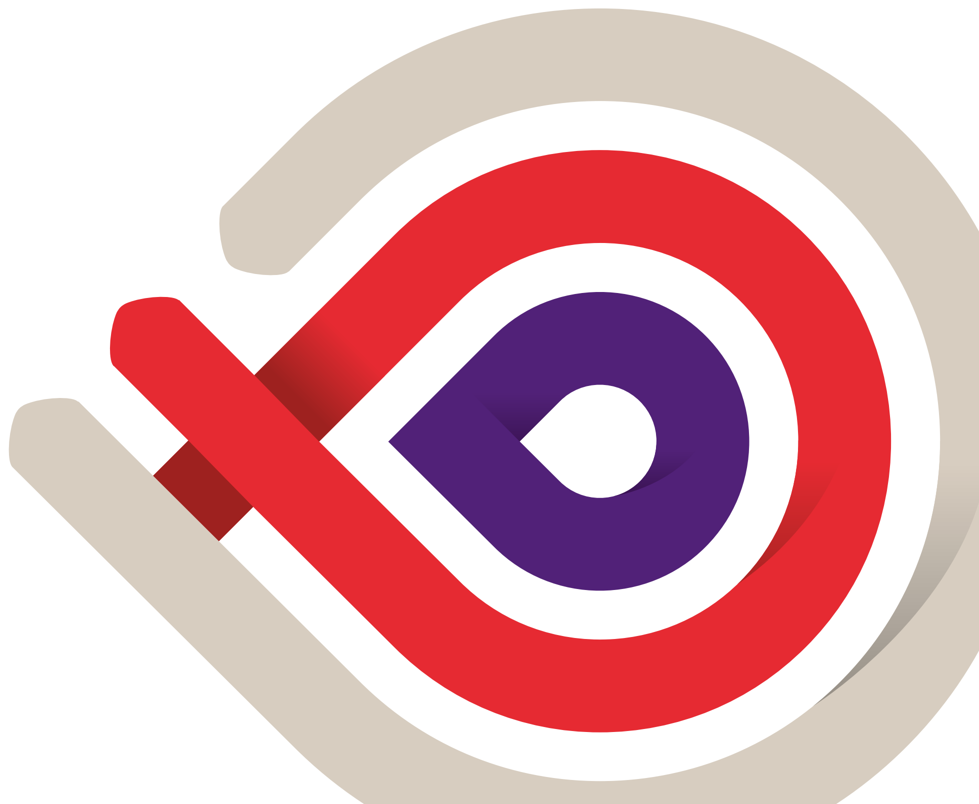
**IFRS 16 represents the first major overhaul of lease accounting in over 30 years. The new Standard will affect most companies that report under IFRS and are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment.**

Since accounting for leases under IFRS 16 results in substantially all leases being recognised on a lessee's balance sheet, the evaluation of whether a contract is (or contains) a lease becomes even more important than it is under IAS 17 and IFRIC 4. In practice, the main impact will be on contracts that are not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease – such as outsourcing, contract manufacturing, transportation and power supply agreements. Currently, this evaluation is based on IFRIC 4; however, IFRS 16 replaces IFRIC 4 with new guidance that differs in some important respects.

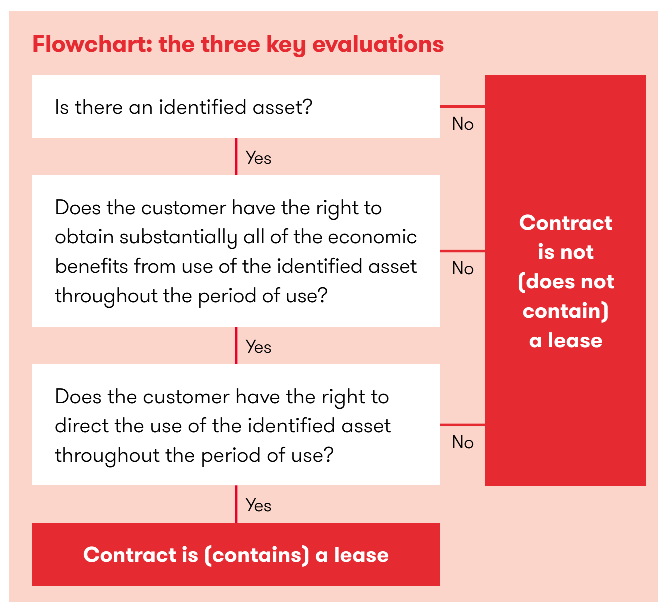
IFRS 16 changes the definition of a lease and provides guidance on how to apply this new definition. As a result, some contracts that do not contain a lease today will meet the definition of a lease under IFRS 16, and vice versa.

Under IFRS 16 a lease is defined as 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'.

A contract can be (or contain) a lease only if the underlying asset is 'identified'. Having the right to control the use of an identified asset means having the right to direct, and obtain all of the economic benefits from, the use of that asset. These rights must be in place for a period of time, which may also be determined by a specified amount of use. Put simply, if the customer controls the use of an identified asset for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way it makes decisions about the use of assets it owns outright. In such cases, the customer (ie the lessee) is required to recognise these rights on its balance sheet as a 'right-of-use' asset. In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service and so there is no right-of-use asset to recognise.



Applying the new definition involves three key evaluations, all of which must be met in order to conclude that a contract is or contains a lease. These evaluations are summarised in the following flowchart:




Let's examine each of these in more detail.

## Is there an identified asset?

An identified asset is an asset that is either:

- explicitly identified in the contract, or
- is implicitly specified by being identified at the time that the asset is made available for use by the customer.

Even if an asset is explicitly specified, a customer does not have the right to use an identified asset if the supplier has a **substantive substitution right** throughout the period of use.

### What is a substantive substitution right?

A substantive substitution right exists if the supplier has the practical ability to substitute alternative assets throughout the period of use and the economic benefits of substituting the asset would exceed the cost (or in other words, the supplier would benefit economically from substituting the asset). When the asset is located at the customer's premises, the costs associated with substituting the asset are likely to be higher, making it less likely that the supplier would economically benefit from making a substitution.

The assessment of whether a supplier's substitution right is substantive is based on facts and circumstances present at inception of the contract. This means that the customer ignores events that are not likely to occur in future such as:

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

If the supplier has the right or obligation to substitute the asset for repair purposes or to provide routine maintenance services (eg, to allow it to install a technical upgrade that has become available), a customer is not precluded from having the right to use an identified asset. A customer is also not required to perform an exhaustive search to determine if a supplier has a substantive substitution right. If a customer cannot readily determine whether a supplier has such a right, it may conclude that a right does not exist.

### Example 1 – Rail cars

In a contract between a customer and a supplier, the supplier needs to transport goods using a particular type of rail car in line with a specified timetable over a three-year period. The timetable and quantity of goods stipulated are equivalent to the customer having the use of six rail cars for three years. The supplier makes available the cars, driver and engines as part of the arrangement. The supplier has a large supply of similar cars and engines that are available to fulfil the obligations of the arrangement. The rail cars and engines are kept at the supplier's premises when they are not being used to transport the goods.

#### Analysis

The contract does not contain a lease of either rail cars or engines.

The rail cars and engines used to transport the customer's goods are not identified assets. The supplier has a substantive substitution right to replace the rail cars and engines as a result of:

- the supplier having the practical ability to substitute each car and engine throughout the period of use. Alternative cars and engines are readily available to the supplier and these can be substituted without the customer's approval, and
- the supplier being able to economically benefit from substituting each car and engine. There would be very little cost associated with substituting these assets as the cars and engines are stored at the supplier's premises and the supplier has a large pool of similar cars and engines.

Therefore, the customer does not have the right to obtain substantially all of the economic benefits from the use of an identified rail car or an engine or directs their use. The supplier chooses which rail cars and engines are used for each delivery and therefore directs them. It has substantially all of the economic benefits from use of the rail cars and engines.

### Can a portion of an asset be an identified asset?

A portion of an asset is an identified asset if it is physically distinct (eg a single floor of an apartment building). Where a portion of an asset is not physically distinct (eg 20% of the capacity of an oil pipeline), the portion of the asset is not an identified asset unless it represents substantially all of the capacity of the asset. If neither of these situations exist, the customer is not provided with the right to obtain substantially all the economic benefits from use of the asset and an identified asset does not exist.

#### Example 2 – Fibre-optic cable

A customer enters into a 10-year contract with a utilities company (the supplier) for the right to use five individually specified, physically distinct fibre-optic strands (fibres) within a larger cable running between New York and London. The customer makes all relevant decisions concerning the use of the individual fibres by connecting them to its own electronic equipment (ie, the customer 'lights' the fibres) and deciding what data, and how much data, each strand will carry. If any of the strands are damaged, the supplier is responsible for effecting any necessary repairs. The supplier owns additional fibres both within the same cable and in adjacent cables but can only substitute those for the customer's strands when performing ongoing maintenance or effecting necessary repairs.

**Analysis**

The contract represents a lease of unlit fibre-optic strands (the identified assets).

The fibre optic strands are identified assets because they are explicitly specified in the contract and are physically distinct from other fibres within the cable. The supplier cannot substitute the fibres for reasons other than repair, maintenance or malfunction.

Conversely, if the customer was entitled only to use an amount of capacity equivalent to five fibres within a cable made up of 15 strands, but not five specific strands, the contract would contain neither an identified asset nor a lease because the capacity represented by five fibres does not represent substantially all the capacity of the 15-strand cable. In this case, the supplier would only be providing data capacity (ie, a service).

## Does the customer have the right to obtain substantially all of the economic benefits from the use of the identified asset throughout the period of use?

The second evaluation involves determining whether a customer has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use. There are many ways that a customer can obtain those economic benefits such as by using, holding or sub-leasing the asset.

When making this evaluation, a customer considers its rights within the defined scope of the contract. For example, if a contract specifies that a customer can only print up to a specified number of pages during the period of use of a printer, the customer considers only the economic benefits arising from use of the printer for those pages, and not beyond.

Variable lease payments based on the customer's use of the asset (eg variable payments based on sales) do not prevent a customer from obtaining substantially all of the economic benefits from the use of the asset. Although the customer passes on some of the benefits to the supplier through variable payments, the customer is still the party that receives the economic benefits arising from use of the asset (in this case, the cash flows arising from the sales). IFRS 16 is explicit on this point to eliminate the possibility that companies might include variable lease payments solely to avoid the arrangement being classified as a lease and therefore lease accounting.

## Does the customer have the right to direct the use of the identified asset throughout the period of use?

In evaluating whether the customer has the right to direct the use of an identified asset, a customer must have the right to direct 'how and for what purpose' the asset is used throughout the period of use. In making this evaluation, a customer considers the decisions that most directly impact the economic benefits to be derived from the use of the asset, including:

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

In many cases, contracts will include terms and conditions that protect the supplier's interest in the asset, protect its personnel and/or ensure the supplier complies with laws and regulations. These rights are considered to be protective and do not, in isolation, prevent the customer from having the right to direct the use of the asset within the scope of the contract.

Examples of protective rights noted in IFRS 16 include:

- specifying the maximum amount of use of an asset (eg an aircraft lease with a maximum usage allowed of 15,000 engine hours per year)
- limiting where or when the customer can use the asset (eg an automotive lease specifying that the identified vehicle can only be driven in France)
- requiring the customer to follow certain operating practices (eg a lease of retail space where opening hours are limited to specific times of the day)
- requiring the customer to notify the supplier if the customer changes how the asset will be used (eg a warehouse lease where the customer must notify the supplier if they plan to change the use of the space from storing inventory to a retail area).

Lastly, IFRS 16 is clear that rights to operate or maintain an asset do not give a customer the right to direct how and for what purpose the asset is used, except for when the 'how and for what purpose' decisions are predetermined. In this case, the customer will control the asset if the customer has the right to operate the asset throughout the period of use or the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

**Example 3 – Ship**

A customer enters into a contract with a shipping company (the supplier) to transport cars from Tokyo to Singapore. The contract specifies the particular ship to be used, the dates of pick-up and delivery, and the cars to be transported (which will occupy the full capacity of the ship). The supplier operates and maintains the ship and is responsible for the safe passage of the cars. The customer is not able to make changes (ie to either the destination or the nature of the cargo) once the contract has been signed.

**Analysis**

The contract does not contain a lease.

After signing the contract, the customer is not able to direct how and for what purpose the ship is used and does not therefore control the use of the asset. The contract pre-determines how and for what purpose the ship will be used and customer neither operates nor designed the ship.

## Transition considerations

On transition to IFRS 16, both lessees and lessors can choose whether to apply the new lease definiton to all of their contracts or apply transitional relief from reassessing whether contracts in place at the date of initial application are, or contain, a lease. If an entity chooses to apply this relief, then the new lease defintion will be applied to contracts entered into or modified on or after the date of intial application (1 January 2019 for calendar year end entities).

# Understanding the discount rate

**Under IFRS 16 'Leases', discount rates are used to determine the present value of the lease payments used to measure a lessee's lease liability. Discount rates are also used to determine lease classification for a lessor and to measure a lessor's net investment in a lease.**

For lessees, the lease payments are required to be discounted using:

- the interest rate implicit in the lease (IRIL), if that rate can be readily determined, or
- the lessee's incremental borrowing rate (IBR).

For lessors, the discount rate will always be the interest rate implicit in the lease.

The **interest rate implicit in the lease** is defined in IFRS 16 as 'the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.'

The **lessee's incremental borrowing rate** is defined in IFRS 16 as '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'.

The incremental borrowing rate is determined on the commencement date of the lease. As a result, it will incorporate the impact of significant economic events and other changes in circumstances arising between lease inception and commencement.

A lessee will need to determine a discount rate for virtually every lease to which it applies the lessee accounting model in IFRS 16. However, a discount rate may not need to be determined for a lease if:

- a lessee applies the recognition exemption for either a short-term or a low-value asset lease
- all lease payments are made on (or prior to) the commencement date of the lease, or
- all lease payments are variable and not dependent on an index or rate (eg, all lease payments vary based on sales or usage).

The interest rate implicit in the lease may be similar to the lessee's incremental borrowing rate in many cases. Both rates consider the credit risk of the lessee, the term of the lease, the security and the economic environment in which the transaction occurs.

## Interest rate implicit in the lease

The definition of interest rate implicit in the lease is the same for both a lessee and a lessor. Because it is based in part upon the initial direct costs of the lessor, it will often be difficult and in many cases impossible for the lessee to readily determine the interest rate implicit in the lease.

For some leases, including most property leases, a lack of detailed information about the fair value of the underlying asset, the expected residual value of the asset at the end of the lease term and any initial direct costs of the lessor will make it difficult or impossible for the lessee to readily determine the interest rate implicit in the lease.

In other cases, the lessee may be able to obtain the relevant information from the lessor during the lease negotiation process. The initial fair value of the underlying asset and residual value of the underlying asset may also be determinable from a reliable external source. The lessee may be able to reasonably determine that the lessor's initial direct costs would not be significant to the overall arrangement. In leasing transactions between related parties, it is likely that most or all of the relevant information can be obtained by the lessee.

While it is relatively common for some traditional equipment finance leases to make explicit reference to an interest rate in the lease documentation, caution is warranted. This rate will not represent the interest rate implicit in the lease if it doesn't include an estimate of residual value for the underlying asset or take the lessor's initial direct costs into account.

**What is readily determinable?**

The interest rate implicit in the lease must be used only if that rate can be readily determined. The meaning of the term 'readily determinable' is open to some interpretation.

Sometimes, particularly in relation to leases of real estate, the lessee uses a valuation expert to determine the interest rate implicit in the lease. In our view, rates determined by experts would not qualify as readily determinable and the lessee should be using its incremental borrowing rate instead.

Similarly, where the interest rate implicit in the lease can only be determined by including significant estimates and assumptions, a lessee would likely conclude that the interest rate implicit in the lease is not readily determinable.

**The impact of variable lease payments on the interest rate implicit in the lease**

Variable lease payments can impact the calculation of the interest rate implicit in the lease. Only variable payments based on an index or rate should be included in the calculation of the interest rate implicit in the lease (ie. variable payments that are included in the definition of lease payments). True variable payments, such as those based on sales or usage, must be excluded. Unfortunately, this can result in rates that are potentially misleading if the lease agreement is structured in a way that most payments are variable. If the calculated interest rate implicit in the lease is negative or otherwise doesn't make sense, in our view the incremental borrowing rate should be used.

## Lessee's incremental borrowing rate

Where the lessee is unable to readily determine the interest rate implicit in the lease, the discount rate will be the lessee's incremental borrowing rate. The incremental borrowing rate is an interest rate specific to the lessee that reflects:

- the credit risk of the lessee
- the term of the lease
- the nature and quality of the security
- the amount 'borrowed' by the lessee, and
- the economic environment (the country, the currency and the date that the lease is entered into) in which the transaction occurs.

With significant judgement required to assess many of the factors noted above, we expect this to be a challenging area in practice.

It is important to note that the lessee needs to determine the incremental borrowing rate for the right-of-use asset, not the underlying physical asset.

In most cases, the lessee will need to determine its incremental borrowing rate separately for each lease. Exceptions are where:

- as a practical expedient, the entity applies lease accounting to a portfolio of leases that have similar characteristics. IFRS 16 allows this practical expedient if the effect is reasonably expected to be materially the same as a lease-by-lease approach, or
- on transition, using the modified retrospective approach, a lessee applies a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

It would not be appropriate for a lessee to use its weighted average cost of capital (WACC), which includes equity as well as borrowings. An entity's weighted average cost of capital is not specific to the term, security and amount of the lease.

It would also not be appropriate for a lessee to use its parent's incremental borrowing rate instead of calculating and determining its own rate.

If a lessee has direct borrowings, the effective interest rate on those borrowings may serve as a helpful starting point for determining the incremental borrowing rate. However, it is important to appreciate this is a starting point and adjustments are likely to be necessary. The interest rate on the direct borrowings may have been determined at a date when market conditions and the credit risk of the lessee were different than they are on the commencement date of the lease, or the borrowing may have been based on a different term or included different security. Substantial adjustment may be required (in either direction) to the interest rate on direct borrowings to determine an appropriate incremental borrowing rate and significant judgement will be involved in making these adjustments.

The interest rate implicit in a lease often incorporates an 'asset risk premium' reflecting the lessor's exposure to the residual value of the asset at the end of the lease term. As these premiums reflect the risks and circumstances of the lessor, they should be ignored when estimating the lessee's incremental borrowing rate.

There is an additional complexity involving the way in which a loan's principal will be repaid. For example, a lender charging 8% for a fully amortising loan (ie, blended payments of principal and interest over the loan term) may charge a different rate for a 'bullet-style' loan where the principal is repaid all at once at the end of the loan's term. Unfortunately, the Standard has no guidance on whether the lessee is required to base its analysis on rates applicable to fully amortising loans, or whether rates for bullet-style loans might also provide a meaningful starting point in assessing incremental borrowing rate. While most leases are likely to involve payment streams similar to an amortising loan, lessees will need to exercise careful judgement and consider all facts and circumstances relevant to their situation.

**Example – Blended rates**

An entity purchases a building. Assume that a loan-to-value (LTV) ratio of 80% applies, ie, the lender is only willing to provide funding for 80% of the appraised value of the building in a secured borrowing. If the entity chooses to finance 100% of the purchase it will need to finance the remaining 20% at a higher rate using an unsecured borrowing.

Now assume that instead of purchasing the building, the entity decides to lease it for a period of 10 years and that a similar LTV ratio applies (ie, the lender is only willing to provide funding for 80% of the estimated value of the right-of-use asset). How should the lessee estimate its incremental borrowing rate?

**Analysis**

The lessee should use the rate at which it would finance 100% of the cost of the right-of-use asset. Ie. (80% x rate for secured borrowing) + (20% x rate for unsecured borrowing). This is sometimes known as the blended rate.

## Reassessments of the lease term and lease modifications

A lessee will need to revise the discount rate when there is a reassessment of the lease liability or a lease modification.

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

The lessee will remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

- there is a change in the lease term as a result of
  - a change in the non-cancellable period of the lease, eg the lessee exercises an option to extend that was not previously included in the lease term (or the lessee does not exercise such an option that was previously included in the lease term), or
  - a lessee reassessing whether it is reasonably certain to exercise an extension option or not to exercise a termination option, or
- there is a change in the assessment of a lessee's option to purchase the underlying asset.

## Transition

For leases previously classified as operating leases under IAS 17 where a lessee elects to apply IFRS 16 for the first time using the modified retrospective approach:

- the lessee recognises a lease liability at the date of initial application by discounting the remaining lease payments using its incremental borrowing rate at the date of initial application, and
- where the lessee elects to measure a right-of-use asset at its carrying amount as if IFRS 16 had been applied since the lease commencement date, the measurement is adjusted by discounting the lease payments using the lessee's incremental borrowing rate at the date of initial application.

We expect that most lessees will use an incremental borrowing rate at transition that reflects a lease term based on the number of months remaining from the date of initial application. This is especially where an entity applies a single discount rate to a portfolio of former operating leases with reasonably similar characteristics. However, as the Standard is silent on this issue, some entities may choose to determine the incremental borrowing rate by reference to the original lease term measured from the lease commencement date.

# Lease payments

**At the commencement of a lease, IFRS 16 requires a lessee to measure the lease liability at the present value of the lease payments that are not paid at that date. This liability includes both fixed payments (including in-substance fixed payments) and variable lease payments that depend on an index or rate, and represents the starting point for the measurement of the related right-of-use asset.**

Deciding which payments need be recognised in the measurement of the liability and how changes in those payments are recognised often involves considerable judgement. Our article aims to help you with this judgement.

Lease payments used to measure the lease liability at commencement date include the following (to the extent they have not yet been paid):

- fixed payments – including in-substance fixed payments (described further below) less any lease incentives receivable
- variable lease payments that depend on an index or a rate (described further below)
- amounts expected to be payable by the lessee under residual value guarantees
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

We will discuss some of these areas in more detail below.

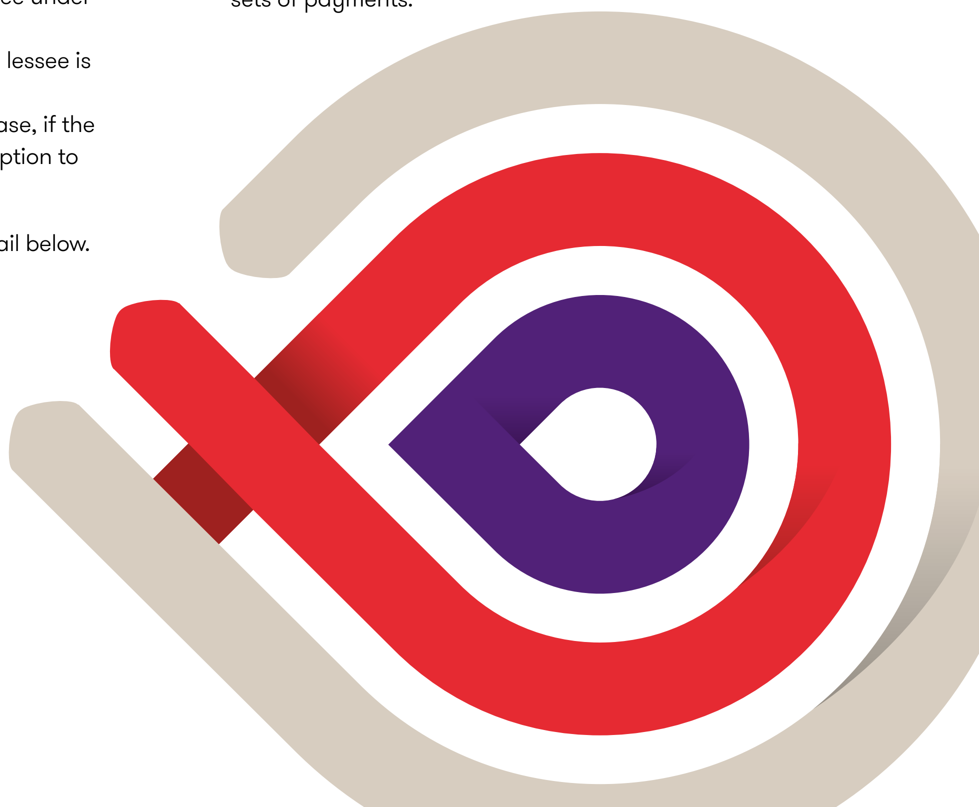
## Fixed payments

Fixed payments are payments, excluding variable payments, that are made to the lessor by the lessee for the right to use an underlying asset during the lease term. These are included in the lease liability at the commencement date.

## In-substance fixed lease payments

The lessee must include in the lease liability any in-substance fixed lease payments. In-substance fixed lease payments are payments whose form appears to contain some variability although they are, in substance, unavoidable. This can occur where:

- payments are structured as variable but there is no genuine variability in those payments
- there is more than one set of payment options described in the lease but only one set of those payments is realistic, or
- there is more than one realistic set of payments described in the lease, but the lessee must select at least one of those sets of payments.



Examples of payments lacking genuine variability include:

- payments that must be made only if an event occurs that has no genuine possibility of not occurring
- payments that must be made only if an asset is proven to be capable of operating during the lease
- payments that are initially structured as variable lease payments linked to the use of an underlying asset, but for which the variability will be resolved after the commencement date such that the payments become fixed for the remainder of the term (in this case the payments become in-substance fixed and are included in the lease liability only once the variability is resolved).

The above examples are all variable in legal form but should be treated as in-substance fixed.

**Example 1 – Minimum lease payments with more than one set of payments**

P is an established Motorway Service Area operator. P leases a Motorway Service Area and under the terms of the lease, P must keep the Service Area open 24 hours per day and cannot sublease the Service Area. Annual rentals are payable under the contract as follows:

- CU100,000 if no sales are made at the service area; or
- CU10,000,000 if any sales are made during the year.

**Analysis**

P concludes that the lease contains in-substance fixed lease payments of CU10,000,000 per annum, on the basis that there is no realistic possibility that P will make no sales at the Service Area, as P is an established Motorway Service Area operator, with a history of successful operations.

## Variable lease payments

Variable lease payments that depend on an index or rate are initially included in the lease liability using the index or rate at the commencement date of the lease. Variable lease payments include payments linked to a consumer price index, payments linked to a benchmark interest rate (such as EURIBOR) or payments that vary to reflect changes in market rental rates.

After the commencement date, the lessee increases the carrying amount to reflect interest on the lease liability and reduces the liability for lease payments made. It also remeasures the carrying amount to reflect changes in the lease payments arising from changes in the index or rate.

In remeasuring the carrying amount, the lessee uses an unchanged discount rate unless the change in lease payments results from a change in floating interest rates. In that scenario the lessee shall use a revised discount rate that reflects changes in the interest rate.

**Example 2 – Variable lease payments dependent on an index**

Entity Q enters into a ten-year lease of a property with annual payments of CU5,000 payable at the beginning of each year. The agreement specifies that the lease payments will increase every two years based on the increase in the consumer price index for the preceding 24 months. The Consumer Price Index at commencement is 125. Entity Q estimates its incremental borrowing rate at 5% per annum; i.e. the fixed rate at which it could borrow for the amount equivalent to the value of the right-of-use asset for the same term and in the same currency.

**Analysis**

At commencement, Entity Q measures the lease liability at CU35,539, being the present value of the remaining nine payments of CU5,000 discounted at 5%. It measures the right-of-use asset at CU40,539, being the present value of the lease liability plus the CU5,000 lease payment made at commencement.

At the end of year two, the lease liability is CU33,932, being the present value of the eight remaining payments of CU5,000. The consumer price index is 135, and the rental payment for year three is set at CU5,400, being "CU5,000 X 135 / 125".

Because there is a change in the future lease payments, Entity Q remeasures the lease liability to reflect the net present value of the eight remaining payments of CU5,400, discounted at the original discount rate of 5%. This increases the lease liability by CU2,714. This is the difference between the lease liability of CU33,932 and the remeasured liability of CU36,646. A corresponding adjustment is made to the right-of-use asset.

**Example 3 – Variable lease payments linked to sales**

Assume the same fact pattern as for Example 2 but Entity Q is also required to make variable lease payments equal to 0.1% of sales generated from the leased property. At commencement, the lease liability is measured at the same amount as in Example 2. This is because the additional lease payments, while variable, are linked to future sales rather than an index or rate. As a result, they do not meet the definition of lease payments under IFRS 16 and are not included in the measurement of the lease liability or the right-of-use asset.

During the first year of the lease, the lessee generates sales of CU800,000. Entity Q incurs an additional expense of CU800 (CU800,000 X 0.1%). This is recognised in profit or loss during the first year.

**Example 4 – Variable lease payments becoming fixed**
Entity S enters into a four-year lease for a specialised photocopier. The lease payments are CU500 per month if the copier is used to produce 100,000 copies or less over the lease term. If the copier is used to make more than 100,000 copies, then the monthly rental is adjusted to CU700 per month (which is applied from the commencement of the lease).

The copier exceeds 100,000 copies at the start of year three. At this point Entity S is required to make a catch-up payment of CU4,800. The remaining payments are adjusted upwards to CU700 per month.

**Analysis**
In our view on commencement the lease liability is based on lease payments of CU500 per month.

At the start of year three the catch-up payment is recorded in profit or loss. The right-of-use asset and lease liability are adjusted for the increase of CU200 per month for the remaining lease term (on a discounted basis). This is because these payments have become in-substance fixed payments.

**Example 6 – Property tax payments**
A contract to lease a building specifies that the lessee must reimburse the lessor for property taxes paid. While this tax will ultimately be paid by the lessee, it isn't a tax obligation of the lessee because the taxing authority imposes the tax on the lessor, as owner of the property. The lessee needs to ascertain whether this represents a lease payment and, if so, whether it is variable based on an index or a rate and therefore should be included when calculating the right-of-use asset and lease liability.

**Analysis**
In our view this represents a lease payment. Whether or not it is included in the lease liability will depend on whether it represents a variable payment based on an index or rate, and the exact wording used in the lease agreement to describe the payment will be key. There are mixed views within the marketplace on this issue. While the answer will ultimately be driven by the facts and circumstances specific to each situation, judgement will be required and as a result we expect some diversity in practice to arise.

## Market rent reviews

Increases in lease payments resulting from market rent reviews are considered to be variable payments based on an index or rate and should therefore be taken into account when assessing lease payments and at the commencement of the lease.

**Example 5 – Impact of market rent reviews affecting optional renewal periods**
Entity A enters into a three-year lease for a property with an option to extend for a further three years. As the entity is reasonably certain the option will be exercised, the lease term is determined to be six years. The terms of the renewal option specify that a market rent review will be performed at the end of year three and the results of this review will determine the lease payments to be made for years four to six. Lease payments belonging to the renewal period will be included when measuring the right-of-use asset and the lease liability at commencement, but at what amount?

**Analysis**
Lease payments subject to future market rent reviews are considered to be payments based on an index or a rate and IFRS 16.27(b) requires Entity A to measure the right-of-use asset and lease liability at commencement using the rate in effect on that date. When the actual rate for years four to six differs on renewal, the lease liability would be remeasured at that time to reflect the revised payments. If the market rent review occurred annually, then the lease liability would be remeasured each year assuming the revised rent applied for all remaining years in the lease term.

## Allocation of non-lease components

A contract may include an amount payable by the lessee for additional services related to the lease. For example, a contract for the lease of a building may require the lessee to make additional payments for maintenance of common areas, or for other goods and services it receives. These are considered non-lease components because they provide the lessee with an additional good or service.

In other cases, a lessee may be required to compensate the lessor for activities and tasks that do not provide a good or service to the lessee. Such charges do not give rise to a separate component of the contract, but are seen to be part of the total consideration that is allocated to the separately identified components of the contract.

When a contract contains a lease component and one or more non-lease components, the lessee allocates the consideration in the contract to each lease component based on the relative stand-alone prices of the lease components and the aggregate standalone price of the non-lease components. If a standalone price is not available then the lessee must estimate it, maximising the use of observable information.

**Example 7 – Lease and non-lease components**

A lessee (Entity U) enters into a five-year lease of equipment, with fixed annual payments of CU6,000. The contact itemises the payments as follows:

- equipment CU4,500
- maintenance CU1,250
- administration CU250.

What are the relevant lease and non-lease components?

**Analysis**

Entity U identifies two components: (a) a lease of equipment and (b) maintenance services. The amount paid for administrative tasks does not transfer a service and so represents additional consideration to be allocated between the lease (equipment) and non-lease (maintenance) components. The total consideration of CU30,000 is allocated between the lease and non-lease components based on their relative standalone prices (not given). The non-lease component is accounted for under the relevant accounting standard.

## Practical expedient – Include non-lease components in the lease accounting

IFRS 16 provides a practical expedient where the lessee may elect, by class of asset, not to separate non-lease components. A lessee making this election accounts for the lease and non-lease components together, as a single lease component.

While taking advantage of this practical expedient will simplify the accounting for contracts containing a lease, it will increase the amount of recognised assets and liabilities and could have implications for impairment.

# Lease term

**Under IFRS 16 'Leases', determining the correct 'lease term' is significant for a number of reasons. Firstly, the longer the lease term, the larger the lessee's right-of-use asset and lease liability will be. Secondly, the length of the lease term determines whether a lease qualifies for the short-term lease exemption. Finally, IFRS 16 contains additional application guidance on how to deal with periods covered by options to extend or terminate a lease. While this detailed guidance can be helpful, it also means there is more to consider when determining the lease term.**

In our view, ascertaining the correct lease term is one of the most challenging issues in applying IFRS 16 as it is likely to require a significant level of judgement.

'Lease term' is defined as the non-cancellable period for which a lessee has the right to use an underlying asset (including any periods covered by a lessor's termination option), plus:

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

While the concept of 'reasonably certain' has not changed from IAS 17, the application of this concept in practice requires consideration of all the facts and circumstances that create a significant economic incentive for a lessee to extend the lease (where a lessee has an extension option) or not to terminate a lease (where the lessee has a termination option). This is ultimately a judgement considering factors specific to the asset, the entity and the wider market. As these factors are wide ranging, we expect this to be a challenging area in practice.

## Enforceability

IFRS 16 requires an entity to assess enforceability when considering the definition of a 'contract'. A contract is defined as 'an agreement between two or more parties that creates enforceable rights and obligations'. A lease is not enforceable when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. When interpreting the term 'penalty', there is currently some diversity of views as to whether it needs to be understood narrowly (only contractual penalties) or more broadly (both contractual penalties and economic disincentives). In the absence of detailed guidance on this point, our view is that entities have an accounting policy choice.

In order to be considered when assessing the lease term, options to extend or terminate the lease must be enforceable. This means that when a lessee exercises its option to extend or terminate the lease, the lessor cannot have the right to decline the request. If the lessor can decline a lessee's request to extend or terminate the lease, then the lessee's option is not enforceable and is ignored when assessing the lease term.

**Example 1 – Extension option requiring approval by both lessee and lessor**

ABC Ltd enters into a contract to lease a floor of a building for five years, with an option to extend for a further three-year period. Both ABC and the lessor must agree to extend the lease for a further three years. ABC is absolutely certain it will want to extend the lease.

**Analysis**

The non-cancellable portion is the five-year period, but is ABC's right to extend the lease enforceable? No, because the lessor has the ability to refuse to extend. It is important that when assessing the lease term, an entity determines the period for which the contract is enforceable. A lease is not enforceable when both the lessee and the lessor can exercise their right to terminate the lease without permission from the other party with no more than an insignificant penalty. In this case, ABC cannot force the lessor to lease to them for a further three-year period. Accordingly, the lease term is five years.

## Initial assessment of the lease term

Entities are required to assess a lease's term at the lease 'commencement date' which is the date on which a lessor makes an underlying asset available for use by a lessee. It is important to contrast the lease commencement date with the lease 'inception date', which is the earlier of the date of a lease agreement and the date of commitment by both parties to the terms and conditions of the lease. A lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

When assessing whether a lessee is reasonably certain to exercise an option to extend the lease or not exercise an option to terminate the lease, the lessee considers all relevant facts and circumstances (both monetary and non-monetary) that create an economic incentive for them to exercise or not exercise that option. It should include any expected changes in facts and circumstances from the commencement date until the exercise date of the option.

### Examples of facts and circumstances that may create an economic incentive to exercise or not exercise an option

| | |
|---|---|
| **Contractual terms and conditions compared with market rates** | Whether contractual terms and conditions for the optional periods compare favourably with market rates, for example:<br>• the amount of lease payments in any optional period<br>• the amount of any variable lease payments for the lease or other contingent payments (eg, termination penalties or residual value guarantees)<br>• the terms and conditions of any options that are exercisable after initial optional periods (e.g, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates). |
| **Significant leasehold improvements** | Significant leasehold improvements undertaken (or expected to be undertaken) over the term of the lease that are expected to have significant economic benefit for the lessee when the option becomes exercisable. |
| **Termination costs** | Costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another suitable asset, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in required condition and/or location. |
| **Importance of the asset to the lessee** | The importance of the leased asset to the lessee's operations, considering, for example, its location, whether the underlying asset is specialised in nature, and whether suitable alternatives are available to the lessee. |
| **Conditions for exercising the option** | Whether certain conditions must be met before the option can be exercised, together with an assessment of the likelihood that those conditions will exist. |
| **Relationship between options and other contractual features** | An entity assumes the lessee is reasonably certain to exercise an option to extend (or not to exercise an option to terminate) when the option has been combined with one or more other contractual features (eg, a residual value guarantee) to guarantee the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. |
| **Length of the non-cancellable period** | A lessee is more likely to exercise an option to extend the lease (or not to exercise an option to terminate the lease) when the non-cancellable period of a lease is shorter. This is because of the costs associated with obtaining a replacement asset. |
| **Lessee's past practice** | An awareness of the period of time over which a lessee has used particular types of assets in the past (whether leased or owned), and its economic reasons for doing so, may provide insight as to whether the lessee is reasonably certain to exercise (or not exercise), an option. |

**Example 2 – Early termination option held by lessor**
XYZ Ltd enters into a contract to lease a floor of a building for ten years. The lessor has the option to terminate the lease after seven years.

**Analysis**
A lessor's right to terminate a lease is ignored in the calculation of the lease term. This is because the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. In this case, XYZ is obligated to make payments for ten years unless the lessor chooses to terminate early. In other words, the lessor can enforce the contract for the full ten-year period. Accordingly, the lease term in this case is ten years.

**Example 3 – Long term lease with option to terminate every 12 months**
Custom Trains Ltd (CTL) enters into a five-year lease with Locomotive Machinery Ltd (LML) for a machine that will form part of CTL's production process. The cost to install the machine in CTL's manufacturing facility is insignificant. CTL and LML each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date.

CTL is currently in final stages of introducing its state-of-the-art next generation trains and the production of this new model requires substantial changes to its manufacturing process. This means the specific machinery leased from LML will be of no use to CTL once production commences for its next generation of trains.

**Analysis**
In this case, the lease term is the one-year non-cancellable period because both CTL and LML have a substantive termination right. Both parties can terminate the lease without penalty and the cost to install a new machine in CTL's manufacturing facility is insignificant. Accordingly, CTL will be eligible to elect the short-term lease exemption for this lease arrangement under which a right-of-use asset and lease liability are not recognised.

## Reassessment of lease term

After the commencement of the lease, the lessee must reassess whether it is reasonably certain to exercise an extension or termination option, if there is a significant event or change in circumstances that:
- is within the lessee's control; and
- affects whether exercise (or non-exercise) is reasonably certain.

In principle, the IASB is of the view that regular reassessment of extension, termination and purchase options by lessees would provide more relevant and useful information to users of financial statements. However, recognising the potential costs associated with such regular reassessments, the IASB adopted a more balanced approach whereby reassessment is only required in the circumstances outlined above. However, reassessment cannot be made upon occurrence of significant events or changes in circumstances that are not in control of the lessee.

Examples of significant events or changes in circumstances that would trigger a reassessment of the lease term include:
- making major leasehold improvements not anticipated at the lease commencement date, that are expected to have significant economic benefit for the lessee when the option becomes exercisable
- making major changes to (or customising) the underlying asset that were not initially predicted
- establishing a sub-lease of the underlying asset which extends beyond the end of the lease term
- making a business decision that is directly relevant to exercising (or not) an option. For example, deciding to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use asset is employed.

The lease term is revised if it is concluded there is a change to the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:
- the lessee exercises an option which was not previously incorporated into the lease term
- the lessee does not exercise an option which was previously included in the lease term
- an event occurs resulting in a contractual obligation for the lessee to exercise an option not previously included in the lease term
- an event occurs that contractually prohibits the lessee from exercising an option previously included in the lease term.

To account for these events the lessee:
- adjusts the lease liability by (i) including the lease payments over the revised term; (ii) applying a revised discount rate (the interest rate implicit in the lease for its remaining term if readily determinable, or the lessee's incremental borrowing rate at the date of reassessment if not)
- makes a corresponding adjustment to the right-of-use asset.

### Example 4 – Reassessment of an extension option

A restaurant operator enters into a five-year lease of real estate on 1.1.20X1 (the commencement date). The annual rental is CU5,000 payable in advance. The contract contains an option for the operator to extend the lease for a further five years at an annual rental of CU6,000. At the commencement date, management concludes that exercise of the extension option is not reasonably certain. This takes account of all relevant facts and circumstances, including that:

- the site will be used for a new restaurant format that is not yet proven in the local market
- leasehold improvements are expected to be at the end of their useful economic lives by the end of year five; and
- the rentals during the extension period are not expected to be below market rates.

Accordingly, management concludes that the lease term is five years. On 1.1.X1 the operator recognises a right-of-use asset and lease liability using its incremental borrowing rate of 4% (having concluded that the interest rate implicit in the lease is not readily determinable):

| 1.1.20X1 | Debit (CU) | Credit (CU) |
|---|---|---|
| Right-of-use asset | 23,150 | |
| Lease liability | | 18,150 |
| Cash | | 5,000 |

The right-of-use asset will be depreciated on a straight-line basis over five years.

After three years, on 31.12.20X3, it is evident that the new restaurant brand has been unsuccessful. Management decides to make a significant investment in rebranding the site to another format that has been very successful. Management determines that this is a significant change of circumstances that makes exercise of the extension option reasonably certain. Accordingly, management reassesses the total lease term to be ten years, of which seven years remain. At the date of reassessment, the operator's incremental borrowing rate is 3% (the interest rate implicit in the lease for its remaining term is not readily determinable).

#### Analysis

As a result, the lease liability is re-measured at 31.12.20X3. The new liability is the present value of two payments of CU5,000 due on 1.1.X4 and 1.1.X5, plus five payments of CU6,000 due from 1.1.X6 to 1.1.X10, discounted at 3% (CU36,533). The lease liability at 31.12.20X3 before reassessment is CU9,808. The increase (CU26,725) is added to the lease liability and the right-of-use asset:

| 31.12.20X3 | Before reassessment (CU) | Adjustment (CU) | After reassessment (CU) |
|---|---|---|---|
| Right-of-use asset | 9,260 | 26,725 | 35,985 |
| Lease liability | 9,808 | 26,725 | 36,533 |

Subsequently, the revised right-of-use asset is depreciated over its revised useful life (eg straight-line over seven years). The revised lease liability is measured using the new effective interest rate of 3%.

### Example 5 – lease term for intermittent period of use

A retailer has a ten-year lease to rent a shop for three months of each year from 1 October to 31 December to sell Christmas products.

#### Analysis

The lease term is considered to be the total time period for which the property is leased. The retailer has the right-to-use the shop for three months every year for ten years, so the lease term is 30 months.

Focus is placed on period the lessee has the right-to-use the asset rather than the contractual term. Another retailer could lease the shop for the other nine months of the year, so this period should not be included in the lease term.

# Sale and leaseback accounting

**IFRS 16 makes significant changes to sale and leaseback accounting. A sale and leaseback transaction is one where an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) for consideration and leases that asset back from the buyer-lessor.**

A sale and leaseback transaction is a popular way for entities to secure long-term financing from substantial property, plant and equipment assets such as land and buildings.

IAS 17 covered the accounting for a sale and leaseback transaction in considerable detail but only from the perspective of the seller-lessee.

As IFRS 16 has withdrawn the concepts of operating leases and finance leases from lessee accounting, the accounting requirements that the seller-lessee must apply to a sale and leaseback are more straight forward. In addition, IFRS 16 provides an overview of the accounting requirements for buyer-lessors too.

When a seller-lessee has undertaken a sale and lease back transaction with a buyer-lessor, both the seller-lessee and the buyer-lessor must first determine whether the transfer qualifies as a sale. This determination is based on the requirements for satisfying a performance obligation in IFRS 15 'Revenue from Contracts with Customers'.

The accounting treatment will vary depending on whether or not the transfer qualifies as a sale. This is described below.

## Transfer of the asset is a sale

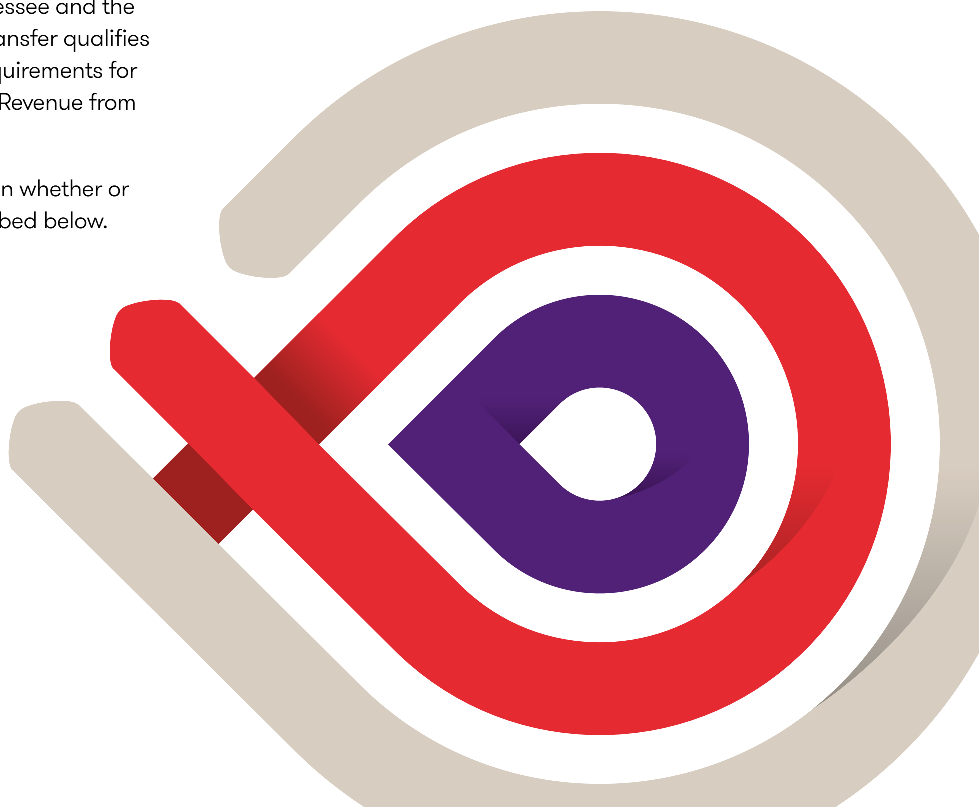
If the transfer qualifies as a sale and the transaction is on market terms the seller-lessee effectively splits the previous carrying amount of the underlying asset into:

- a right-of-use asset arising from the leaseback, and
- the rights in the underlying asset retained by the buyer-lessor at the end of the leaseback.

The seller-lessee recognises a portion of the total gain or loss on the sale. The amount recognised is calculated by splitting the total gain or loss into:

- an unrecognised amount relating to the rights retained by the seller-lessee, and
- a recognised amount relating to the buyer-lessor's rights in the underlying asset at the end of the leaseback.

The leaseback itself is then accounted for under the lessee accounting model.



The buyer-lessor accounts for the purchase in accordance with the applicable standards (eg IAS 16 'Property, Plant and Equipment' if the asset is property, plant or equipment or IAS 40 'Investment Property' if the property is investment property). The lease is then accounted for as either a finance lease or an operating lease using IFRS 16's lessor accounting requirements.

Adjustments are required if consideration for the sale is not at fair value and/or payments for the lease are not at market rates. These adjustments result in recognition of:

- a prepayment to reflect below-market terms
- additional financing provided by the buyer-lessor to the seller-lessee to reflect above-market terms.

**Example 1 – Sale and leaseback**

SellCo sells a building to BuyCo for cash of CU1,800,000, which is its fair value at that date. The previous carrying value of the building is CU1,000,000. At the same time, SellCo enters into a lease with BuyCo conveying back the right to use the building for 18 years. Annual payments are CU120,000 payable at the end of each year, which is at market rate. The transfer qualifies as a sale based on the guidance on satisfying a performance obligation in IFRS 15.

The rate implicit in the lease is 4.5%, which is readily determinable by SellCo.

**Analysis**

SellCo

The present value of the annual payments (18 payments of CU120,000, discounted at 4.5%) is CU1,459,200.

SellCo measures the right-of-use asset retained through the leaseback as a proportion of the previous carrying amount of the building. This is calculated as: CU1,000,000 (previous carrying value) x [CU1,459,200 (PV of lease payments)/ CU1,800,000 (fair value of building)]. The right-of-use asset calculated in this way is CU810,667.

SellCo recognises a portion of the total gain on the sale, to the extent it relates to the rights retained in the underlying asset by BuyCo at the end of the leaseback. The total gain on sale of building is CU800,000 (CU1,800,000 – CU1,000,000). This total is split into:

- the portion relating to the rights to use the building retained by SellCo, calculated as CU800,000 × [CU1,459,200/ CU1,800,000] which is CU648,533; and
- the portion relating to BuyCo's rights in the underlying asset at the end of the leaseback, calculated as CU800,000 × [(CU1,800,000 – CU1,459,200)/CU1,800,000], which is CU151,467.

At the commencement date, SellCo's accounting entries are:

| | Debit (CU) | Credit (CU) |
|---|---|---|
| Cash | 1,800,000 | |
| Right-of-use asset | 810,667 | |
| Building | | 1,000,000 |
| Gain on sale | | 151,467 |
| Lease liability | | 1,459,200 |

BuyCo

At the commencement date, BuyCo's accounting entries are:

| | Debit (CU) | Credit (CU) |
|---|---|---|
| Building | 1,800,000 | |
| Cash | | 1,800,000 |

BuyCo classifies the lease as an operating lease taking into account, among other things, that the present value of the lease payments is 19% less than the fair value of the building. BuyCo accounts for the lease accordingly.

## Transfer of the asset is not a sale

If the transfer does not qualify as a sale the parties account for it as a financing transaction. This means that:

- the seller-lessee continues to recognise the asset on its balance sheet as there is no sale. The seller-lessee accounts for proceeds from the sale and leaseback as a financial liability in accordance with IFRS 9. This arrangement is similar to a loan secured over the underlying asset – in other words a financing transaction
- the buyer-lessor has not purchased the underlying asset and therefore does not recognise the transferred asset on its balance sheet. Instead, the buyer-lessor accounts for the amounts paid to the seller-lessee as a financial asset in accordance with IFRS 9. From the perspective of the buyer-lessor, this arrangement is a financing transaction.

## Sale and leaseback transactions on transition to IFRS 16

Where the overall sale and leaseback arrangement has been settled (ie the lease has expired) before the date of initial application of IFRS 16 then there is nothing to consider.

However, those transactions that are important to consider on transition to IFRS 16 are those sale and leaseback transactions entered into before the date of initial application of IFRS 16 and which still have historic balances that need to be accounted for until the end of the leaseback period.

Therefore, on applying IFRS 16 for the first time, an entity will need to consider any on-going leases, and assets and liabilities that remain because of historic sale and leaseback transactions accounted for under IAS 17.

The following questions should be considered when determining the correct accounting treatment on transition to IFRS 16:

1. Do entities re-assess sale and leaseback transactions arising before transition to assess whether they were a sale under IFRS 15?
   The answer is no. The IASB have said that the historic judgements on previous sale and leaseback arrangements are not re-opened.

   IFRS 15 is only applicable when a sale and leaseback transaction has occurred on or after the date of initial application of IFRS 16.

2. From the perspective of the seller-lessee, what if a transaction was a sale and finance leaseback under IAS 17?
   Where a transaction was a sale and finance leaseback the entity continues to account for the finance leaseback like any other finance lease at transition to IFRS 16.

   For example, the seller-lessee will reflect a right-of-use asset and a lease liability.

   Any deferred gain arising on the historical application of IAS 17 continues to be amortised going forward under IFRS 16.

3. From the perspective of the seller-lessee – what if a transaction was a sale and operating leaseback under IAS 17?
   The entity accounts for the operating leaseback like any other operating lease at transition to IFRS 16. The seller-lessee will again reflect a right-of-use asset and a lease liability.

   However, this time the seller-lessee adjusts the right-of-use asset for any deferred gains or losses relating to off-market terms remaining on the balance sheet immediately prior to date of initial application of IFRS 16.

# Interim periods

**How do you treat a variable lease payment in the financial statements of an interim period?**

IFRS 16 must first be applied to accounting periods beginning on or after 1 January 2019, including interim periods beginning on or after that date. The application of IFRS 16 to those interim periods will broadly follow the requirements of IFRS 16 except in one key respect.

IFRS 16 requires a variable lease payment, provided it is not in-substance fixed or based on an index or rate, to be recognised in profit or loss in the period in which the triggering event or condition occurs. Therefore, you might assume that the same would apply in interim periods. In other words, a variable lease payment would only be recognised in the interim period in which the event that crystallises the payment occurs.

However, IAS 34.B7 requires a variable lease payment to be recognised if it is expected that the event will occur before the end of the current annual reporting period.

This appears to be a direct conflict between the two Standards.

In our view, when preparing a set of interim financial statements under IAS 34, the IAS 34 approach should be taken to ensure the interim financial statements are compliant with IAS 34. However, given the evident conflict, it is not possible to entirely rule out an IFRS 16 approach.

**Example 1**

Entity A has a December year-end and leases a high street store. As well as making fixed lease payments each year, Entity A is required to make a further lease payment of £100,000 every year the store makes sales of at least £10 million. Considering both IFRS 16 and IAS 34 when should a liability be recognised for the additional £100,000 payment? Assume Entity A reports on a six-monthly basis.

**Analysis**

IFRS 16 will only require recognition of that additional lease payment in any annual reporting period if the triggering event, ie sales of at least £10 million, has occurred.

However, in its first interim financial statements to 30 June 2019, Entity A must assess whether it expects the store to make sales of at least £10 million before the end of the year. In our view, the entity should apply an IAS 34 approach and recognise a liability for the additional payment if it expects the threshold to be met.

IAS 34 does not specify whether or not the expense can be pro-rated, ie whether the expense can be based on the proportion of the target sales recognised to date or on a time apportionment basis. Given the lack of specific guidance on this point management will need to exercise their judgement in selecting an appropriate accounting policy.

**Example 2**

Entity A has a December year-end and leases a high street store for a four-year period. As well as making fixed lease payments each year, Entity A is required to make a further lease payment in year 4 of £200,000 if the store makes sales of at least £10 million over the first 3 years. At the start of the lease, Entity A believes the threshold will be exceeded at some point in the third year and therefore the amount will be payable. The liability is triggered in October of the third year. Considering both IFRS 16 and IAS 34 when should a liability be made for the £100,000 additional payment?

**Analysis**

As with example 1 above, IFRS 16 will only require recognition of that additional lease payment in any annual reporting period if the triggering event, ie sales of at least £10 million, has occurred. This means the payment will be recorded in year 3 when the sales exceed £10 million.

However, in our view, IAS 34 will require Entity A to begin recognising a provision in the first interim period of the third year.

For both scenarios it is important to note that IAS 34 is a Standard relating to interim reports only and therefore should not influence how IFRS 16 is applied to the year-end financial report.

# Transition choices

**Many recent accounting standards include significant transition reliefs to make first time application simpler – IFRS 16 is no exception. Appendix C to IFRS 16 contains all the details of the transition provisions that are available.**

This article sets out the choices that are available and discusses some of their practical implications. The final page then includes a flow chart summarising the decisions to be made.

The key takeaway is that there are a significant number of choices available and decisions about these can have a significant impact on the reported balance sheet and income statement. It is therefore important to ensure that you obtain all the data necessary to apply the Standard, and that you model the possible options to ensure you select the one that will best meet your needs. For example, the application of the various transitional provisions could have an impact on:

- your ability to make dividend payments
- tax payments
- your banking covenants
- the attractiveness of employee bonus arrangements
- the availability of investor reliefs
- the metrics your investors use to assess your position and performance.

## Identify leases

The first decision to be made on transition is which lease definition to use when identifying leases. For contracts in place at the date of initial application you can either:

- apply the IAS 17/IFRIC 4 definition of a lease, or
- apply the IFRS 16 definition of a lease.

Initial application is the beginning of the annual reporting period in which an entity first applies IFRS 16. For entities with a year-end of 31 December, the date of initial application will be 1 January 2019, unless the Standard is adopted early.

Although the definition of a lease under IFRS 16 is similar to IAS 17 and IFRIC 4, IFRS 16.9 introduces the requirement that a lease contract must convey the 'right to control the use of an identified asset for a period of time in exchange for consideration'.

While there will likely be a significant overlap between leases identified under IAS 17 and IFRS 16, we expect some differences to arise, with the key difference between the two standards being the ability to "control" an identified asset. IFRS 16 includes substantially more guidance on identifying a lease which can be found in the application guidance (Appendix B of IFRS 16).

**The practical implications**

- Have you identified all your lease contracts?
- Does the altered definition have any implications in practice?
- What is the impact of the revised definition, will this result in more or less leases?

## The application methods to choose

IFRS 16 provides two methods for first time application of the Standard:

- full retrospective application
- modified retrospective application.

**Full Retrospective**

If the full retrospective approach is taken, the liability and asset are measured as if IFRS 16 had been applied since the start of the lease. There are no further transition reliefs available if this route is taken and full retrospective application in accordance with IAS 8 'Accounting Policies, Estimates and Errors' is required. Comparatives also need to be restated.

**Modified Retrospective**

The cumulative effect of adopting IFRS 16 is recognised in equity as an adjustment to the opening balance of retained earnings for the current period. Prior periods are not restated. This will result in the current and prior periods not being comparable, therefore consideration should be given to how this is explained to the users in the financial statements.

Under the modified retrospective approach, for leases previously classified as operating leases, the lease liability is measured at the present value of the remaining lease payments and discounted using the incremental borrowing rate at the date of initial application. The right-of-use asset can be measured at:

- an amount equal to the lease liability, adjusted by prepayments or accrued lease payments relating to that lease at the date of initial application; or
- the asset's carrying value as if the Standard had been applied since the commencement date of the lease. Although the carrying value is determined from the commencement of the lease, it is discounted using the lessee's incremental borrowing rate at the date of initial application.

For those leases previously classified as finance leases, the right-of-use asset and the lease liability are measured at the same amounts as IAS 17 at the date of initial application.

**Handy hint: using the first of these approaches to measuring the right-of-use asset will be the more straightforward option. However, in many situations, it will result in a higher asset value on transition. This means higher depreciation charges recognised on the right-of-use asset and, more importantly, lower net income in the periods following adoption.**

**The practical implications**

- How will you estimate the incremental borrowing rate for leases in place at the date of initial application?
- Will you apply the portfolio approach described in IFRS 16.B1 and IFRS 16.C10(a) to determine incremental borrowing rates for groups of assets? If so, what portfolios of assets will you determine incremental borrowing rates for? For example, separating assets into portfolios for:
  - property and cars, or
  - property in London, other property in the UK and cars, or
  - some other portfolios?
- What evidence will your auditors require that your identification of portfolios would not give a materially different result to applying the Standard on a lease-by-lease basis?
- Can you source the data needed to calculate the original asset carrying value? Will this be beneficial to either the income statement or the balance sheet position?

## Advantages and disadvantages of applying the modified retrospective approach

The main advantage of using a modified approach as opposed to a full retrospective approach is the cost savings that can be made. Costs are saved as a result of not having to restate comparatives and the additional transitional reliefs that are available to be applied (these are discussed further below).

The biggest disadvantage is the loss of comparability of information.

## Other transitional reliefs when applying the modified retrospective approach

If the modified retrospective transition method is chosen, there are further policy decisions which need to be made for those leases previously accounted for as operating leases under IAS 17. Each of these choices can be made on an individual lease-by-lease basis.

### Low value assets

On transition, if the lease is for a low value asset, then there is no requirement to recognise any transition adjustments and can account for the lease expense on a straight-line basis or another systematic basis if more representative.

### Leases of investment property

Prior to the adoption of IFRS 16, IAS 40 'Investment property' permitted you to recognise an asset in respect of investment property held under an IAS 17 operating lease if that asset was accounted for using the fair value method. Upon adoption of IFRS 16, no transition adjustments are required for these assets. IAS 40 and IFRS 16 are applied from the date of initial application onwards.

For operating leases of investment property not previously recognised as an asset, the new right-of-use asset is accounted for at fair value if the fair value model in IAS 40 is going to be applied. Subsequent to the date of initial application the right-of-use asset and the lease liability are accounted for by applying IAS 40 and IFRS 16.

### Discount rate

This transitional relief allows a single discount rate to be applied to a portfolio of leases. Each portfolio needs to have reasonably similar characteristics, for example similar remaining lease terms for similar classes of assets in similar economic environments.

### Impairment

Right-of-use assets must be assessed for impairment on transition. To do this, you can either:

- apply IAS 36 at the date of initial application, or
- adjust the right-of-use asset by the amount previously recognised as an onerous lease provision.

### Leases ending within 12 months of initial application

For an existing lease which ends within 12 months of initial application of IFRS 16, you can choose to either recognise the right-of-use asset and liability in accordance with the normal requirements of IFRS 16 or account for the lease as a short-term lease. If accounted for as a short-term lease, the lease would continue to be accounted for as it has been under IAS 17 with payments recognised as an expense over the lease term on a straight-line basis or another systematic basis if more representative.

### Initial direct costs

On transition, you can choose to either include or exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

### Use of hindsight

A lessee is permitted, but not required, to apply hindsight when applying the Standard. For example, in determining the lease term where there are options to extend or terminate the lease.

### Practical decisions to make

- How will you account for operating leases of investment property not previously recognised as an asset under the IAS 40 fair value model?
- Will you apply the small value asset exemption to leases in place at the date of initial application?
- Which approach will you use to determine the impairment of right-of-use assets at the date of initial application?
- For leases with less than 12 months to run at the date of initial application will you apply IFRS 16 and account for the right-of-use asset and lease liability or treat them as short-term leases?
- Can you identify any initial direct costs at the date of initial application? Will you choose to exclude these from the measurement of the right-of-use asset?
- Are you able to determine the decisions you would have made in the past concerning judgemental areas such as whether or not to exercise extension or termination options? If not, the hindsight practical expedient is likely to be valuable.

## Other transitional provisions

There are further transitional provisions which are not set out in detail here. These relate to:

- lessor accounting where the lessor is an intermediate lessor
- sale and leaseback transactions before the date of initial application
- amounts previously recognised in business combinations.

**Example**

Applying the transition options to a simplified example demonstrates how the balance sheet and statement of profit or loss will vary depending on the choices made.

Facts

- CU10,000 payable annually in arrears from lease commencement date
- 10-year lease, starting 1 January 2016, previously accounted for as an operating lease
- Right-of-use asset is depreciated on a straight-line basis
- 7% discount rate at lease commencement (interest rate implicit in the lease)
- 10% incremental borrowing rate at date of initial application – 1January 2019
- Company's year-end is 31 December.

**Analysis – Full retrospective approach**

The right-of-use asset and the lease liability are recorded in the financial statements as if IFRS 16 has been applied since the start of the lease, and comparative amounts for 2018 are restated. The liability at the commencement of the lease is calculated as the future lease payments discounted at 7%.

The relevant calculations are as follows:

Lease liability

| Year | Balance brought forward at 1 January | Lease payment | Interest expense | Balance carried forward at 31 December |
|---|---|---|---|---|
| 2016 | 70,236 | (10,000) | 4,917 | 65,153 |
| 2017 | 65,153 | (10,000) | 4,560 | 59,713 |
| 2018 | 59,713 | (10,000) | 4,180 | **53,893** |
| 2019 | 53,893 | (10,000) | 3,773 | 47,666 |
| 2020 | 47,666 | (10,000) | 3,336 | 41,002 |
| 2021 | 41,002 | (10,000) | 2,870 | 33,872 |
| 2022 | 33,872 | (10,000) | 2,371 | 26,243 |
| 2023 | 26,243 | (10,000) | 1,837 | 18,080 |
| 2024 | 18,080 | (10,000) | 1,266 | 9,346 |
| 2025 | 9,346 | (10,000) | 654 | – |

Right-of-use asset

| Year | Balance brought forward at 1 January | Depreciation | Balance carried forward at 31 December |
|---|---|---|---|
| 2016 | 70,236 | (7,024) | 63,212 |
| 2017 | 63,212 | (7,023) | 56,189 |
| 2018 | 56,189 | (7,024) | **49,165** |
| 2019 | 49,165 | (7,023) | 42,142 |
| 2020 | 42,142 | (7,024) | 35,118 |
| 2021 | 35,118 | (7,024) | 28,094 |
| 2022 | 28,094 | (7,023) | 21,071 |
| 2023 | 21,071 | (7,024) | 14,047 |
| 2024 | 14,047 | (7,023) | 7,024 |
| 2025 | 7,024 | (7,024) | – |

On transition to IFRS 16 the financial statements will therefore include:

| Year | 1 January 2019 | 2018 restated comparatives |
|---|---|---|
| Right-of-use asset | **49,165** | 56,189 |
| Lease liability | **53,893** | 59,713 |
| Equity adjustment at 1 January | 4,728 | 3,524 |

The impact on the balance sheet at the date of transition is a reduction of net assets of CU4,728.

The expenses post transition are as follows:

| Year | Depreciation | Interest | Total |
|---|---|---|---|
| 2019 | 7,023 | 3,773 | 10,796 |
| 2020 | 7,024 | 3,336 | 10,360 |
| 2021 | 7,024 | 2,870 | 9,894 |
| 2022 | 7,023 | 2,371 | 9,394 |
| 2023 | 7,024 | 1,837 | 8,861 |
| 2024 | 7,023 | 1,266 | 8,289 |
| 2025 | 7,024 | 654 | 7,678 |
| **Total** | **49,165** | **16,107** | **65,272** |

Under this method, the total expense post-transition to IFRS 16 is CU65,272.

### Analysis – Modified retrospective approach

The lease liability is measured at the present value of the remaining lease payments, discounted using the incremental borrowing rate at the date of initial application, which in this case is 10%. As mentioned above, there are two methods for valuing the right-of-use asset, and these methods are illustrated below.

#### Method 1 for calculating right-of-use asset

The right-of use-asset is measured at an amount equal to the lease liability, adjusted by prepayments or accrued lease payments relating to that lease at the date of initial application. This produces the following amounts:

Lease liability

| Year | Balance brought forward at 1 January | Lease payment | Interest expense | Balance carried forward at 31 December |
|---|---|---|---|---|
| 2016 | | | | |
| 2017 | | | | |
| 2018 | | | | |
| 2019 | **48,684** | (10,000) | 4,868 | 43,552 |
| 2020 | 43,552 | (10,000) | 4,355 | 37,907 |
| 2021 | 37,907 | (10,000) | 3,791 | 31,698 |
| 2022 | 31,698 | (10,000) | 3,170 | 24,868 |
| 2023 | 24,868 | (10,000) | 2,487 | 17,355 |
| 2024 | 17,355 | (10,000) | 1,736 | 9,091 |
| 2025 | 9,091 | (10,000) | 909 | – |

Right-of-use asset

| Year | Balance brought forward at 1 January | Depreciation | Balance carried forward at 31 December |
|---|---|---|---|
| 2016 | | | |
| 2017 | | | |
| 2018 | | | |
| 2019 | 48,684 | (6,955) | 41,729 |
| 2020 | 41,729 | (6,955) | 34,774 |
| 2021 | 34,774 | (6,955) | 27,819 |
| 2022 | 27,819 | (6,955) | 20,864 |
| 2023 | 20,864 | (6,955) | 13,909 |
| 2024 | 13,909 | (6,955) | 6,954 |
| 2025 | 6,954 | (6,954) | – |

On transition to IFRS 16 the financial statements will therefore include:

| Year | 1 January 2019 | 2018 restated comparatives |
|---|---|---|
| Right-of-use asset | **48,684** | N/A |
| Lease liability | **48,684** | N/A |
| Equity adjustment at 1 January | – | N/A |

The impact on the balance sheet at the date of transition is zero reduction of net assets. The expenses post-transition are as follows:

| Year | Depreciation | Interest | Total |
|---|---|---|---|
| 2019 | 6,955 | 4,868 | 11,823 |
| 2020 | 6,955 | 4,355 | 11,310 |
| 2021 | 6,955 | 3,791 | 10,746 |
| 2022 | 6,955 | 3,170 | 10,125 |
| 2023 | 6,955 | 2,487 | 9,442 |
| 2024 | 6,955 | 1,736 | 8,691 |
| 2025 | 6,954 | 909 | 7,863 |
| **Total** | **48,684** | **21,316** | **70,000** |

Under this method, the total expense post-transition to IFRS 16 is CU70,000.

### Method 2 for calculating right-of-use asset

The right-of-use asset is measured at the asset's carrying value as if the Standard had been applied since the commencement date of the lease. While the carrying value is determined from the commencement of the lease, it is discounted using the lessee's incremental borrowing rate at the date of initial application. This produces the following amounts:

Lease liability

| Year | Balance brought forward at 1 January | Lease payment | Interest expense | Balance carried forward at 31 December |
|---|---|---|---|---|
| 2016 | | | | |
| 2017 | | | | |
| 2018 | | | | |
| 2019 | **48,684** | (10,000) | 4,868 | 43,552 |
| 2020 | 43,552 | (10,000) | 4,355 | 37,907 |
| 2021 | 37,907 | (10,000) | 3,791 | 31,698 |
| 2022 | 31,698 | (10,000) | 3,170 | 24,868 |
| 2023 | 24,868 | (10,000) | 2,487 | 17,355 |
| 2024 | 17,355 | (10,000) | 1,735 | 9,090 |
| 2025 | 9,090 | (10,000) | 910 | – |

Right-of-use asset

| Year | Balance brought forward at 1 January | Depreciation | Balance carried forward at 31 December |
|---|---|---|---|
| 2016 | 61,446 | (6,145) | 55,301 |
| 2017 | 55,301 | (6,145) | 49,156 |
| 2018 | 49,156 | (6,144) | 43,012 |
| 2019 | **43,012** | (6,145) | 36,867 |
| 2020 | 36,867 | (6,144) | 30,723 |
| 2021 | 30,723 | (6,145) | 24,578 |
| 2022 | 24,578 | (6,144) | 18,434 |
| 2023 | 18,434 | (6,145) | 12,289 |
| 2024 | 12,289 | (6,144) | 6,145 |
| 2025 | 6,145 | (6,145) | – |

On transition to IFRS 16 the financial statements will therefore include:

| Year | 1 January 2019 | 2018 restated comparatives |
|---|---|---|
| Right-of-use asset | **43,012** | N/A |
| Lease liability | **48,684** | N/A |
| Equity adjustment at 1 January | 5,672 | N/A |

The impact on the balance sheet at the date of transition is a reduction of net assets of CU5,672. The expenses post transition are as follows:

| Year | Depreciation | Interest | Total |
|---|---|---|---|
| 2019 | 6,145 | 4,868 | 11,013 |
| 2020 | 6,144 | 4,355 | 10,499 |
| 2021 | 6,145 | 3,791 | 9,936 |
| 2022 | 6,144 | 3,170 | 9,314 |
| 2023 | 6,145 | 2,487 | 8,632 |
| 2024 | 6,144 | 1,735 | 7,879 |
| 2025 | 6,145 | 910 | 7,055 |
| **Total** | **43,012** | **21,316** | **64,328** |

Under this method, the total expense post-transition to IFRS 16 is CU64,328.

### Comparison of methods

| | Full retrospective | Modified retrospective method 1 | Modified retrospective method 2 |
|---|---|---|---|
| Right of use asset on transition | 49,165 | 48,684 | 43,012 |
| Lease liability on transition | 53,893 | 48,684 | 48,684 |
| Impact on net assets | (4,728) | – | (5,672) |
| Post-transition expense | 65,272 | 70,000 | 64,328 |

For contracts previously classified as operating leases under IAS 17, the various practical expedients identified above will also play a significant role in determining the amounts recognised as lease liabilities and right-to-use assets upon adoption and the related impacts on profit or loss.

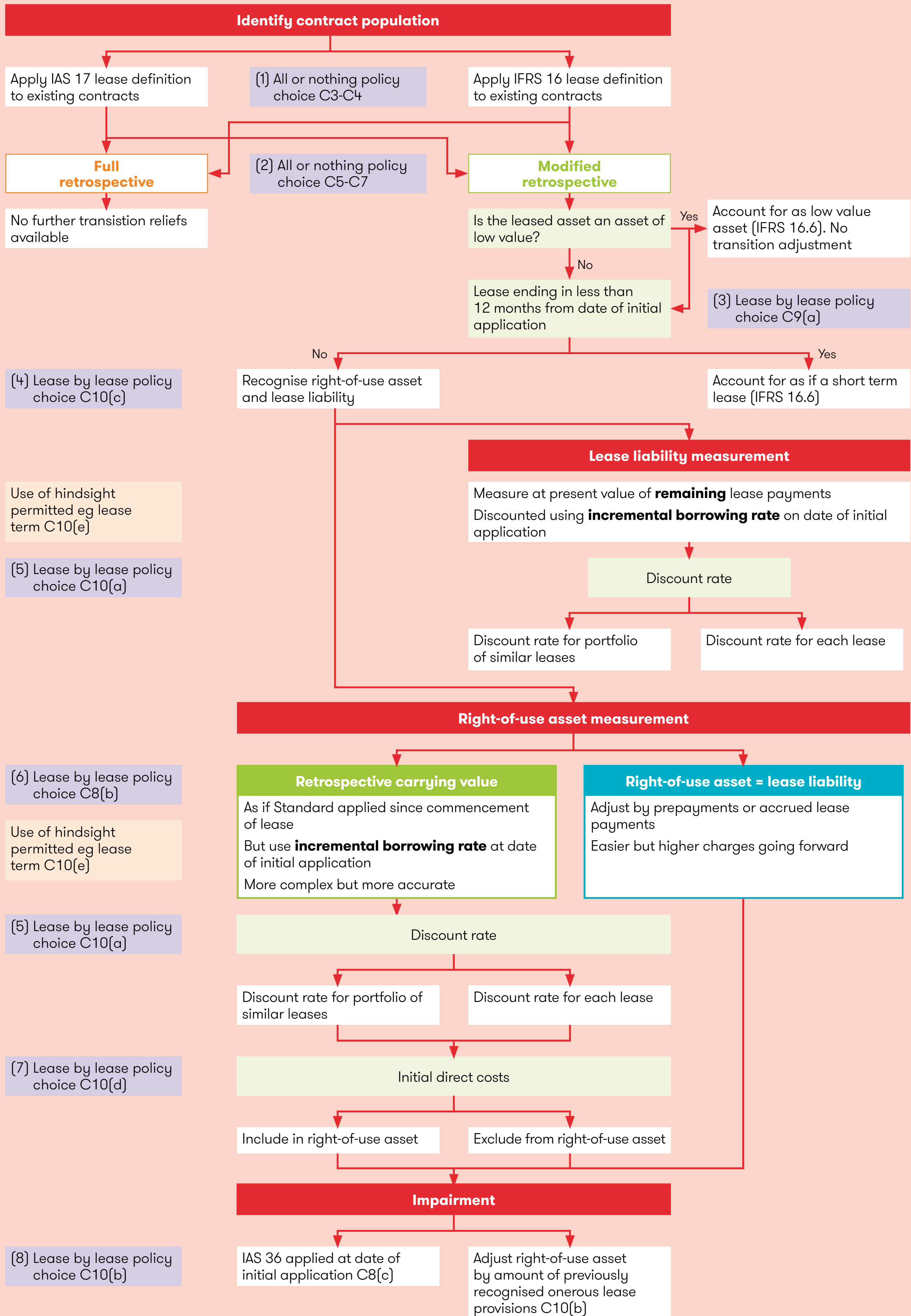
## Disclosures on transition

If a lessee opts to use the modified retrospective approach for transition to IFRS 16, a lessee should disclose:

- the information required by IAS 8.28, including:
  - the fact IFRS 16 has been adopted
  - that the adoption is in accordance with IFRS 16's transitional provisions (and a description of them)
  - if applicable, any transitional provisions that might impact future periods
  - a description of the nature of the change in accounting policy
  - where practicable, the extent that the adjustment relates to periods before those presented.
- the lessee's incremental borrowing rate applied to lease liabilities that have been recognised in the balance sheet on transition, and
- any differences that have arisen between:
  - operating lease commitments disclosed at the end of the previous annual reporting period when IAS 17 had been applied, discounted using the incremental borrowing rate at transition date; and
  - lease liabilities recognised in the balance sheet at the date of transition.

In addition, if a lessee has opted to use any of the practical expedients mentioned above on transition, it should disclose this information.

As mentioned previously, the main disadvantage of the modified retrospective approach is the lack of comparability. In our view, one way in which you can partially overcome this is to provide a set of proforma comparatives. These would explain what the prior period amounts would have been if IFRS 16 had been in place in the prior year.



Choices available on transition to IFRS 16 for leases previously classified as operating under IAS 17
Identify contract population
Apply IAS 17 lease definition to existing contracts
(1) All or nothing policy choice C3-C4
Apply IFRS 16 lease definition to existing contracts
Full retrospective
(2) All or nothing policy choice C5-C7
Modified retrospective
No further transition reliefs available
Is the leased asset an asset of low value?
Yes
Account for as low value asset (IFRS 16.6). No transition adjustment
No
Lease ending in less than 12 months from date of initial application
(3) Lease by lease policy choice C9(a)
No
Yes
(4) Lease by lease policy choice C10(c)
Recognise right-of-use asset and lease liability
Account for as if a short term lease (IFRS 16.6)
Lease liability measurement
Use of hindsight permitted eg lease term C10(e)
Measure at present value of remaining lease payments
Discounted using incremental borrowing rate on date of initial application
(5) Lease by lease policy choice C10(a)
Discount rate
Discount rate for portfolio of similar leases
Discount rate for each lease
Right-of-use asset measurement
(6) Lease by lease policy choice C8(b)
Retrospective carrying value
As if Standard applied since commencement of lease
But use incremental borrowing rate at date of initial application
More complex but more accurate
Right-of-use asset = lease liability
Adjust by prepayments or accrued lease payments
Easier but higher charges going forward
Use of hindsight permitted eg lease term C10(e)
(5) Lease by lease policy choice C10(a)
Discount rate
Discount rate for portfolio of similar leases
Discount rate for each lease
(7) Lease by lease policy choice C10(d)
Initial direct costs
Include in right-of-use asset
Exclude from right-of-use asset
Impairment
(8) Lease by lease policy choice C10(b)
IAS 36 applied at date of initial application C8(c)
Adjust right-of-use asset by amount of previously recognised onerous lease provisions C10(b)

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