IFRS Accounting Standards

in Practice 2024/2025 –
IFRS 16 *Leases*

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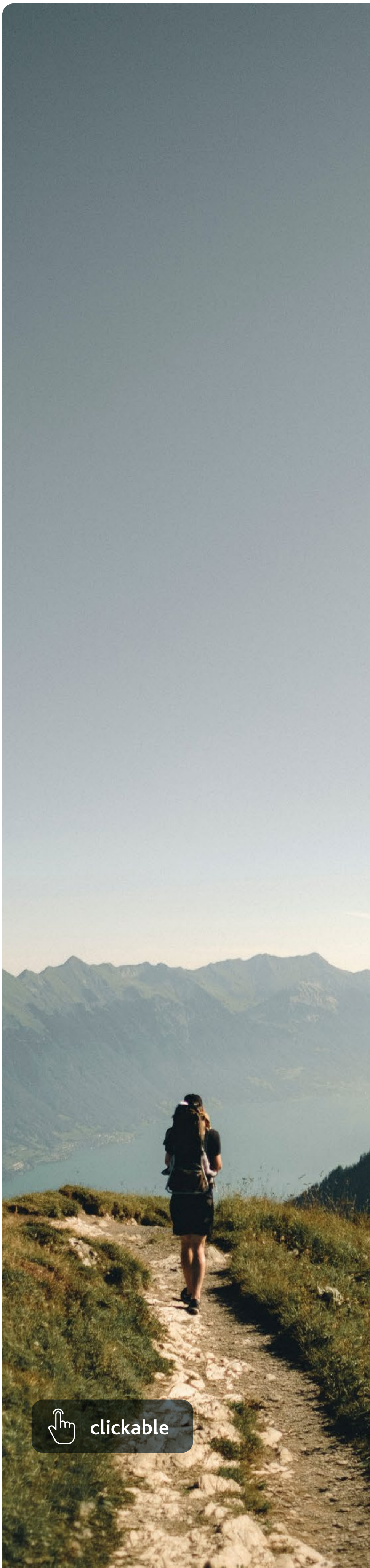
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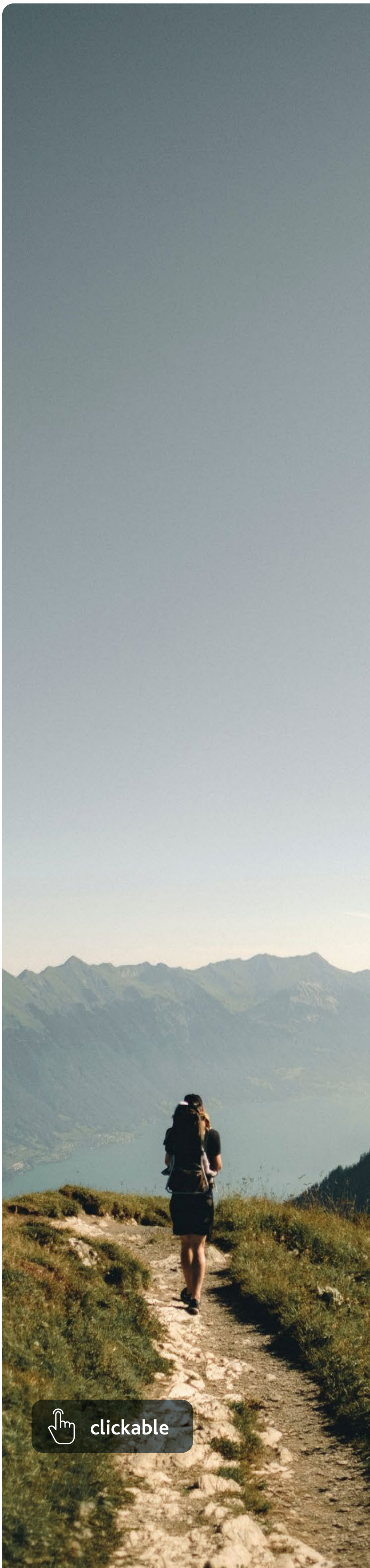

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1. INTRODUCTION

IFRS 16 *Leases*, effective for annual reporting periods beginning on or after 1 January 2019, brought significant changes in accounting requirements for lease accounting, primarily for lessees. IFRS 16 replaced the following suite of standards and interpretations on leases:

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

This BDO IFRS® *Accounting Standards In Practice* sets out the requirements of IFRS 16 in relation to the classification and measurement of leases, primarily from the perspective of lessees, with a brief overview of the requirements for lessor accounting.

The requirements of IFRS 16 in relation to classification and measurement of leases are summarised as below:

Lessees

Almost all leases are recognised in the statement of financial position as a 'right-of-use' asset and a lease liability. There are narrow exceptions to this recognition principle for leases where the underlying asset is of low value and for short term leases (i.e. those with a lease term of 12 months or less). The asset is subsequently accounted for in accordance with the cost or revaluation model in IAS 16 *Property, Plant and Equipment* (IAS 16) or, if the right of use asset meets the definition of investment property, in accordance with the requirements of IAS 40 *Investment Property* (the fair value model is required if the lessee measures investment property at fair value). The liability and right-of-use asset are unwound over the term of the lease giving rise to an interest expense and depreciation charge, respectively.

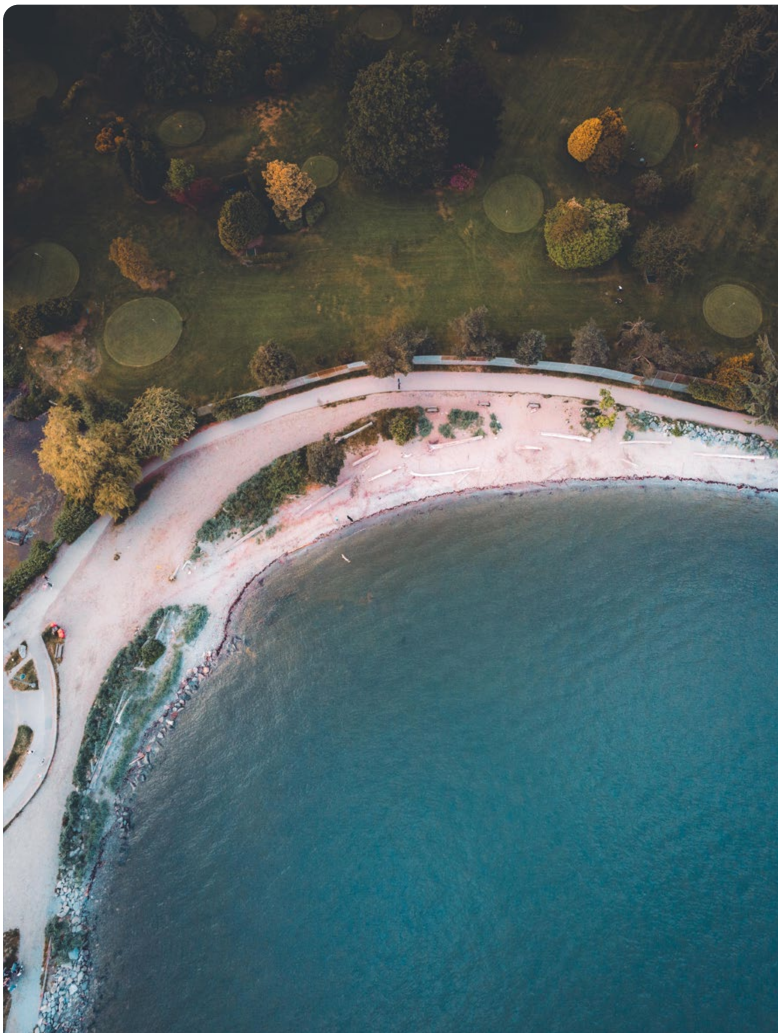
Lessors

Lessors need to account for leases as either operating or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee. An exception is intermediate lessors, where the classification of the sublease is determined with reference to the intermediate lessor's right of use asset, and not the underlying asset.

In case of operating leases, the underlying assets continue to be recognised as assets in the statement of financial position and lease income is recognised on a straight line basis over the lease term. For finance leases, a lessor is required to derecognise the underlying asset and record a receivable equal to the net investment in the lease, with a gain or loss on sale. Finance income is subsequently recognised at the interest rate implicit in the lease over the lease term.

Comparison with US GAAP

IFRS 16 began as a joint project between the International Accounting Standards Board (IASB) and its US counterpart, the Financial Accounting Standards Board (FASB). However, the Boards did not agree on some points and, ultimately, the FASB's standard differs from the IASB's in that the FASB's standard retains distinct categories of leases for lessees with different accounting requirements.



2. SCOPE

IFRS 16 applies to contracts meeting the definition of a lease (see section 3), except for:

Section 3

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

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

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

(d) licences of intellectual property granted by a lessor within the scope of IFRS 15; and

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

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described in paragraph (e) above.

BDO comment – Leases to explore for Non-regenerative Resources (e.g. minerals, oil, etc.)

As noted above, IFRS 16 excludes from its scope ‘leases to explore for or use mineral, oil, natural gas and similar non-regenerative resources’. Interpreting precisely how this scope exclusion should be applied may be challenging in practice. For example:

1. Does the exemption only apply to projects in the scope of IFRS 6, *Exploration for and Evaluation of Mineral Resources*?
2. Does the exemption apply to ‘surface rights’ (i.e. amounts paid to private owners of land to access the surface of the land that contains non-regenerative resources) in addition to amounts paid to government authorities to obtain the right to explore for those non-regenerative resources?
3. Does the exemption apply to leases for equipment necessary for the exploration and/or extraction process?
4. Does the exemption apply to leases to access land necessary for the extraction of resources (e.g. a lease of land to place equipment necessary in the extraction process or to place roads needed to access sites)?

Regarding issue #1, as the scope exclusion applies to '…leases to explore…', it is unclear whether the scope exclusion is limited to only those projects that are within the scope of IFRS 6. As IFRS 6 is not explicitly noted in IFRS 16's scope exclusion, it would appear that the scope exclusion applies in a more broad sense than only projects still within the scope of IFRS 6 (i.e. projects still in the exploration and evaluation phase of their development).

Item #2 above appears to satisfy the scope exclusion in both cases as they relate to a right to explore land for non-regenerative resources.

For item #3, while this relates to a project for the exploration of non-regenerative resources, the rights relate to items necessary to explore for the resources, not the right to explore directly. Leases of equipment do not fall within the scope exclusion in IFRS 16 (i.e. they are not excluded from the requirements of the standard).

For item #4, it is necessary to understand which portion of land is being leased. For example, a lease of land which contains an oil field, where the lessee is granted permission to access the land for the purposes of oil exploration and/or extraction would fall within the scope exclusion in IFRS 16. However, leases of other areas of land would be within the scope of IFRS 16. For example, in addition to entering into the lease above over land which contains an oil field, the lessee might also enter into leases of adjacent land (for example, to place pipes for the transporting of oil away from the extraction area). These leases would fall within the scope of IFRS 16 (the scope exclusion would not apply).

It may be complex to determine the point in which the lIt may be complex to determine the point in which the lease of land ceases to be within the scope exclusion to IFRS 16. In our view, a principle that may be applied is that the scope exclusion ceases when significant inputs and processing are no longer being applied to the applicable natural resource. For example, an oil field may be situated on leased property, where the land lease would be excluded from the scope of IFRS 16. The entity would also have to place an oil battery on land that is also leased, immediately adjacent to the oil field. An oil battery is a group of tanks that receive crude oil, where the volume is measured and tested for being pumped into a pipeline system for transport. Cleaning and treating of the oil also typically occur in the battery. In our view, the scope exclusion would apply to the land lease where the battery is placed, since at that point, the land lease still relates to 'leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources'. Once the oil passes beyond the battery into pipelines for transportation, the scope exclusion would cease, as the land over which the pipelines are placed do not relate to 'exploration'. The entity would apply the criteria for determining whether the land on which pipelines are placed meet the definition of a lease since the scope exclusion from IFRS 16 would not apply.

Determining the boundary of the scope exclusion will depend on the precise facts and circumstances, and this analysis would not apply in all cases. For example, the conclusion may differ if the oil battery were placed at a significant distance from the oil field from which the oil is extracted.

2.1 Recognition Exemptions

In addition to the above scope exclusions, a lessee can elect not to apply IFRS 16's recognition and measurement requirements to:

(a) short-term leases; and

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

The short-term lease exemption must be applied consistently to all underlying assets in the same class. The low value lease exemption, in contrast, may be applied on a lease-by-lease basis. See below for guidance on short-term leases and low value leases and section 3 for identification of a lease.

Section 3

If an entity applies either exemption, it must disclose that fact and certain information to make the effect of the exemption known to users of its financial statements (see section 7 – Disclosure). The lease payments associated with these leases shall be recognised as an expense on either a straight-line basis over the lease term or another systematic basis.

Section 7

Short-term Leases

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

BDO comment

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

It is important to note that IFRS 16's definition of 'lease term' must be considered carefully before concluding that a lease is a short-term lease. In particular, the lease term must consider the effect of options to extend or terminate a lease. This means that it will be unlikely to be possible to keep a lease off balance sheet by, say, structuring the contract with an initial term of 11 months and 29 days, with extension options for further periods of 11 months and 29 days, or by including periodic lessor termination options. This is because the 'lease term' as defined includes periods covered by extension options that are reasonably certain to be exercised by the lessee and the existence of termination options exercisable only by the lessor are disregarded.

Determining the lease term is discussed in more detail in section 4 below.

Section 4

Leases of Low Value Assets

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

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

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

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

This means that a lessee cannot claim that, for example, an aircraft or a vehicle are comprised of a large number of low value items (individual components) because, in the context of the overall operating asset, these components are highly dependent on and interrelated with each other.

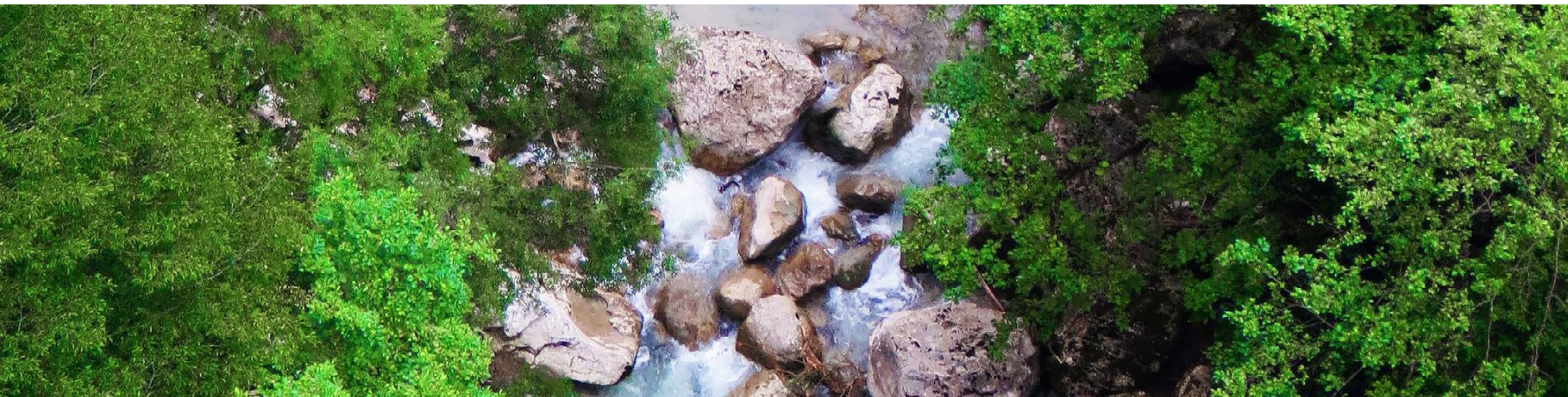
If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

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

BDO comment

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

The assessment of low value should be applied consistently, regardless of the lessee's size and nature. This is illustrated in the following two examples.



Example 2.1-1 – Low Value Lease Assessment

Entity A is a large, multi-national technology company with approximately CU10 billion in its annual operating budget. It enters into a contract to lease one floor of an office building in a major city in Central America for a total lease cost of CU50,000 per annum for five years. The operations of the facility and the lease cost are immaterial to Entity A.

Assessment

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

Example 2.1-2 – Low Value Lease Assessment

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

(a) leases of real estate (both office buildings and warehouses);

(b) leases of manufacturing equipment;

(c) leases of company cars, both for sales personnel and senior management and of varying quality, specification and value;

(d) leases of trucks and vans used for delivery purposes, of varying size and value;

(e) leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones);

(f) leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as the lessee has needed to increase the storage capacity of the servers;

(g) leases of office equipment:

(i) office furniture (such as chairs, desks and office partitions);

(ii) water dispensers; and

(iii) high-capacity multifunction photocopier devices.

Assessment

The lessee determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are (or were) individually of low value:

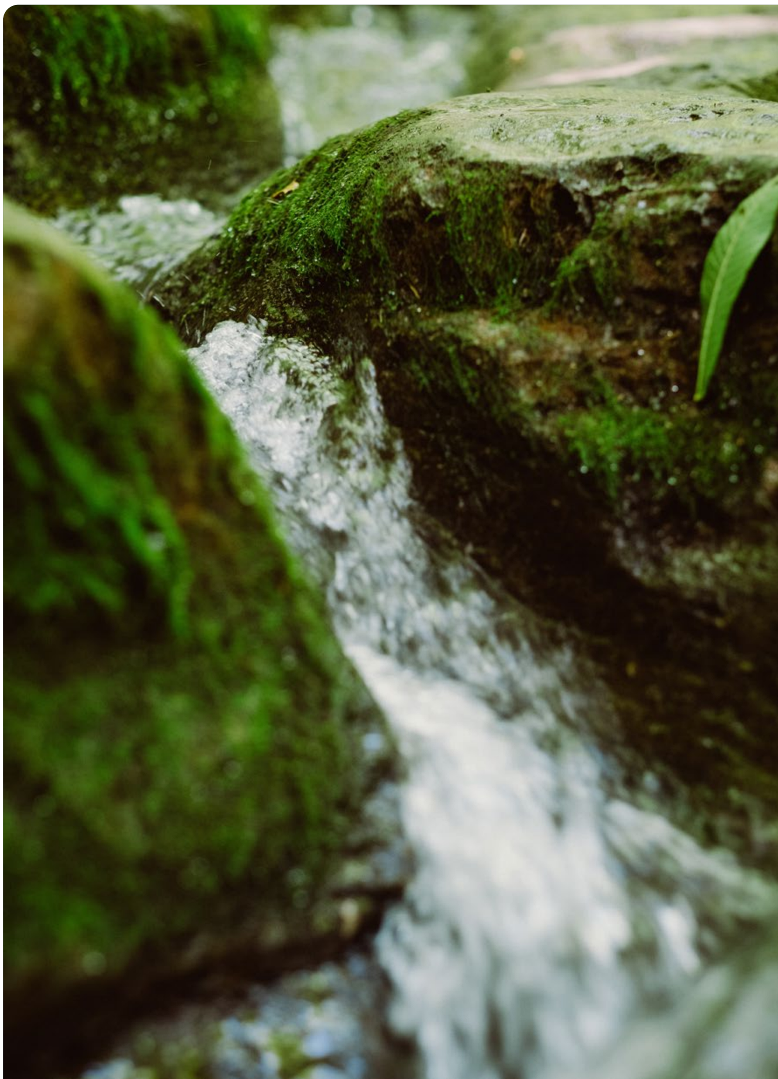
(a) leases of IT equipment for use by individual employees; and

(b) leases of office furniture and water dispensers.

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

Although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low-value assets. This is because each module is highly interrelated with other parts of the servers. The lessee would not lease the modules without also leasing the servers.

The other items of equipment (including the high-capacity multifunction photocopier devices) all have a cost when new which exceeds US$ 5,000 and therefore do not qualify for the low value lease exemption.



3. IDENTIFYING A LEASE

As all leases (except for the limited exceptions described in Section 2) are recorded 'on balance sheet' by the lessee, a key consideration is whether a contract meets the definition of a lease in IFRS 16:

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

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

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

Unit of Account

IFRS 16 is written in the context of accounting for the lease of a single asset. This means that the low value asset exemption described in section 2.1 above applies even if there is only a single lease contract for, say, 1,000 low value computers.

However, as a practical expedient to treating the unit of account as the lease of a single asset, an entity may apply IFRS 16 to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the standard to the portfolio would not differ materially from applying the standard to the individual lease contracts within the portfolio.

If it accounts for the leases on a portfolio basis, an entity is then able to make estimates and assumptions that reflect the size and composition of the portfolio. Therefore, if an entity leases 1,000 vehicles under 1,000 separate contracts (i.e. each contract is for a single vehicle) it may be possible to consider the portfolio of leases as a single right to use 1,000 vehicles, rather than 1,000 rights to use a single vehicle. It will depend on how similar the features of each contract are (such as the specification of the vehicles), the extent to which they were entered into at or around the same time and how similar or dissimilar the lease term is. As IFRS 16 requires that an entity must demonstrate that the application of this practical expedient would not result in a materially different result, entities may be required to perform some level of calculations to support this assertion. The more disparate the characteristics of lease contracts that are grouped into a portfolio, the more difficult it will be for entities to satisfy the requirements to use this practical expedient.

Legal title to the underlying asset

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

If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a sale and leaseback transaction (refer section 9 for guidance on accounting for sale and leaseback transactions). However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but as a lease.

Section 9

Determining the IFRS Accounting Standard applicable to the transaction

BDO comment

Judgement must be applied in determining whether the underlying asset is within the scope of IAS 16, IAS 38, or is a service arrangement. The facts and circumstances related to the right to use the underlying asset must be analysed to determine the appropriate accounting treatment. For example, if it is determined that the underlying asset is in the scope of IAS 16, a right-of-use asset and corresponding lease liability would be recognised as per Section 5 below. In contrast, for a right to use an intangible asset in the scope of IAS 38, an accounting policy choice exists. A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights (which are excluded from the scope of IFRS 16).

Section 5

IFRS Interpretations Committee agenda decision - Interaction between IFRS 11 and IFRS 16

At its March 2019 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of a question it had received about the recognition of liabilities by a joint operator in relation to its interest in a joint operation (as defined in IFRS 11). In the fact pattern described in the request, the joint operation is not structured through a separate vehicle. One of the joint operators, as the sole signatory, enters into a lease contract with a third-party lessor for an item of property, plant and equipment that will be operated jointly as part of the joint operation's activities. The joint operator that signed the lease contract (hereafter, the operator) has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual arrangement to the joint operation.

The Committee noted that identifying the liabilities that a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions in all contractual agreements that relate to the joint operation, including consideration of the laws pertaining to those agreements.

The Committee observed that the liabilities a joint operator recognises include those for which it has primary responsibility. Therefore, the joint operator that entered into the lease contract must recognise the lease liability as it is primarily responsible for lease payments.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for the operator to identify and recognise its liabilities in relation to its interest in a joint operation. Consequently, the Committee decided not to add this matter to its agenda.

BDO comment

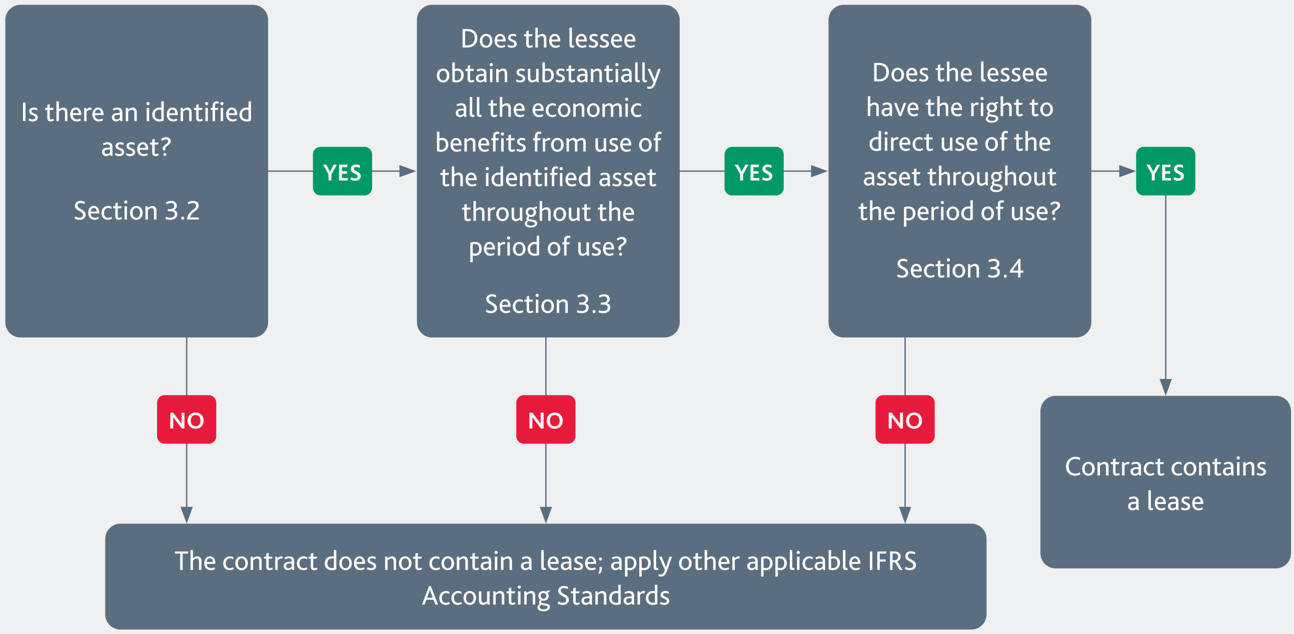
Previously, some joint operators may have accounted only for their share of the lease liability (e.g. a percentage of the total lease liability based on the agreement giving rise to the joint operation). Consequently, the clarification provided by this agenda decision may result in a significant change in practice.

To illustrate the effect of the agenda decision, consider three non-related entities (A, B and C) that enter into a joint operation that is not structured through a separate vehicle. Entity A enters into a lease agreement with a lessor for equipment that will be used for the purposes of the joint operation. The lease has a term of 10 years with CU1,000 in payments due each year. A has a contractual agreement to be compensated 1/3 from both B and C. In A's financial statements, the full amount of the lease liability (i.e. CU10,000, ignoring the effect of discounting) must be presented, as Entity A is the party to the lease agreement with the lessor. Regardless of the right of reimbursement that A holds, the agenda decision makes it clear that since A is the lessee in the arrangement and is primarily responsible for the payments to the lessor, it must present the full lease liability in its financial statements.

3.1 Applying the Definition of a Lease

IFRS 16 provides detailed guidance on the evaluation of a contract to determine whether it contains a lease.

In applying the definition of a lease, there are several criteria that must be met, as illustrated below:


Is there an identified asset?
Section 3.2
YES
Does the lessee obtain substantially all the economic benefits from use of the identified asset throughout the period of use?
Section 3.3
YES
Does the lessee have the right to direct use of the identified asset throughout the period of use?
Section 3.4
YES
NO
NO
NO
Contract contains a lease
The contract does not contain a lease; apply other applicable IFRS Accounting Standards

3.2 Identified Asset

The first criterion to be assessed in determining whether a contract between a customer and a supplier contains a lease is whether there is an identified asset. This is consistent with the requirement that for a lease to exist, the customer must control the asset. Typically, an asset will be explicitly identified in a contract (for example, by specifying the registration or chassis number of a car as well as a description of the manufacturer and model). Alternatively, a contract can involve the use of an identified asset if that asset is implicitly identified at the point at which it is made available for use by the customer.

However, even if a contract specifies a particular asset, a customer does not have the right to use an identified asset if the supplier has a substantive right to substitute the asset throughout the period of use.

Substitution Rights

A supplier's right to substitute an asset would be substantive, and therefore the customer would not account for a lease of that asset, if both of the following conditions are met:

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

BDO comment

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

In addition, IFRS 16 requires that this substitution right must exist 'throughout the period of use'. If a substitution right were to only be exercisable upon the occurrence of a specific event, after a period of time has elapsed or on a specific date, then the substitution rights would not be substantive for the purposes of IFRS 16 as they are not present 'throughout the period of use'.

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

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

In situations where the asset is located at the lessee's premises or elsewhere away from the lessor, the cost to substitute the asset may outweigh any perceived benefit to the lessor. In addition, a supplier's right to substitute an asset for the purposes of repairs or maintenance (if the asset is not operating properly) or to be upgraded when a technical update becomes available, does not mean the lessor has a substantive right of substitution.

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

BDO comment

That the standard requires lessees to conclude substitution rights are non-substantive where it is unclear means that in situations of doubt lessees should assume that the contract contains a lease. Consequently, notwithstanding the existence of the substitution rights, if an asset is identified in the contract (by being explicitly or implicitly specified), further analysis of the contract is needed to see if the other two conditions of the definition of a lease are met (see sections 3.3 and 3.4 below).

Section 3.3 Section 3.4

IFRS Interpretations Committee agenda decision – Sub-surface Rights

In June 2019, the IFRS Interpretations Committee (the Committee) issued an agenda decision relating to sub-surface rights, which addressed whether a specific fact pattern satisfied the ‘identified asset’ criteria in determining whether a contract is, or contains a lease, or alternatively was within the scope of IAS 38, *Intangible Assets*.

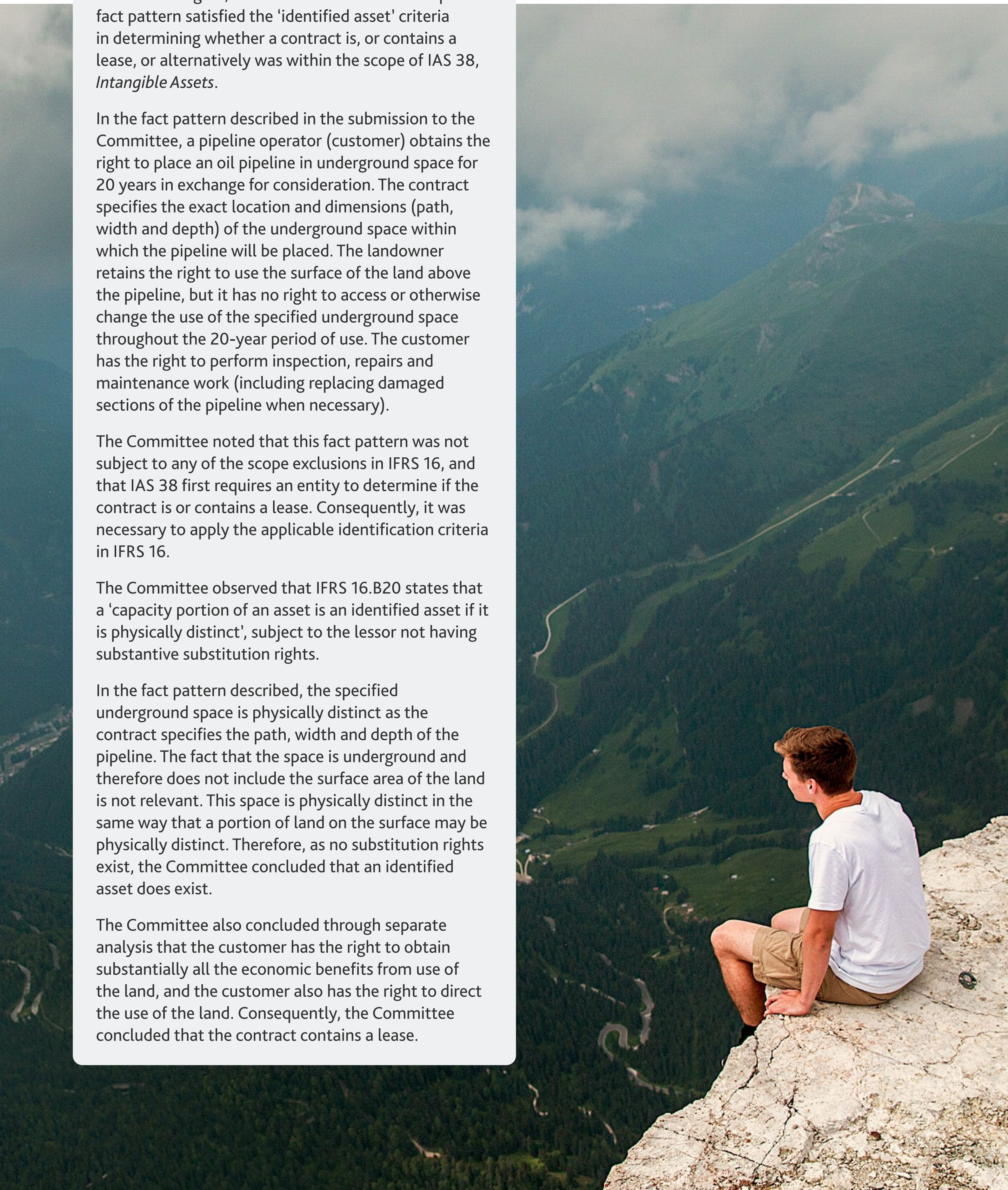
In the fact pattern described in the submission to the Committee, a pipeline operator (customer) obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground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

The Committee noted that this fact pattern was not subject to any of the scope exclusions in IFRS 16, and that IAS 38 first requires an entity to determine if the contract is or contains a lease. Consequently, it was necessary to apply the applicable identification criteria in IFRS 16.

The Committee observed that IFRS 16.B20 states that a ‘capacity portion of an asset is an identified asset if it is physically distinct', subject to the lessor not having substantive substitution rights.

In the fact pattern described, the specified underground space is physically distinct as the contract specifies the path, width and depth of the pipeline. The fact that the space is underground and therefore does not include the surface area of the land is not relevant. This space is physically distinct in the same way that a portion of land on the surface may be physically distinct. Therefore, as no substitution rights exist, the Committee concluded that an identified asset does exist.

The Committee also concluded through separate analysis that the customer has the right to obtain substantially all the economic benefits from use of the land, and the customer also has the right to direct the use of the land. Consequently, the Committee concluded that the contract contains a lease.



IFRS Interpretations Committee agenda decision – Definition of a Lease – Substitution Rights

In April 2023, the IFRS Interpretations Committee (the Committee) issued an agenda decision about how to assess whether a contract contains a lease.

One of the questions in the request was related to supplier's substitution rights, specifically on assessment of whether a contract contains a lease if the supplier:

i. has the practical ability to substitute alternative assets throughout the period of use; but

ii. would not benefit economically from the exercise of its right to substitute the asset throughout the period of use.

In the fact pattern described in the request, a customer enters into a 10-year contract with a supplier for the use of 100 similar new assets—batteries used in electric buses. The customer uses each battery together with other resources (buses) readily available to it. It is assumed that the supplier has the practical ability to substitute alternative assets throughout the contract term. At inception of the contract, it is expected that the supplier would not benefit economically from substituting a battery that has been used for less than three years but could benefit economically from substituting a battery that has been used for three years or more.

The Committee made the following observations regarding the requirements of IFRS 16 related to assessment of whether a contract contains a lease (emphasis added):

- IFRS 16.B9 states that a contract is, or contains, a lease if the contract conveys the right to control the use of an **identified asset** for a period of time in exchange for consideration.
- IFRS 16.B13 states that an asset is typically **identified** by being **explicitly specified** in a contract. However, an asset can also be identified by being **implicitly specified** at the time that the asset is made available for use by the customer.
- IFRS 16.B14 states that even if an asset is specified, a customer does **not have the right to use an identified asset** if the **supplier has the substantive right to substitute** the asset **throughout the period of use**. IFRS 16.B14 requires both of the following two conditions to exist for a supplier's right to substitute to be substantive:

a) the supplier has the **practical ability** to substitute alternative assets t**hroughout the period of use**; and

b) the supplier would **benefit economically** from the exercise of its right to substitute the asset.

The Committee noted that in the fact pattern described in the request, each battery is specified. Even if not explicitly specified in the contract, a battery would be implicitly specified at the time it is made available for the customer's use. Therefore, the Committee observed that, unless the supplier has the substantive right to substitute the battery throughout the period of use, each battery is an identified asset.

The fact pattern assumes the condition in IFRS 16.B14(a), i.e. the practical ability to substitute the asset throughout the period of use, to exist.

The Committee noted that IFRS 16.B14(a) specifies that a supplier has the practical ability to substitute alternative assets throughout the period of use even if the supplier does not already have alternative assets but could source those assets within a reasonable period of time. The Committee noted that this illustrates that the term 'throughout the period of use' does not mean at all times within that period.

With respect to the condition in IFRS 16.B14(b), the Committee observed that because the supplier is not expected to benefit economically from exercising its right to substitute a battery for at least the first three years of the contract, the condition in IFRS 16.B14(b) does not exist throughout the period of use. Therefore, the supplier does not have the substantive right to substitute a battery throughout the period of use.

Therefore, the Committee concluded that each battery is an identified asset.

The agenda decision also addressed a question related to the level at which to evaluate whether a contract contains a lease – by considering each asset separately or all assets together—when the contract is for the use of more than one similar asset. Refer to section 3 above for details of the analysis and the Committee's conclusion on this question.

Section 3

Example 3.2-1 – Lease of Rail Cars

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

Assessment

Supplier's substitution rights in this example are substantive because it:

(a) has the practical ability to substitute the rail cars throughout the period of use; and

(b) it would benefit economically from substituting the rail cars because there is a large pool of them available and they are stored at its premises. Potential benefits to Supplier are deploying the rail cars to a nearby location for use in other contracts or to use any of the 10 rail cars that are sitting idle for other purposes because they are not currently being used by Customer.

Therefore, although the contract makes use of identified assets (the rail cars), the contract does not contain a lease of those rail cars because Supplier has substantive substitution rights.

3.2-2 – Lease of retail units

Entity A owns a retail space having multiple retail units. Entity B enters into a contract with Entity A to use Retail Unit 101 for a period of five years.

Entity A can require Entity B to relocate to another retail unit within the same premises. In that case, Entity A is required to provide Entity B with a retail unit of similar quality and specifications to Retail Unit 101 and to pay for Entity B's relocation costs. Entity A would benefit economically from relocating Entity B only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favourable to cover the costs of relocating Entity B and other tenants in the retail space. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise.

Assessment

Retail Unit 101 is an identified asset. Entity A has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Entity A's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise.

Portions of Assets

A capacity portion of an asset may be an identified asset if it is physically distinct (e.g. a floor of a building). A capacity portion of an asset that is not distinct (e.g. a specified capacity of fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset.

Example 3.2-3(a) – Fibre Optic Cable

A customer enters into a 15-year contract with a supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong and Tokyo. The specified amount is equivalent to the customer having the full capacity of 3 fibre strands within a 15 strand cable. The supplier makes decisions about the transmission of data (i.e. which fibres are used to transmit the lessee's data).

Assessment

The contract does not contain a lease as the capacity specified is not physically distinct and it does not represent substantially all of the underlying asset as the capacity is only 20% of the total capacity of the cable. If the contract specified an amount of capacity equivalent to, say, 14 fibre strands of the total cable, the contract would contain a lease because this represents substantially all (approximately 94%) of the cable's capacity.

Example 3.2-3(b) – Fibre Optic Cable (specific strands)

A customer enters into a 15-year contract with a supplier for the right to use 3 of 10 specific strands of fibre optic cable connecting Paris and London. The customer has the exclusive right to use these strands to transfer their data.

Assessment

The contract does contain an identified asset as the strands of fibre optic cable are distinct from one another and the vendor does not have the right to substitute the strands for others in the same cable. Despite the number of strands not being substantially all of the cable's total capacity, the strands are identified, therefore the contract provides a specified asset to the customer.

BDO comment

The requirement that a portion of an asset can meet the identifiability criterion can be seen as a potential 'anti-avoidance' provision of the standard. Without this provision, a contract could exclude an insignificant portion of an asset's capability, and not meet the identifiability criterion.

Although IFRS 16 makes reference to a capacity portion that is 'physically distinct', in our view this approach also applies when a capacity portion is technologically distinct. For example, a lease could be of all of the light blue colour capacity of a fibre optic cable. In that case, the light blue component would be an identified asset for the purposes of IFRS 16.

3.3 Obtaining Economic Benefits

The next criterion to analyse in determining if a customer controls the use of an identified asset is whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, for example by having exclusive use of the asset throughout the period of the contract or by having a right to sub-lease the asset.

Simply because lease payments include a portion of the cash flows derived from an asset (e.g. a percentage of sales from the operations of a property) does not mean that the customer does not obtain substantially all of the economic benefits associated with the asset. Such requirements are common in retail lease contracts.

Example 3.3-1 – Obtaining Economic Benefits with Outputs Flowing to Supplier

A retailer enters into a contract for the lease of a store in a shopping centre for five years. The rental terms include annual payments equal to 10% of the gross sales revenue generated from the store, payable at the end of the year. The retailer has the right to determine which products are to be sold, the interior design of the store, etc.

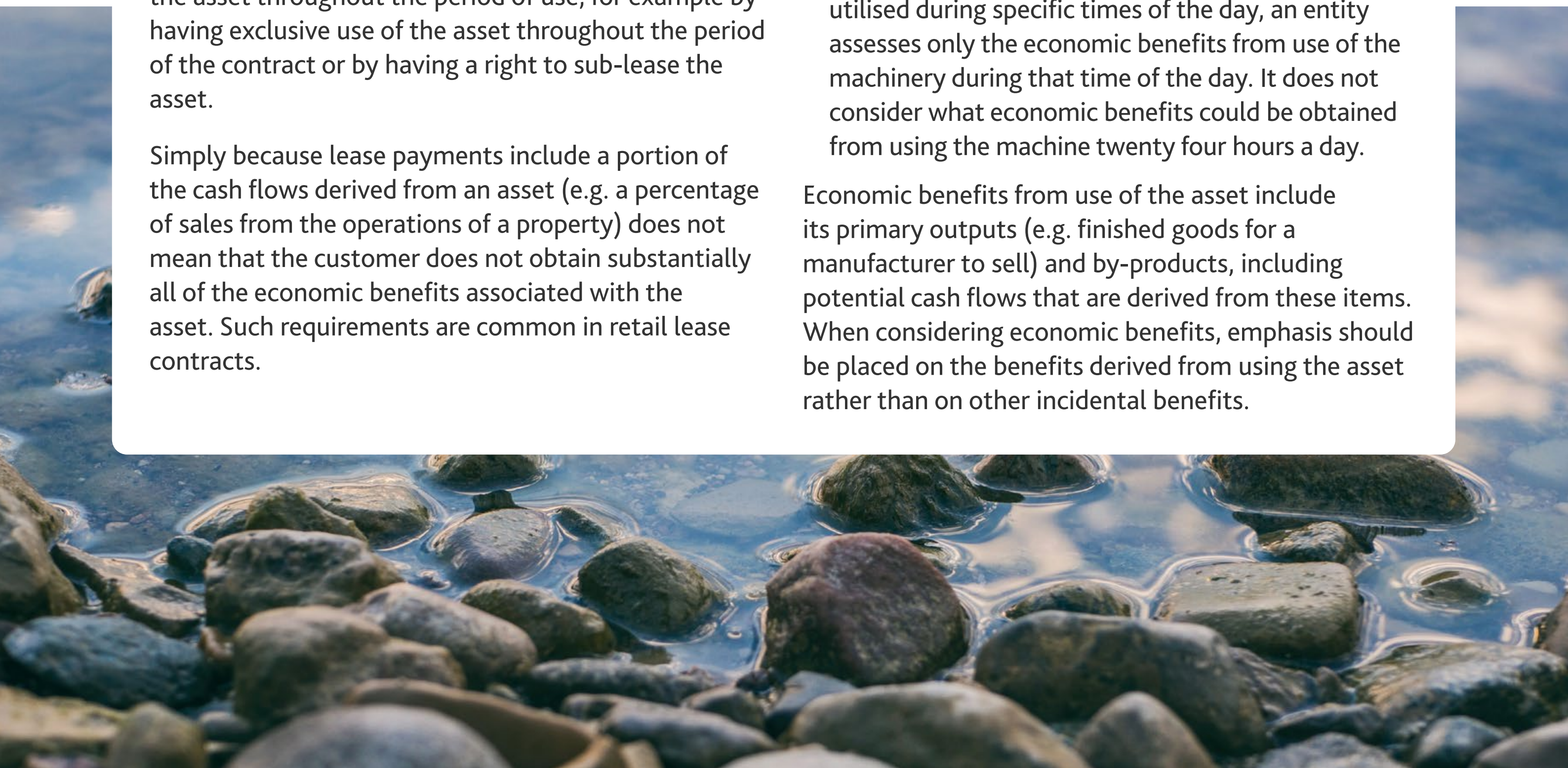
Assessment

It is the customer's control and use of the property which generates all of the sales revenue. The fact that a portion of the cash flows generated from use of the property are passed to the lessor is not relevant. The lessee has a right to 100% of the sales revenue generated from the store (i.e. all of the economic benefits generated by the store), albeit that it has negotiated a contract which results in rent being determined by reference to that gross sales revenue.

In assessing whether a customer has a right to substantially all the economic benefits from the use of an identified asset, the assessment should be made based on the asset's use within the defined scope of the contract. For example:

- If a contract limits the use of a vehicle to only a particular geographic area, an entity assesses only the economic benefits from use of the motor vehicle within that territory. It does not consider what economic benefits could be obtained had there not been any geographical restriction in the contract.
- If a contract specifies a machine can only be utilised during specific times of the day, an entity assesses only the economic benefits from use of the machinery during that time of the day. It does not consider what economic benefits could be obtained from using the machine twenty four hours a day.

Economic benefits from use of the asset include its primary outputs (e.g. finished goods for a manufacturer to sell) and by-products, including potential cash flows that are derived from these items. When considering economic benefits, emphasis should be placed on the benefits derived from using the asset rather than on other incidental benefits.



Example 3.3-2 – Obtaining Economic Benefits from use versus ownership of an asset

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

Assessment

The contract transfers to the customer the right to obtain substantially all of the economic benefit from use of the underlying asset (the power plant) because the customer has exclusive use of the primary product of the facility (i.e. the electricity).

Although the supplier obtains economic benefits in the form of tax incentives, these derive from legal ownership of the asset, and not from its use. Therefore, the value of these tax incentives should be disregarded in assessing which party obtains substantially all the economic benefits of the bio-mass facility.

IFRS Interpretations Committee agenda decision – Economic Benefits from Use of a Windfarm

In December 2021, The IFRS Interpretations Committee (the Committee) issued an agenda decision relating to determination of whether an electricity retailer has the right to obtain substantially all the economic benefits from use of a windfarm.

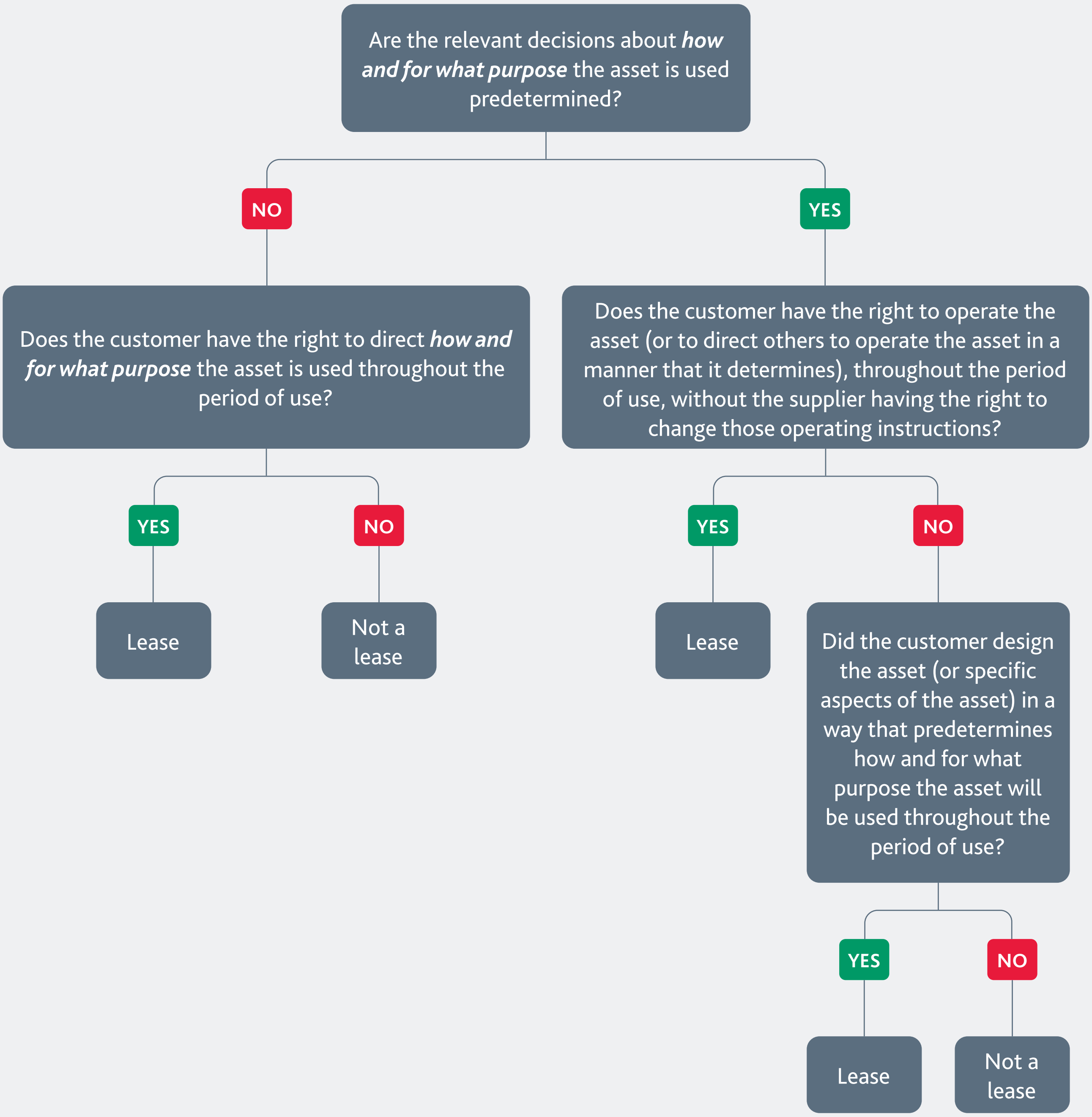
In the fact pattern described in the request, the electricity retailer and supplier purchase and sell electricity via the market's electricity grid, the spot price of which is set by the market operator. The retailer enters into an agreement with the supplier for a period of 20 years to swap the spot price of the electricity supplied to the grid for a fixed price, to be settled net in cash. The agreement also transfers to the retailer all renewable energy credits that accrue from use of the windfarm.

The Committee observed that, in the fact pattern described in the request, the economic benefits from use of the windfarm include the electricity it produces (as its primary output) and the renewable energy credits (as a by-product or other economic benefit from use of the windfarm). The Committee further observed that the agreement conveys neither the right nor the obligation for the retailer to obtain any of the electricity the windfarm produces and supplies to the grid.

Therefore, the Committee concluded that the retailer does not have the right to obtain substantially all the economic benefits from use of the windfarm. Consequently, the agreement does not contain a lease.

3.4 Right to Direct the Use of the Asset

In determining whether a customer has the right to direct the use of an asset, an analysis of whether the *relevant decisions* about how and for what purpose the asset is used are *predetermined* and who directs ***how and for what purpose*** the asset is used throughout the period of use needs to be carried out:



Are the relevant decisions about ***how and for what purpose*** the asset is used predetermined?

NO

Does the customer have the right to direct ***how and for what purpose*** the asset is used throughout the period of use?

YES — Lease

NO — Not a lease

YES

Does the customer have the right to operate the asset (or to direct others to operate the asset in a manner that it determines), throughout the period of use, without the supplier having the right to change those operating instructions?

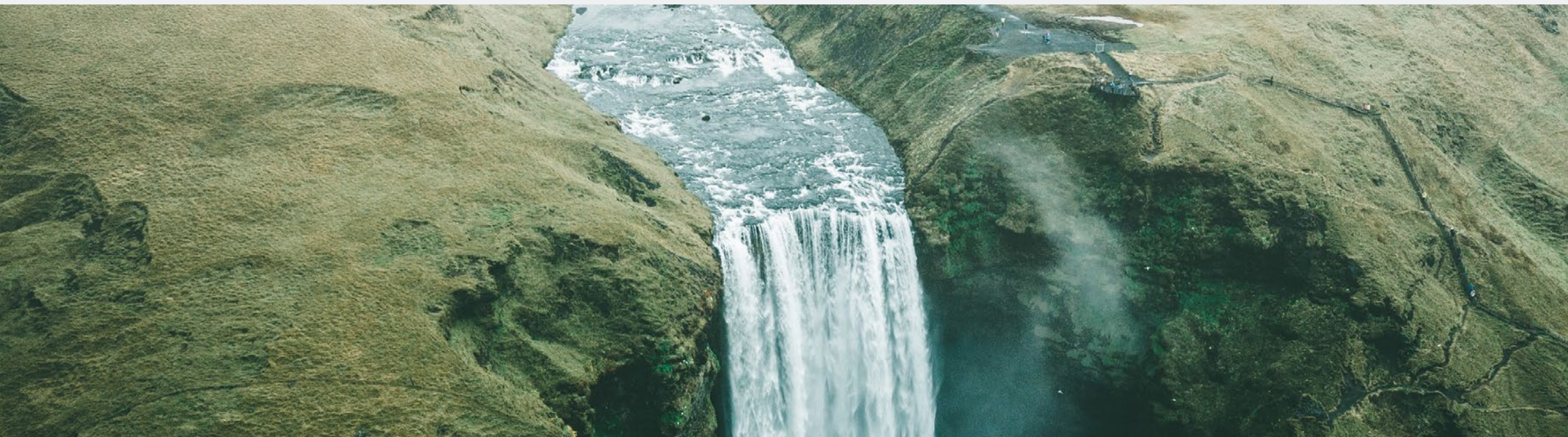
YES — Lease

NO

Did the customer design the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use?

YES — Lease

NO — Not a lease



A customer has the right to direct how and for what purpose an asset is used if, within the scope of its right-of-use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. Certain decision making rights are clearly more relevant than others. Those that affect the economic benefits derived from use of the asset (as outlined in section 3.3) are the most relevant.

Section 3.3

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

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

Decision-making rights relating to operating or maintaining an asset do not grant the right to change how and for what purpose the asset is used. However, the rights to operate an asset may grant a customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used is predetermined.

BDO comment

The guidance on determining who has the right to direct the use of the asset focuses on control. This is consistent with the IASB's focus on control being a primary element in determining whether transactions qualify for recognition in other standards, such as IFRS 10 *Consolidated Financial Statements* and IFRS 15 *Revenue from Transactions with Customers*.

Example 3.4-1 – Customer Directs Use

A customer enters into a five-year contract with a supplier where the customer will purchase up to 100% of the energy produced by a bio-mass facility. The energy must be produced from this particular facility and the supplier does not have substantive substitution rights to provide energy from a separate facility. Alternative arrangements can only be made in extraordinary circumstances (for example, emergency situations rendering the facility inoperative). Under the contract the customer tells the supplier how much energy to produce and when to produce it and the supplier must stand ready to operate the facility to meet the customer's needs. To the extent there is spare capacity, the supplier is not allowed to generate energy for sale to other customers. The supplier must therefore stand ready to provide all of the power output to the customer if needed. The supplier designed the facility when it was constructed some years before entering into the contract with the customer, who had no involvement in that original design.

Assessment

It is clear that the bio-mass facility is identified in the contract and the customer obtains substantially all of the economic output (it can take any amount up to 100% of the production capacity without anyone else being able to benefit from any spare capacity). The contract contains a lease for the bio mass facility because the customer also has the right to direct its use. That is, the customer makes the relevant decisions as to how and for what purpose the facility is used because it decides when and how much power is produced. The supplier's staff simply follow the directions of the customer. The fact that the customer had no involvement in the design of the underlying asset is only relevant when decisions about how and for what purpose the asset will be used are predetermined, as illustrated in example 3.4.1-1 below.

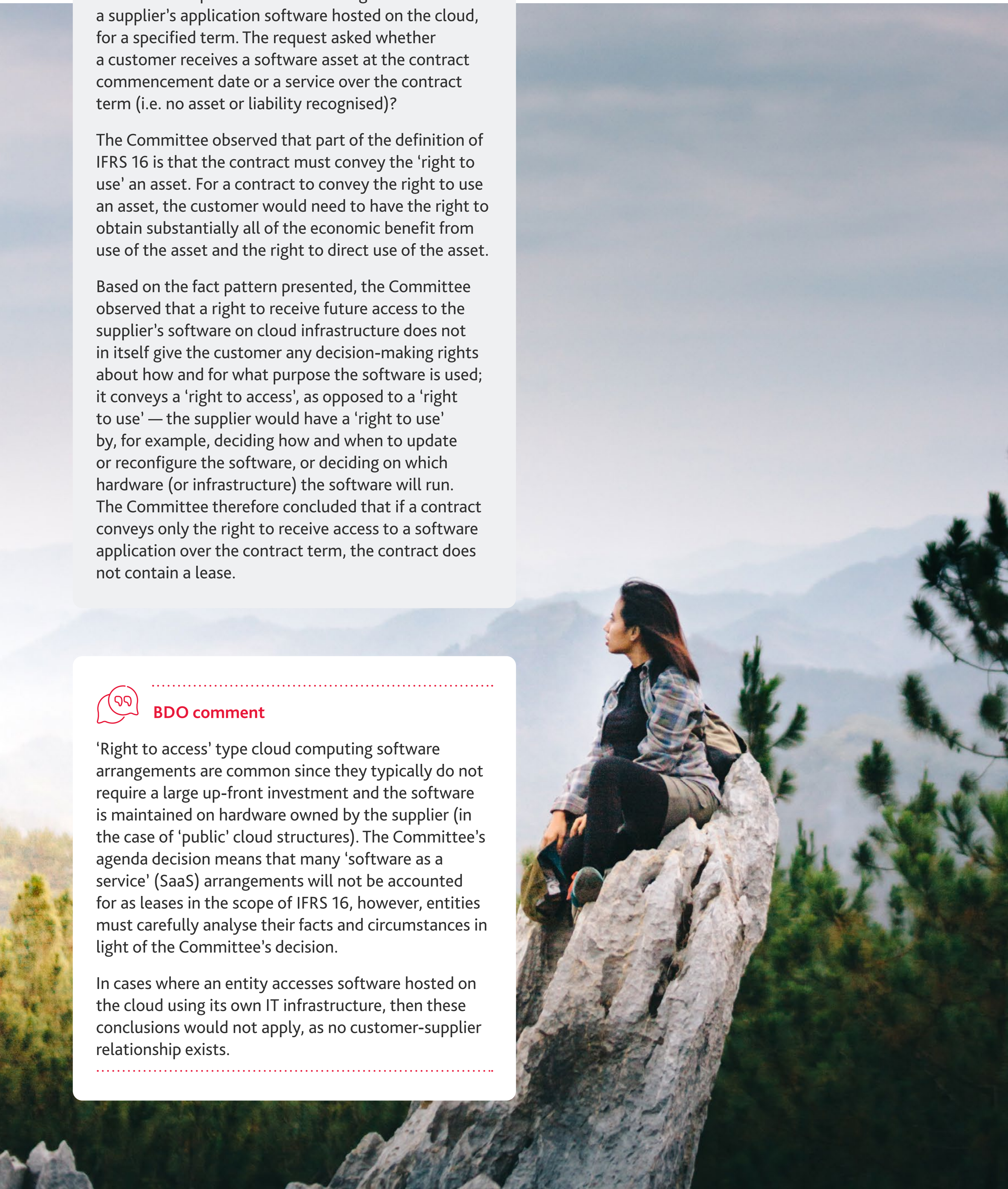
The customer therefore needs to determine how much of the total contractual payments to the supplier are for the leased asset as distinct from fees that may be charged for other services (such as operation and maintenance of the facility) and capitalise those lease payments on balance sheet. Alternatively, as a practical expedient, the customer can treat the entire contract as a lease, recognising an asset and liability for the present value of all payments to be made under the contract.

IFRS Interpretations Committee agenda decision – Cloud Computing

At its March 2019 meeting, the IFRS Interpretations Committee (the Committee) published an Agenda Decision in respect of a customer's right to access a supplier's application software hosted on the cloud, for a specified term. The request asked whether a customer receives a software asset at the contract commencement date or a service over the contract term (i.e. no asset or liability recognised)?

The Committee observed that part of the definition of IFRS 16 is that the contract must convey the 'right to use' an asset. For a contract to convey the right to use an asset, the customer would need to have the right to obtain substantially all of the economic benefit from use of the asset and the right to direct use of the asset.

Based on the fact pattern presented, the Committee observed that a right to receive future access to the supplier's software on cloud infrastructure does not in itself give the customer any decision-making rights about how and for what purpose the software is used; it conveys a 'right to access', as opposed to a 'right to use' — the supplier would have a 'right to use' by, for example, deciding how and when to update or reconfigure the software, or deciding on which hardware (or infrastructure) the software will run. The Committee therefore concluded that if a contract conveys only the right to receive access to a software application over the contract term, the contract does not contain a lease.



BDO comment

'Right to access' type cloud computing software arrangements are common since they typically do not require a large up-front investment and the software is maintained on hardware owned by the supplier (in the case of 'public' cloud structures). The Committee's agenda decision means that many 'software as a service' (SaaS) arrangements will not be accounted for as leases in the scope of IFRS 16, however, entities must carefully analyse their facts and circumstances in light of the Committee's decision.

In cases where an entity accesses software hosted on the cloud using its own IT infrastructure, then these conclusions would not apply, as no customer-supplier relationship exists.

IFRS Interpretations Committee agenda decision – Definition of a Lease – Decision-making Rights

At its January 2020 meeting, the IFRS Interpretations Committee (the Committee) published an Agenda Decision dealing with whether a customer has the right to direct the use of a ship and consequent identification of a lease.

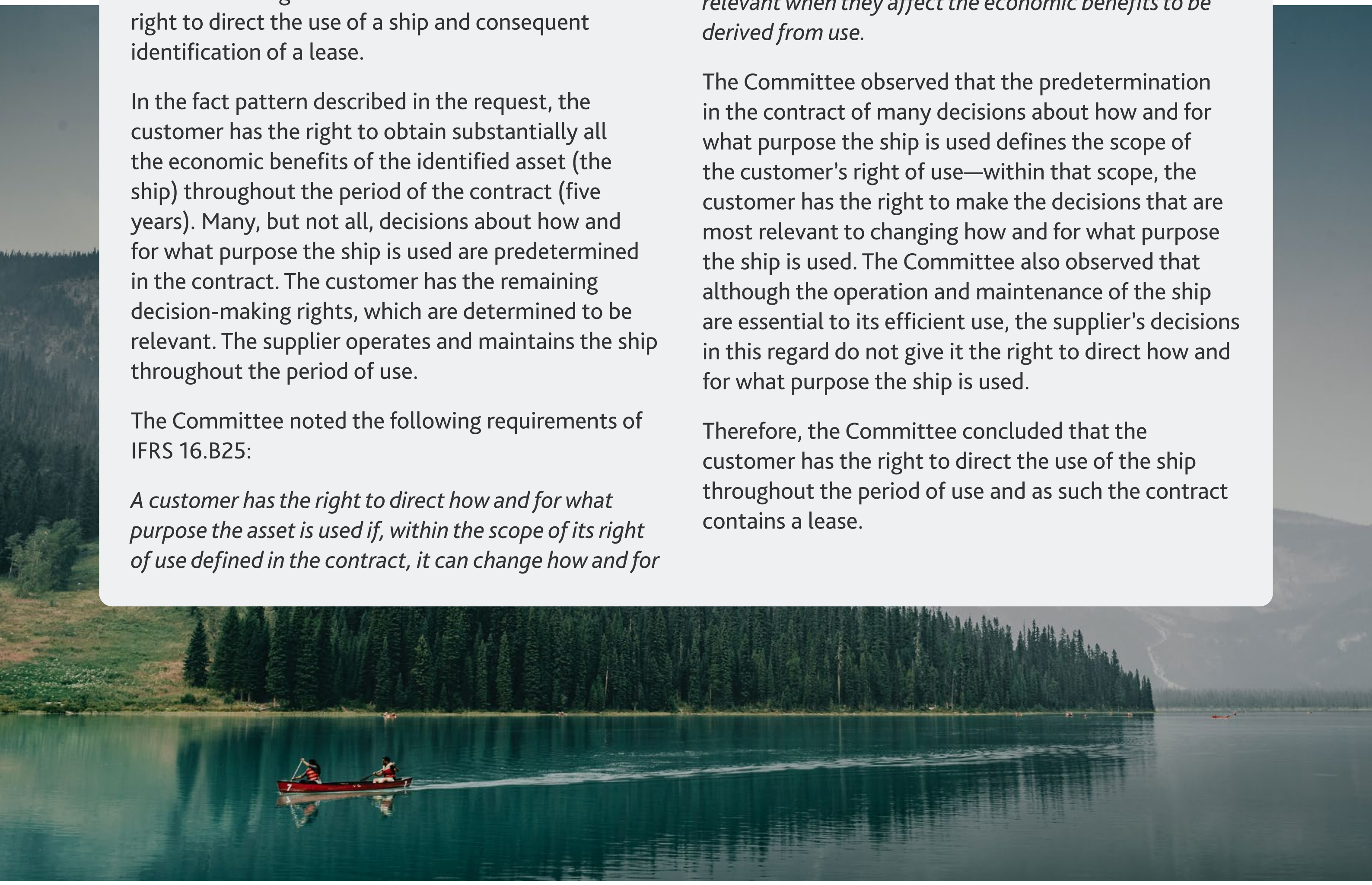
In the fact pattern described in the request, the customer has the right to obtain substantially all the economic benefits of the identified asset (the ship) throughout the period of the contract (five years). Many, but not all, decisions about how and for what purpose the ship is used are predetermined in the contract. The customer has the remaining decision-making rights, which are determined to be relevant. The supplier operates and maintains the ship throughout the period of use.

The Committee noted the following requirements of IFRS 16.B25:

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

The Committee observed that the predetermination in the contract of many decisions about how and for what purpose the ship is used defines the scope of the customer's right of use—within that scope, the customer has the right to make the decisions that are most relevant to changing how and for what purpose the ship is used. The Committee also observed that although the operation and maintenance of the ship are essential to its efficient use, the supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used.

Therefore, the Committee concluded that the customer has the right to direct the use of the ship throughout the period of use and as such the contract contains a lease.



3.4.1 Relevant Decisions are Pre-Determined

The nature of an asset or contractual restrictions may indicate that relevant decisions about how and for what purpose an asset will be used are pre-determined.

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

(a) The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or

(b) The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

BDO comment

Assets that may fall into this category include those that are:

- technologically advanced such that they are designed for highly specific purposes;
- costly to modify or repurpose for other uses; and/or
- whose use is restricted based on regulation or law.

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

Example 3.4.1-1 – Pre-determined Functionality

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. The customer designed the bio-mass facility before it was constructed by hiring experts in the field to assist in determining the location of the facility and the engineering of the equipment to be used. The supplier is responsible for building the facility to the customer's specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

Assessment

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

3.5 Separation of Lease Components and combining contracts

Separation of Lease Components:

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

(a) the lessee can benefit from use of the underlying asset either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee has already obtained (from the lessor or from other transactions or events); and

(b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

For a contract that is, or contains, a lease component, an entity accounts for each lease component within the contract separately from non-lease components. However, a lessee may apply a practical expedient by class of underlying asset, and ignore the requirement to separate non-lease components (such as services) from the lease components. Instead it may account for the entire contract as a single lease contract. For example, a contract for the lease of an asset together with its maintenance during the lease term can be accounted for in its entirety as a lease contract rather than accounting for the lease of the asset separately from the maintenance service. This practical expedient is only available to lessees; it does not apply to lessors. The lessee is not permitted to apply this practical expedient to embedded derivatives that are required to be separated from the host contract and required to be accounted for as a derivative in accordance with IFRS 9 *Financial Instruments*.

It should be noted that this practical expedient does not override the requirement to account for each lease component in a contract as a lease separately. For example, if a contract contains two lease components and a non-lease component, the lessee is not permitted to account for the entire contract as a single lease.

Allocation of consideration to components by a lessee

If the practical expedient to not separate lease and non-lease components is not used, a lessee must allocate the total contract consideration to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate standalone price of the non-lease components. The non-lease components are then accounted for applying other applicable IFRS Accounting Standards.

The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If standalone prices are not available, then they must be estimated, maximising the use of observable information. This can be quite complex and judgemental and so applying the practical expedient simplifies the accounting. A consequence of using the practical expedient is that the amounts recognised on balance sheet are greater than would be the case from identifying the payments related to, and separately accounting for, the non-lease components. This is because by accounting for non-lease components as part of the lease component, those payments are included in the measurement of the lease liability and right-of-use asset.

Allocation of consideration to components by a lessor

A lessor is required to allocate the consideration to lease and non-lease components applying the requirements of IFRS 15.

A contract may include an amount payable by the lessee to the lessor for activities and costs that do not transfer a good or service to the lessee, such as a charge towards administrative costs incurred by the lessor. Such amounts are considered to be part of the total consideration that is allocated to the separately identified components of the contract.

BDO comment

Non-lease components exist in numerous types of lease agreements. For example, they may arise from maintenance included in the lease payments for vehicles, or common area maintenance costs for multi-unit real estate leases to cover shared costs such as security, cleaning, etc. In determining whether to elect to include non-lease components in the measurement of the lease contract, entities should consider the cost vs. benefit of determining stand-alone prices for the individual components.

Additionally, for non-lease components such as common area maintenance costs, entities should consider whether such costs are variable in nature and not dependent on an index or rate, and therefore would not be included in the lease measurement regardless of the accounting policy choice (see Section 5.1 for discussion of common area maintenance and variable lease payments).

Section 5.1

Example 3.5-1 – Allocation of consideration between lease and non-lease components by a lessee

Entity A leases construction equipment from Entity B for a period of three years. The contract also provides for annual maintenance of the equipment and deployment of two personnel for operating the equipment.

Total consideration of the contract consists of the following:

1. CU200,000 per year for three years

2. Annual maintenance charges of CU20,000

Similar equipment is available on lease from Entity B for CU150,000 per year, without annual maintenance and deployment of staff for operations.

Entity B also sells similar equipment and provides annual maintenance service for the equipment for CU25,000.

Entity B does not deploy staff for operating the machines separately without leasing or selling the equipment. Staff of similar qualification and experience as those deployed by Entity B can be hired by Entity A for a monthly salary of CU3,000.

Entity A elects not to use the practical expedient of not separating lease and non-lease components.

Assessment

The contract contains the following three components:

1. Lease component: Lease of the equipment

2. Non-lease component: Annual maintenance service

3. Non-lease component: Deployment of two personnel

The stand-alone prices of the above components are determined to be:

Component	(CU)	Stand-alone price (CU)
Lease of equipment (CU150,000 * 3 years)		450,000
Non-lease components		
• Annual maintenance service (CU25,000 * 3 years)	75,000	
• Deployment of two personnel (CU3,000 * 2 personnel * 36 months)	216,000	
Total non-lease component		291,000
Total standalone price		**741,000**

Total consideration for the contract is:

	Charges (CU)
Lease charges (CU200,000 * 3)	600,000
Annual maintenance charges (CU20,000 * 3)	60,000
Total	**660,000**

The total consideration will be allocated to the lease and non-lease components as below:

Component	Stand-alone price (CU)	Ratio of stand-alone price	Allocation of consideration
Lease of equipment	450,000	60.7%	660,000 * 60.7% = 400,810
Non-lease components	291,000	39.3%	660,000 * 39.3% = 259,190
Total	**741,000**	**100.0%**	**660,000**

BDO comment

If the contract contains more than one component and has both variable and fixed payments, a question arises about the allocation of the variable consideration.

IFRS 16 does not provide any specific requirements for allocation of variable consideration when a contract contains more than one component. In the absence of an IFRS Accounting Standard that specifically applies to a transaction, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires the management to develop and apply an accounting policy using its judgement. In making such judgements, IAS 8 requires the management to refer to and consider the applicability of the requirements in IFRS Accounting Standards dealing with similar and related issues. IFRS 15 includes requirements on allocation of variable consideration to a performance obligation, which may be referred to for allocating variable consideration of components of a lease.

IFRS 15.85 requires an entity to allocate variable consideration entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met:

a) the terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service)

b) allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in IFRS 15.73 when considering all of the performance obligations and payment terms in the contract.

If the above criteria are not met, the entity is required to allocate the consideration on the basis of relative stand-alone selling prices.

The above requirements in IFRS 15 would directly apply to lessors for allocation of variable payments in a lease contract.

In the absence of any specific requirements in IFRS 16, a lessee may follow a similar approach for allocation of variable payments. Therefore, a variable payment would be allocated to a specific component if:

a) the variable payment represents the stand-alone price of that specific component; and

b) other payments represent stand-alone prices of the remaining components.

In other cases, the total consideration (fixed and variable) would be allocated to all the components in the contract on the basis of relative stand-alone prices.

Example 3.5-2 – Allocation of variable payments only to a specific component

Entity A obtains an office space on lease from Entity B for a period of three years. Entity B also provides cleaning services.

The contract provides for the following payments:

a) Fixed payment of CU100,000 per month

b) Variable payment of CU100 per hour of cleaning time. Total variable payment is estimated to be CU6,000 per month. There is no minimum number of cleaning hours that must be purchased.

Entity B would charge the same fixed payment (CU100,000 per month) towards rent of the premises even if cleaning services are not purchased by the lessee. Cleaning services are available from external agencies at a monthly rate in the range of CU5,800 - CU6,200.

Assessment

The contract consists of two components:

1. Lease component: Lease of office premises

2. Non-lease component: Cleaning services

Entity B provides office premises at the same rate as in the contract even if cleaning services are not purchased. Therefore, Entity A concludes that the fixed payment of CU100,000 per month represents the stand-alone price of the lease component.

The estimated variable payment to be charged by Entity B (CU6,000) for cleaning services is well within the range of prices charged by external suppliers. Therefore, Entity A concludes that the variable payment represents the stand-alone price of the cleaning services.

As the variable payment represents the stand-alone price of the non-lease component and the fixed payment represents the stand-alone price of the lease component, the variable payment is entirely allocated to the non-lease component i.e. cleaning services and the fixed payment is entirely allocated to the lease component.

Example 3.5-3 – Allocation of fixed and variable payments to multiple components

Entity A obtains an office space on lease from Entity B for a period of three years. Entity B also provides cleaning services.

The contract provides for following payments:

c) Fixed payment of CU100,000 per month

d) Variable payment of CU100 per hour of cleaning time. Total variable payment is estimated to be CU6,000 per month. There is no minimum number of cleaning hours that must be purchased.

Entity B would charge the same fixed payment (CU100,000 per month) towards rent of the premises even if cleaning services are not purchased by the lessee. Cleaning services are available from external agencies at an average monthly rate of CU12,000.

Assessment

The contract consists of two components:

1. Lease component: Lease of office premises

2. Non-lease component: Cleaning services

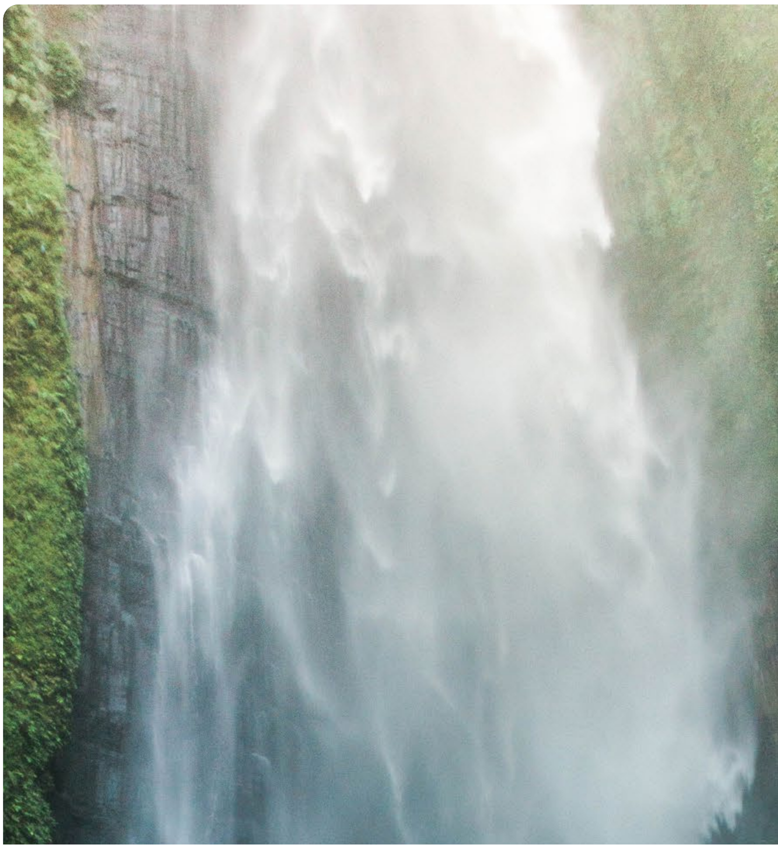
Entity B provides office premises at the same rate as in the contract even if cleaning services are not purchased. Therefore, Entity A concludes that the fixed payment of CU100,000 per month represents the stand-alone price of the lease component.

The estimated variable payment to be charged by Entity B (CU6,000) for cleaning services is below the average monthly rate charged by external agencies. Therefore, Entity A concludes that the variable payment does not represent the stand-alone price of cleaning services. The stand-alone price of cleaning services is determined to be CU12,000 per month.

Although the fixed payment represents the stand-alone price of the lease component, the variable payment does not represent the stand-alone price of the non-lease component. Therefore, fixed and variable payments cannot be individually allocated to lease and non-lease components respectively.

The allocation of the fixed and variable payment will be made on the basis of relative stand-alone prices.

The allocation of the monthly fixed payment will be done at the commencement of the lease as below:



Component	Stand-alone price (CU)	Ratio of stand-alone price	Allocation of consideration
Lease of equipment	100,000	(100,000/112,000) = 89.29%	100,000 * 89.29% = 89,290
Non-lease components	12,000	(12,000/112,000) = 10.71%	100,000 * 10.71% = 10,710
Total	**112,000**	**100.00%**	**100,000**

Variable payments are allocated in the same ratio and are expensed when incurred for both lease and non-lease component.

A similar allocation approach as in the above example will be followed if the variable payment represents the stand-alone price of one component, but the fixed payment does not represent the stand-alone price of the remaining components or if neither fixed nor variable payments represent the stand-alone price of any single component.

IFRS Interpretations Committee agenda decision – Definition of a Lease – Substitution Rights

At its April 2023 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision that dealt with a question related to assessment of whether a contract contains a lease.

In the fact pattern described in the request, a customer enters into a 10-year contract with a supplier for the use of 100 similar new assets - batteries used in electric buses. The customer uses each battery together with other resources (buses) readily available to it.

The request asked about the level at which to evaluate whether a contract contains a lease – by considering each asset separately or all assets together—when the contract is for the use of more than one similar asset.

IFRS 16.B12 states that 'an entity shall assess whether a contract contains a lease for each potential separate lease component'.

IFRS 16.B32 specifies that the right to use an underlying asset is a separate lease component if both:

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

b. the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

In the fact pattern described, the Committee observed that:

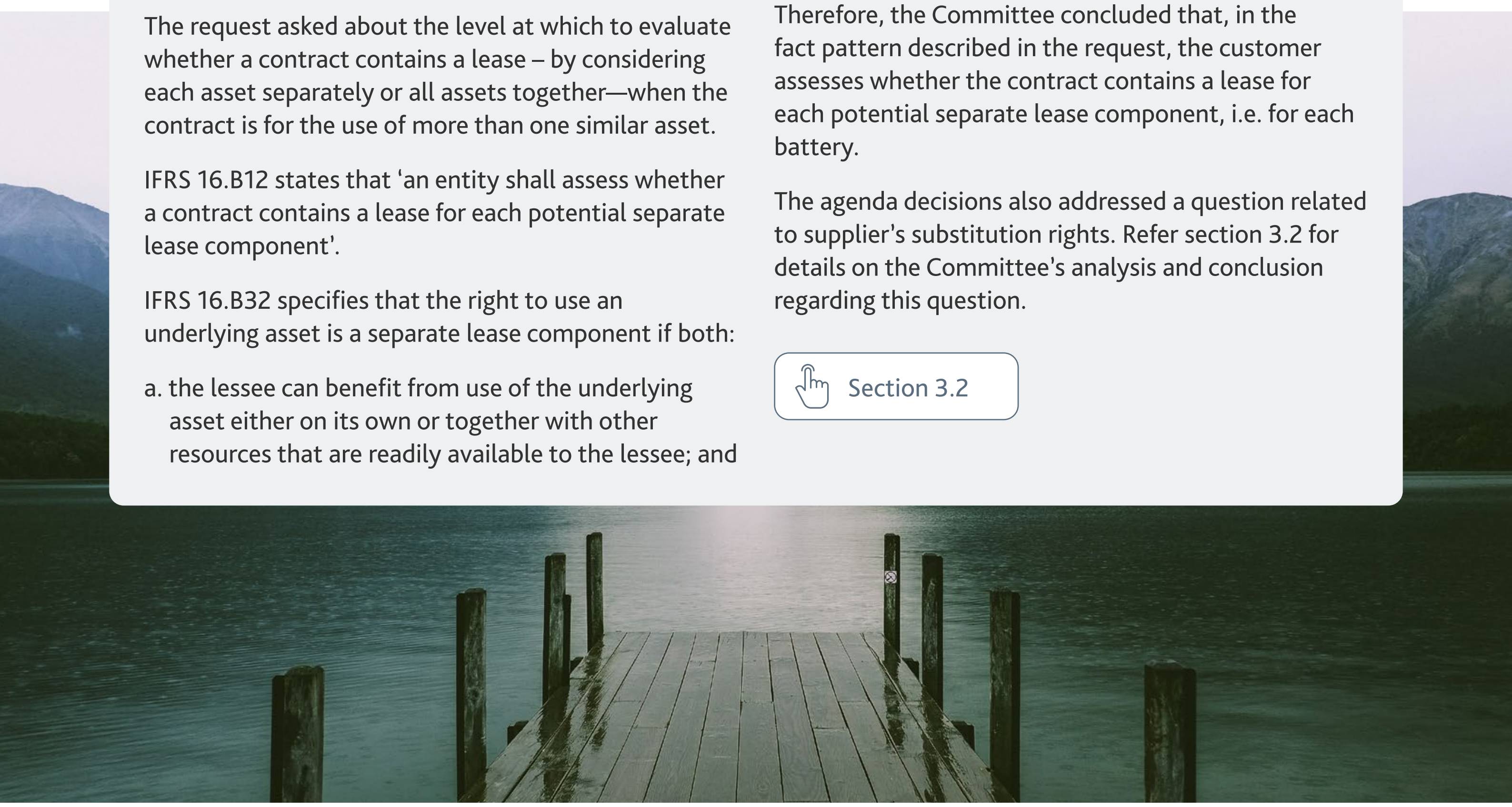
a. the customer is able to benefit from use of each asset (a battery) together with other resources (a bus) available to it; and

b. each battery is neither highly dependent on, nor highly interrelated with, the other batteries in the contract.

Therefore, the Committee concluded that, in the fact pattern described in the request, the customer assesses whether the contract contains a lease for each potential separate lease component, i.e. for each battery.

The agenda decisions also addressed a question related to supplier's substitution rights. Refer section 3.2 for details on the Committee's analysis and conclusion regarding this question.

Section 3.2



Combining Contracts

It may be necessary to combine two or more contracts to assess whether the combined transaction constitutes a lease. For example, the substance of multiple legal agreements entered into at or near the same time with the same counterparty (or parties related to the counterparty) might only be understood when viewed as a single, composite contract. Combination of contracts is required if any one or more of the following criteria are met:

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

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

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

Example 3.5-4 – Identification of lease components and combining contracts

Entity C intends to lease a manufacturing facility, with fabrication machinery of certain specifications, in a particular location. Entity D owns a factory with required fabrication machinery in the location, which it intends to lease out.

Entity C leases the factory facility and fabrication machinery in the facility from Entity D. There are two separate contracts entered for the factory facility and the machinery. The contracts are executed a few days apart.

The contracts provide for the following payments:

1. Contract for lease of factory facility: Fixed payment of CU60,000 per month
2. Contract for lease of machinery: Variable payment of CU10 for each unit manufactured using the fabrication machinery. Estimated number of units manufactured per month is 10,000, resulting in an estimated variable payment of CU100,000 per month.

A similar factory facility is available for rent, without the machinery, for a monthly payment of CU80,000. Similar machines are available for a monthly payment of CU75,000.

Assessment

Entity C evaluates the two contracts entered into a similar time to see if they meet the criteria to be combined into a single lease contract, as follows:

1. Condition (a): In this case, the contracts are negotiated as a package. They are executed near the same time with the same counterparty with an overall single commercial objective i.e. to obtain a complete manufacturing facility on rent.
2. Condition (b): A lower fixed payment as compared to market rates is agreed for the factory space with the expectation of making up the shortfall through variable payment estimated to be above market rate.
3. Condition (c): The contracts convey the right to use two underlying assets – the factory facility and the machinery.
   - The lessee is able to readily obtain on lease a factory facility and the machinery separately.
   - The factory facility and the machinery are not highly dependent on or highly interrelated with each other. The factory facility can be used for any other machinery. The machinery leased can be used in any other manufacturing unit.

   Therefore, the two underlying assets are separate lease components.

Combination of contracts would be required if any one or more of the above criteria are met. As conditions (a) and (b) are fulfilled, the two contracts are considered as a single contract.

However, condition (c) is not fulfilled i.e. the rights to use underlying assets conveyed in the contracts do not form a single lease component.

Therefore, there is a single lease contract with two separate lease components - the factory facility and machinery. Accordingly, the total consideration (fixed and variable) is allocated to the two components based on relative stand-alone prices.

4. DETERMINING THE LEASE TERM

If a contract is, or contains, a lease, the lease term needs to be determined.

With the exception of the requirement to reassess whether an option is reasonably certain to be exercised, which applies only to lessees (refer to section 4.2.1), the requirements of IFRS 16 regarding determination of lease term apply to both lessees and lessors.

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

It comprises (emphasis added):

Section 4.2.1

The non-cancellable period

+

Periods covered by an option to extend the lease if the **lessee is reasonably certain** to exercise that option

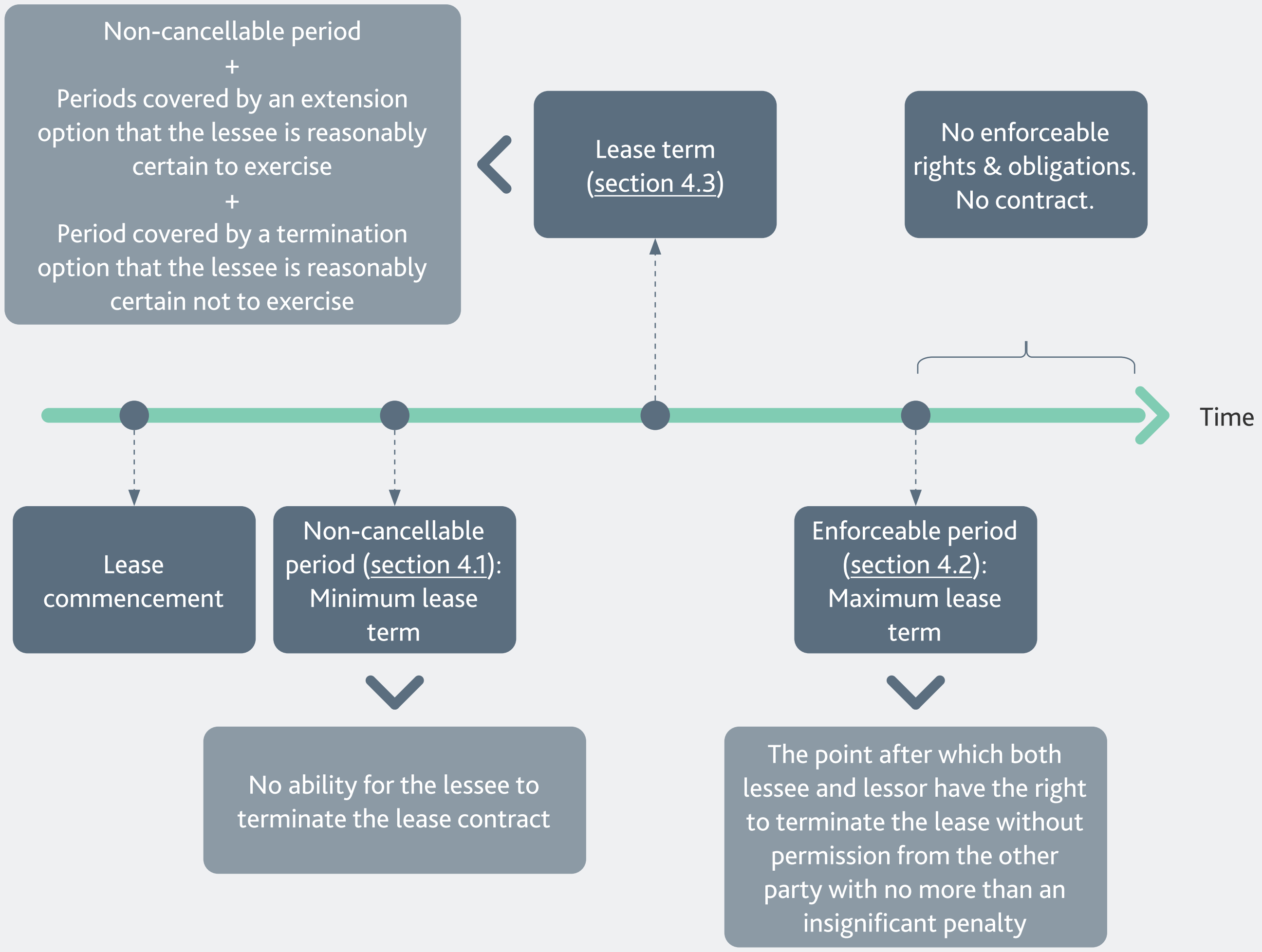
+

Periods covered by an option to terminate the lease if the **lessee is reasonably certain** not to exercise that option

See Appendix B for a flowchart that may assist entities in applying the requirements of IFRS 16 in determining the lease term. The flowchart summarises the guidance noted below, including assessing the period of time over which a lease remains enforceable.

There are three periods which need to be considered when determining the lease term in accordance with IFRS 16 – the non-cancellable period, the enforceable period and the lease term, as depicted in the following diagram.

Appendix B



Non-cancellable period + Periods covered by an extension option that the lessee is reasonably certain to exercise + Period covered by a termination option that the lessee is reasonably certain not to exercise

Lease term (section 4.3)

No enforceable rights & obligations. No contract.

Lease commencement

Non-cancellable period (section 4.1): Minimum lease term

Enforceable period (section 4.2): Maximum lease term

No ability for the lessee to terminate the lease contract

The point after which both lessee and lessor have the right to terminate the lease without permission from the other party with no more than an insignificant penalty

The following sections discuss how these periods are determined, along with illustrative examples and a summary of the methodology that should be applied in determining the lease term.

IFRS 16.B34 requires the following with respect to determination of lease term:

> *IFRS 16.B34 (emphasis added)*
>
> *In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the **definition of a** contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor **each has the right to terminate** the lease without permission from the other party with **no more than an insignificant penalty**.*

4.1 Non-cancellable Period

This is the period during which the lessee is unable to terminate the contract.

If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term.

If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease. In these cases, 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. For example, Entity A leases office space for a period of 5 years from Entity B. The contract provides Entity B with the right to terminate the lease after 2 years. Entity A does not have such termination option.

In this case, the termination option available only to the lessor, i.e. Entity B, is disregarded for the purpose of determining the non-cancellable period as Entity A has an unconditional obligation to pay for the right to use the asset for the period of 5 years, unless and until Entity B decides to terminate the lease. Therefore, the non-cancellable period is determined to be 5 years.

The non-cancellable period establishes the minimum lease term.

4.2 The enforceable period

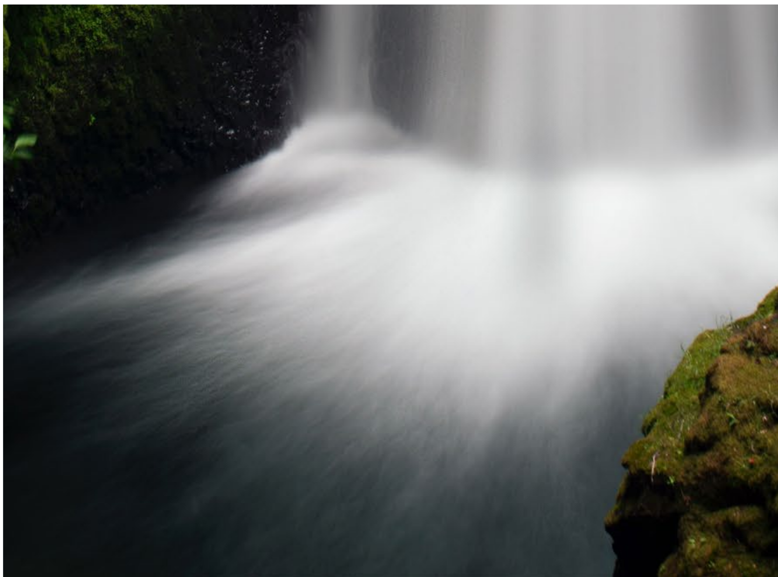
This is the period for which enforceable rights and obligations exist between the lessee and lessor. A lease is no longer enforceable at the point at which 'the lessee and lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty'. This means that both the lessee and the lessor have to satisfy this condition.

The enforceable period establishes a maximum lease term.

The effect of lessee and lessor termination rights on the enforceable period is summarised below:

	Lessee does not have the right to terminate the lease without permission from the lessor with no more than an insignificant penalty	**Lessee has the right to terminate the lease without permission from the lessor with no more than an insignificant penalty**
Lessor does not have the right to terminate the lease without permission from the lessee with no more than an insignificant penalty	Lease considered enforceable	Lease considered enforceable
Lessor has the right to terminate the lease without permission from the lessee with no more than an insignificant penalty	Lease considered enforceable	Lease not considered enforceable

The meaning of 'penalty' is discussed below in the November 2019 IFRS Interpretations Committee agenda decision and subsequent BDO comment.



IFRS Interpretations Committee agenda decision – Lease Term

In November 2019, the IFRS Interpretations Committee (the Committee) finalised an agenda decision on determination of lease term for cancellable and renewable leases.

The request to the Committee described these leases as follows:

Cancellable lease: A lease that does not specify a particular contractual term but continues indefinitely until either party to the contract gives notice to terminate. The contract includes a notice period of, for example, less than 12 months and the contract does not oblige either party to make a payment on termination.

Renewable lease: a lease that specifies an initial period, and renews indefinitely at the end of the initial period unless terminated by either of the parties to the contract.

The request asked whether, when applying paragraph B34 of IFRS 16, an entity considers broader economics in a contract (e.g. the significance of installed leasehold improvements, the importance of the leased asset itself, etc.) or only contractual termination penalties (e.g. a payment specified in the lease contract that a lessee must make to the lessor if the lessee chooses to terminate the lease).

The Committee observed that the Board's view is that the lease term is meant to 'reflect an entity's reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information' (see IFRS 16.BC156).

Therefore, the Committee concluded that in applying IFRS 16.B34 and determining the enforceable period of the lease described in the request, an entity considers:

a) the broader economics of the contract, and not only contractual termination payments (e.g. economic incentive not to terminate the lease such that it would incur a penalty on termination that is more than insignificant); and

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

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), it applies the requirements in IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

BDO comment

Consider a situation where a lease contract is entered for a period of 10 years with a non-cancellable period of five years. After the end of the non-cancellable period, both lessee and lessor have a right to terminate the lease with a notice period of one month. The lessee has installed significant leasehold improvements that have a useful life of 10 years. In this case, termination of the lease soon after five years could result in a more than insignificant penalty for the lessee, but not for the lessor.

It might be argued that the lease is not enforceable after five years because the lessor could terminate the lease at any point after five years as the lessor would not incur a more than insignificant penalty on termination.

However, IFRS 16 requires that in determining the enforceable period, an entity that is party to a lease contract must identify the point at which both it and the counterparty have a right to terminate the lease without permission from the other party and, if so, whether the termination would result in a more than insignificant penalty for the party exercising its right. As long as a more than insignificant penalty exists for either party on the exercise of its right to terminate the lease, the contract is enforceable for the purposes of the accounting requirements of IFRS 16.

In this case, as a more than insignificant penalty exists for the lessee for termination before 10 years due to significant leasehold improvements, the contract is considered enforceable even after five years.

Assessment of a more than an insignificant penalty

If a more than an insignificant penalty exists for either party on the exercise of its right to terminate the lease, then the enforceable period is longer than the non-cancellable period, and will extend until the point at which a no more than an insignificant penalty exists for either the lessor or the lessee.

In this assessment, the entity needs to consider the broader economics of the contract and not only the contractual termination penalties, as clarified in the abovementioned agenda decision.

Entities should consider all factors relevant to both the lessee and lessor in determining whether a more than an insignificant penalty exists, which may include other economic consequences (e.g. moving costs, loss of the use of a key location, and the cost of the current lease in comparison to current market rates). Thus, a lessee is required to consider factors relevant to both the lessee and lessor and a lessor is required to consider factors relevant to both the lessee and the lessor in determining whether a more than an insignificant penalty exists. This assessment may involve significant judgement.

4.2.1 Lessee Extension and Termination Options

Once the non-cancellable period and the enforceable period have been determined, the next step is the determination of the lease term. Determining the lease term requires an assessment of options that may exist within lease contracts.

Options to extend or terminate a lease contract are common in many types of leases.

The lease term includes any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

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

Factors that would be considered in this assessment include, but are not limited to:

(a) Contractual terms and conditions for the optional periods compared with market rates, such as:

i. the amount of payments for the lease in any optional period;

ii. the amount of any variable payments for the lease or other contingent payments;

iii. the terms and conditions of any options that are exercisable after periods covered by another option (or other options), e.g. a purchase option that is exercisable at the end of one or more extension periods at a rate that is currently below market rates.

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

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

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

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

A lessee's past practice with leases, particularly leases of similar assets, should also be considered in determining the likelihood of options being exercised.

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

The reason for exercising such options may not be apparent from any single criterion, but may relate to synergies and a weighting of several reasons that must be considered in aggregate. Therefore, two lessees may determine different lease terms on identical lease contracts because the facts and circumstances under which they operate may mean that one lessee concludes it is reasonably certain to exercise one or more options, whereas the other might conclude it is not reasonably certain any of them will be exercised.

Sometimes, an option to extend or terminate a lease is combined with one or more contractual features. For example, consider a situation where the contract provides for a residual value guarantee under which the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, IFRS 16 requires the entity to assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

4.2.1.1 Termination option held by only the lessee or only the lessor

Some lease contracts provide a termination option to only the lessee or only the lessor. IFRS 16.B35 requires the following with respect to the determination of the lease term in such cases:

> *IFRS 16.B35 (emphasis added)*
>
> *If **only a** lessee **has** the right to terminate a lease, that right is considered to be an **option to terminate** the lease available to the lessee that an entity considers when determining the lease term. If **only a** lessor **has the right** to terminate a lease, **the non-cancellable period of the lease includes the period covered by the option to terminate** the lease.*

As noted by the IASB in the Basis for Conclusions, a lessee's right to extend or terminate the lease provides enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, a lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease. This is the fundamental reason why lessee and lessor termination options are treated differently for purposes of determining the lease term.

BDO comment

Requiring a lessee to estimate the likelihood of the lessor exercising termination options (or not exercising extension options) would have necessitated making significant judgements about the intentions and economic conditions of lessors, for which the lessee will often have only limited information. A lessee also has an unconditional obligation to pay for the right-of-use asset during periods covered by lessor extension and termination options, unless and until the lessor decides to terminate the lease. Therefore, IFRS 16 requires a lessee to assume that a lessor will continue to enforce a contract over the period of time during which the lessor has the sole, unilateral right to terminate the contract. This is the case even if the lessee believes it is highly likely that the lessor will exercise a termination option. This is because the exercising of the lessor's option to terminate is outside of the lessee's control, meaning that the lease payments meet the definition of liabilities because the lessee can be compelled to continue making payments to the lessor.

Example 4.2.1.1-1 – Assessment of Lease Term (only lessee has termination option)

A customer is considering entering into a lease for equipment to manufacture widgets.

The lease has a five-year term, with an option exercisable by the lessee only to extend the lease for an additional two years. This means that there is effectively a termination option for the lessee at the end of year five, but not for the lessor. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional two-year period if the lessee exercises its extension option.

The customer operates in a remote location where the cost of shipping and installation for pieces of equipment is significant.

Assessment

Paragraph B34 does not apply, since only the lessee can terminate the lease (i.e. the enforceable period is seven years). The customer lacks a direct, contract-specific economic incentive to extend the lease given that lease payments are at a market rate throughout the period of the lease. However, all relevant facts and circumstances that create an economic incentive for the customer to exercise, or not exercise, options must be considered. This, therefore, includes entity-specific factors such as the costs the customer would incur to obtain a suitable replacement asset, the importance of the asset to the customer's operations, and the availability of suitable replacement assets. As the customer operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement, it concludes that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be seven years.

In the following scenario, in which both the lessee and lessor have termination options, IFRS 16 paragraph B34 is relevant:

Example 4.2.1.1-2 – Assessment of Lease Term (both lessee and lessor have termination option)

Assume similar facts to the prior example except both the lessee and the lessor have a termination option at the end of year five with a zero termination payment, which can be exercised without permission from the other party.

Assessment

The first criterion of IFRS 16.B34 does apply, since both the lessee and lessor have a termination option which is exercisable without permission from the other party. Therefore, the second criterion of IFRS 16.B34 is addressed to determine if there is no more than an insignificant penalty. This assessment determines whether the lease is enforceable beyond the non-cancellable five-year period.

The contract specifies there is no monetary penalty; however, this is only one kind of penalty that could arise. There needs to be no more than an insignificant penalty of any type for either party in order for the termination clause to have economic substance and the lease term to be enforceable for only five years. There could be other kinds of economic penalties in addition to those explicitly in the contract. In this instance, due to the remote location and likely difficulty in obtaining a new tenant, the lessor would have an economic penalty. In addition, as noted in example 4.2.1.1-1, the lessee would also have economic penalties because it operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement. Therefore, the penalty is determined to be more than insignificant and the contract is enforceable.

The term of the lease is then determined based on the lessee factors similar to example 4.2.1.1-1 with the conclusion that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be seven years. Therefore, it is important to note that a lease contract containing a mutual termination option does not automatically limit the lease term to the period up to the point at which the mutual termination option is exercisable.

Example 4.2.1.1-3 – Assessment of Lease Term (only lessor has termination option)

Entity A, the lessee, enters into a lease of office space with Entity B, the lessor, for a period of five years. The agreement provides a right to Entity B to terminate the lease at the end of three years, with a 90 day notice period. Entity A does not have a right to terminate the lease before five years.

Assessment

Paragraph B35 applies in this case. As only the lessor has the right to terminate the lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease. Therefore, the non-cancellable period of the lease is five years.

IFRS Interpretations Committee agenda decision – Useful life of leasehold improvements

At its November 2019 meeting, the IFRS Interpretations Committee (the Committee) finalised an agenda decision about whether the useful life of non-removable leasehold improvements is limited by the lease term of the associated lease. For example, if an entity installs non-removable leasehold improvements that would normally have a useful life of 10 years, but the underlying lease term, as determined by IFRS 16, is only five years, would the useful life of the leasehold improvements be limited to the five year lease term?

The Committee observed that IAS 16.56(d) specifies that in determining the useful life of an asset, an entity considers any legal or similar limits on the use of the asset, such as expiry dates of related leases. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the entity does not expect to use the leasehold improvements beyond the lease term of the related lease then, applying paragraph 57 of IAS 16, it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term.

Interaction between lease term and useful life

In assessing whether the lessee is reasonably certain to extend or not to terminate a lease, IFRS 16.B37 requires a lessee to consider all relevant facts and circumstances that create an economic incentive for the lessee. This includes leasehold improvements which are expected to have a significant economic benefit for the lessee when an option to extend or terminate the lease becomes exercisable.

The entity is required to consider the broader economics of the contract when determining the enforceable period of the lease, which includes, for example, the costs of abandoning or dismantling non-removable leasehold improvements.

If an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur a more than an insignificant penalty if it terminates the lease. Consequently, applying paragraph B34 of IFRS 16, an entity considers whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

4.3 The lease term

The lease term is the non-cancellable period of a lease plus any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option. The lease term is between a minimum of the non-cancellable period and a maximum of the end of the enforceable period.

BDO comment

When determining the lease term, **both the lessee and the lessor** assess the reasonable certainty of the lessee exercising an extension option or not exercising a termination option.

Thus, the lessor also assesses whether the **lessee and not the lessor** is reasonably certain to exercise an extension option or not to exercise a termination option.

Reasonable certainty vs. more than an insignificant penalty

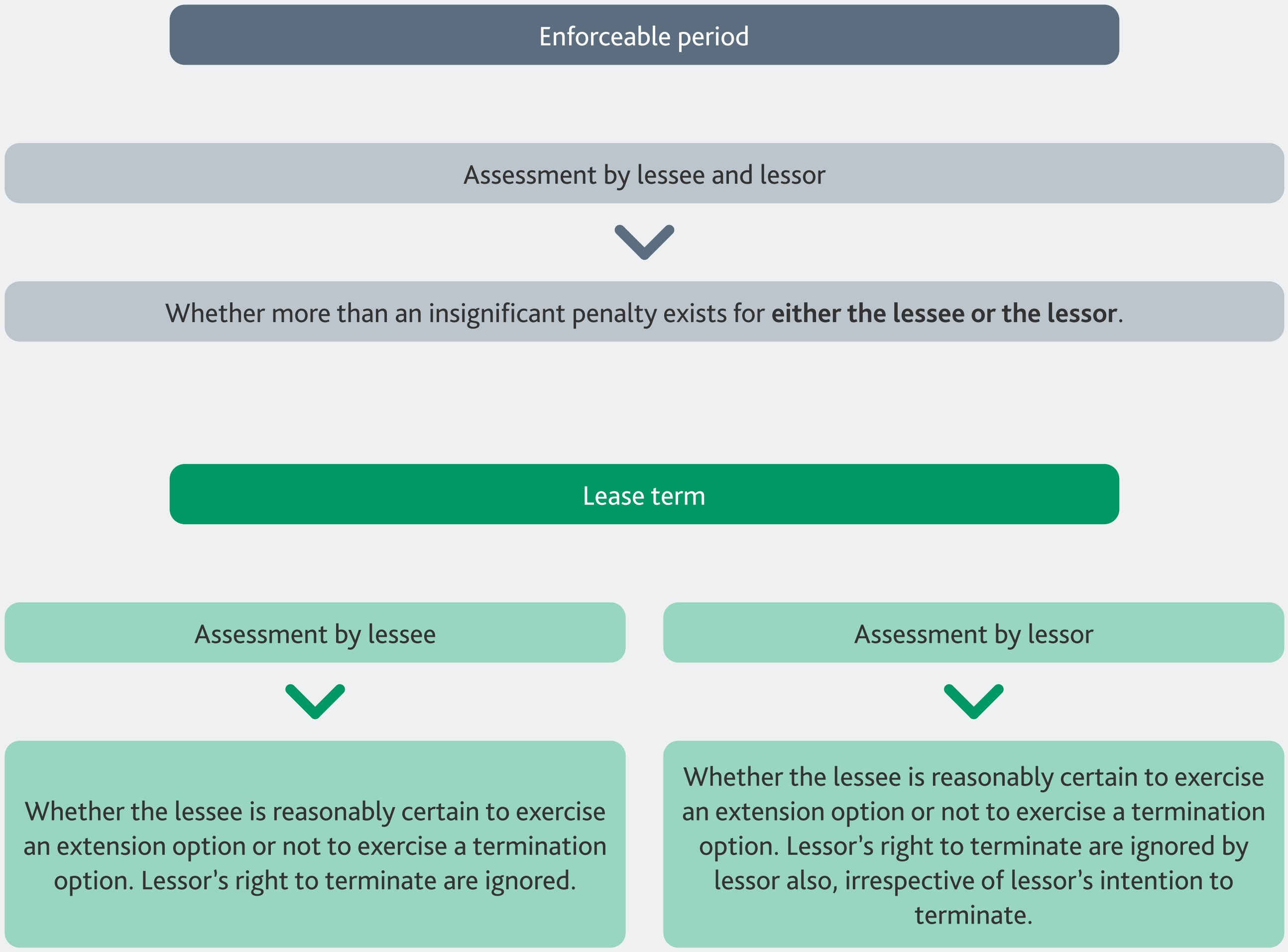
The assessment threshold for the determination of lease term is 'reasonable certainty' i.e. whether the lessee is reasonably certain to exercise or not to exercise an extension or termination option. Whereas, for the determination of the enforceable period, the assessment refers to a 'more than an insignificant penalty'. Generally, 'reasonable certainty' may be considered a higher threshold than a 'more than insignificant penalty', meaning that the lease term may be shorter than the enforceable period. For example, a lessee may not be reasonably certain to exercise an extension option despite the period covered by the extension option being part of the enforceable period of the lease.

Assessment of enforceable period vs. lease term by a lessee and a lessor

When assessing the enforceable period, both lessee and lessor assess whether there is a more than an insignificant penalty for **either the lessee or the lessor** to exercise a termination option.

When assessing the lease term, both lessee and lessor assess whether **the lessee** is reasonably certain to exercise an extension option or not to exercise a termination option.

The following diagram summarises these requirements:



Enforceable period

Assessment by lessee and lessor

Whether more than an insignificant penalty exists for **either the lessee or the lessor**.

Lease term

Assessment by lessee

Whether the lessee is reasonably certain to exercise an extension option or not to exercise a termination option. Lessor's right to terminate are ignored.

Assessment by lessor

Whether the lessee is reasonably certain to exercise an extension option or not to exercise a termination option. Lessor's right to terminate are ignored by lessor also, irrespective of lessor's intention to terminate.

4.4 Lease term – Common application issues

Notice period:

As noted by the IASB in the Basis for Conclusions, notice periods in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. For example, a lessee and a lessor enter into a contract for use of premises for a period of four years, with a non-cancellable period of two years. After two years, both the lessee and the lessor have a right to terminate the lease with three-months notice. Assuming neither the lessee, nor the lessor will suffer a more than an insignificant penalty on termination, the lease term would be two years and three months.

Rent-free period

Many lease agreements provide for a rent-free period, usually at the beginning of the contract. The lease term includes any rent-free periods provided to the lessee by the lessor. Assuming a lease contains fixed lease payments, the lease liability would accrete during this rent-free period, resulting in the recognition of finance expense (see section 5.4) and the right-of-use asset would be amortised (see section 5.4).

Section 5.4

Clause providing for 'first look' to the lessee for renewal

Some lease agreements contain a fixed, non-cancellable period followed by a period for which the lessee and the lessor may (but are not obliged in any way to) extend the lease if they agree to new terms and conditions (i.e. a 'first look' to the lessee before entering into a contract with any other party). This is an invitation to enter into a new contract (provided there are no other factors such as local laws giving rise to rights and obligations resulting in a longer lease term), and not an arrangement that could result in an extension of the existing, original contract.

Instances where the non-cancellable period, enforceable period and lease term are the same

There may be situations where the non-cancellable period, enforceable period and the lease term are the same. For example, if the contract provides for a non-cancellable period of five years and no other provisions exist that could extend that period beyond that date (that is, the only way to extend the lease would be to enter into a new contract), then the non-cancellable period, enforceable period and lease term are all five years.

Similarly, a contract might contain a fixed, non-cancellable period with there being no other factors (such as local laws) that could give rise to a longer lease term. At the end of the fixed period, the lessee could voluntarily continue to use the leased asset and pay monthly amounts to the lessor, and the lessor might accept this arrangement. In this scenario, the two parties have voluntarily chosen to continue an expired lease on a 'month to month' basis. As a result, after the original contract expires, the lease term is one month and resets each month thereafter. This differs from a situation where local laws provide that a contract will automatically convert into a 'month to month' lease after the non-cancellable period expires or 'evergreen leases' (see example 4.4-3) discussed below.

Effect of rights and obligations arising from law, statute or common law

IFRS 16 defines a contract as an agreement between two or more parties that creates enforceable rights and obligations. This definition of a contract is the same as that in IFRS 15.

IFRS 15.10 provides further guidance on the definition of a contract (emphasis added):

> A contract is an agreement between two or more parties that **creates enforceable rights and obligations**. Enforceability of the rights and obligations in a contract is a **matter of law**. Contracts can be written, oral or implied by an entity's customary business practices. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity (for example, they may depend on the class of customer or the nature of the promised goods or services). An entity shall consider those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

Thus, the definition of a lease contract in IFRS 16 captures all enforceable rights and obligations between the lessee and the lessor, whether they arise from the contractual terms of the agreement or the underlying legal framework.

Therefore, while determining the rights and obligations that exist between the lessee and the lessor, an entity should consider not only the rights and obligations arising from the contractual terms of the lease contract itself but also the rights and obligations that arise from law, statute or common law. Many jurisdictions have legislation and/or common law that provides lessees and lessors with rights and obligations beyond those that are explicit in the documented lease contract, which entities must consider while determining the lease term.

Example 4.4-1 – Effect of rights and obligations arising from law on determination of lease term

Scenario 1:

Entity A, the lessee, enters into a lease contract with Entity B, the lessor, for use of premises for a period of five years. The lease agreement grants Entity A the right to remain in the leased premises subsequent to the five year fixed period as long as Entity A continues to make lease payments, which become indexed to CPI after the fixed period.

Scenario 2:

Entity C, the lessee, enters into a lease contract with Entity D, the lessor, for use of premises for a period of five years. The lease agreement does not contain any provision granting the right to Entity C to remain in the leased premises after the period of five years. However, local laws grant the lessee the right to remain in the leased premises as long as they continue to make lease payments, which become indexed to CPI after the fixed period.

Assessment

While the two lease contracts in the above scenarios differ in their strict contractual terms, the rights and obligations of the lessee and lessor are identical in both scenarios because the lessee is granted rights by the local legal framework in the second scenario rather than the documented lease contract. Therefore, in determining the lease term, both contracts are in-substance identical.

Cancellable leases, renewable leases, evergreen leases

The IFRS Interpretations Committee (the Committee) dealt with the issue of determination of lease term for cancellable or renewable leases in an agenda decision finalised in November 2019. Refer section 4.2 for the details of the agenda decision. These leases are often referred to as evergreen, rolling or perpetual leases, where these leases do not have a fixed lease term and continue until one of the parties terminate the lease, usually requiring a short notice period or they renew automatically on a periodic basis such as day-to-day, week-to-week, month-to-month.

Section 4.2

As concluded by the Committee in the agenda decision, when determining the lease term for a cancellable or renewable lease, an entity considers the broader economics of the contract, and not only contractual termination payments and whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Therefore, the enforceable period and/or the lease term of the lease may extend beyond the non-cancellable period into the 'rolling' period when the lease renews automatically until one of the parties terminates.

Example 4.4-2 – Determination of lease term for cancellable leases

Entity A leases a machine from Entity B for a construction project. There is no contractual term specified in the agreement. Both entities have a right to terminate the lease at any time by giving one month's notice to the other party. The machine leased is specifically identified in the contract. Entity B's right to substitute is not considered substantive.

The project is expected to take two years for completion and the machine is required for the entire duration of the project.

Entity A has concluded that the contract contains a lease.

Assessment

The non-cancellable period of the lease is one month, which is the notice period. Neither the lessee nor the lessor will be able to terminate the lease before one month.

The enforceable period of the lease may be longer than one month. Although Entity A does not have any contractual obligation to continue using the machine leased from Entity B for the entire project duration, the costs for Entity A to terminate this lease and entering into a new lease (e.g. finding a new supplier, legal costs, interruption in the construction project, additional transportations/ deployment costs) may result in a more than an insignificant penalty for Entity A. In that scenario, the enforceable period of the contract may be up to two years. As the machine is required for the entire duration of the project, the lease term may also be two years depending on the particular facts and circumstances.

Example 4.4-3 – Determination of lease term for evergreen leases

Entity A enters into a lease of office premises from Entity B. The contract is for an initial period of one month. The contract provides for automatic renewal of the lease at the end of the month for another period of one month, unless terminated by either the lessee or the lessor (i.e. the lease is a month-to-month lease).

Entity A concludes that the contract contains a lease.

The location is suitable for Entity A's business and premises of similar size are not readily available in the vicinity. Entity A expects a substantial increase in the number of employees at the end of two years, which would necessitate relocation to larger office premises. Entity B would not incur a more than an insignificant penalty on termination of the lease at any point.

Assessment

The non-cancellable period of the lease is one month, which is the initial period of the contract during which neither the lessee nor the lessor can terminate the lease.

The enforceable period of the lease is longer than one month. As the location is suitable for Entity A's business and premises of similar size are not readily available in the vicinity, there is a compelling economic reason for Entity A to continue with the same premises for two years, after which it anticipates that it will need to move to larger premises. This economic reason would result in a more than an insignificant penalty for Entity A to terminate the lease before two years. Therefore, the enforceable period of the lease would be two years.

Based on the particular facts and circumstances, Entity A determines that it is reasonably certain not to terminate the lease before two years. Therefore, the lease term is two years.

If, in the above example, similar office premises were readily available in the vicinity, the assessment of lease term may change. In this case, there may not be a compelling economic reason and there may not be a more than an insignificant penalty for Entity A to terminate the lease before two years. Therefore, the lease term would be one month. In such a case, Entity A would be eligible for the short-term lease exemption.

Thus, it should be noted that evergreen or rolling leases may not always qualify for the short-term lease exemption. The lessee is first required to assess the lease term at commencement and if it is less than 12 months, the lease would qualify for short-term lease exemption.

Lessor's right to refuse an extension request

Some leases contain a clause that provides that the lessee may request a renewal of the lease, subject to the lessor's agreement.

The IASB has noted in the Basis for Conclusions of IFRS 16 that, in assessing the enforceability of a contract, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease.

A question arises whether the lessor's right to refuse a request from the lessee to extend the lease prevents the contract from being enforceable. The lessee's option not to request a renewal and the lessor's option to refuse a renewal are substantially equivalent to termination options. The term ‘enforceable’ is not defined in IFRS 16. However, in the context of IFRS 16.B34, ‘enforceable’ is not strictly a legal concept. As required by IFRS 16.B34,

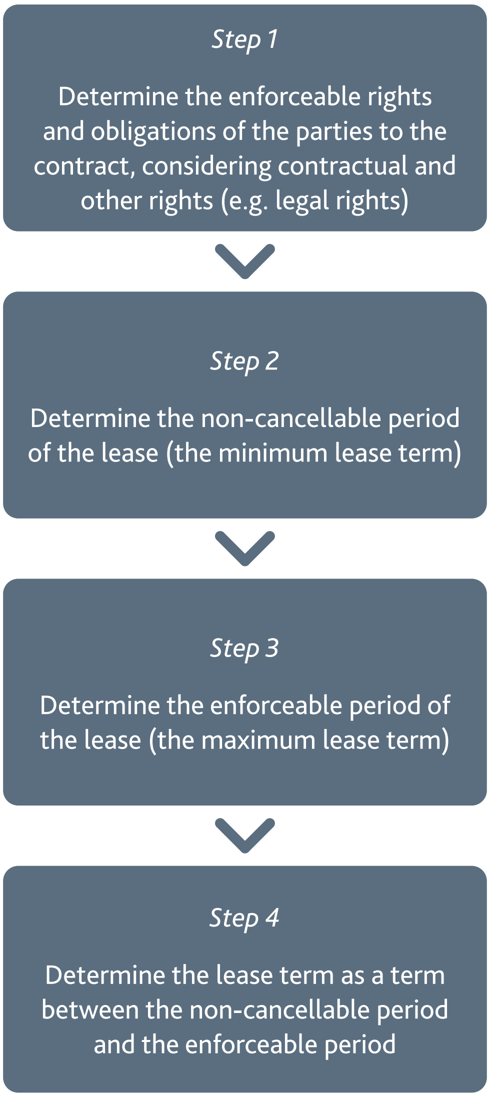
> *… A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty.*

Therefore, in cases where the contract provides for an extension subject to the lessee requesting an extension and the lessor agreeing, for purposes of determining the enforceable period, the entity needs to assess whether the lessee or the lessor would suffer a more than an insignificant penalty. For example, a lease contract provides the lessee with a right to request an extension to the lease and the lessor with a right to refuse the extension request from the lessee. If neither the lessee nor the lessor is expected to suffer a more than an insignificant penalty by not extending the contract (which is in substance a termination option), the extension period will not be included in the enforceable period. However, if the lessee is expected to suffer a more than an insignificant penalty by not extending the lease, the enforceable period will include the extension period. A lessor’s right to refuse an extension request, by itself, cannot be considered to prevent the contract from being enforceable for the purpose of accounting in accordance with IFRS 16 (see section 4.2). Note that the lease term may or may not include the periods covered by the extension option, depending on the assessment of the options (see section 4.2).

Section 4.2

4.5 Determination of lease term – examples

In summary, in determining the lease term, entities are required to consider the following:



Step 1

Determine the enforceable rights and obligations of the parties to the contract, considering contractual and other rights (e.g. legal rights)

Step 2

Determine the non-cancellable period of the lease (the minimum lease term)

Step 3

Determine the enforceable period of the lease (the maximum lease term)

Step 4

Determine the lease term as a term between the non-cancellable period and the enforceable period

Example 4.5-1 – Determination of lease term: Non-cancellable period followed by a rolling period

A lessee enters into a lease for retail space with a five year non-cancellable period. At the end of the non-cancellable period, based on the local common law in the applicable jurisdiction, the lease converts into a 'month to month' lease, whereas the lessee and the lessor may each terminate the lease with 1 months' notice with no contractual penalty owing. During this 'month to month' period, the lease payments are based on the last month's lease payment from the end of the non-cancellable period, indexed for inflation. The lessee has installed leasehold improvements with a useful life of 12 years that would have to be abandoned if it vacated the property. If the lessee were to vacate the space, the lessor would be able to lease the space to a new lessee with little to no cost.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes certain rights and obligations and local common law also provides the lessee with the right to continue occupying the space subsequent to the non-cancellable period. All of these rights should be considered in determining the lease term.

Step 2:

The non-cancellable period is five years, as neither the lessee nor the lessor may terminate the lease over this period of time.

Step 3:

The enforceable period of the lease is longer than five years. This is because the lessee has the right to continue occupying the space subsequent to the non-cancellable period based on common law in the applicable jurisdiction. The enforceable period is 12 years, because the leasehold improvements that the lessee would have to abandon if it vacated the property create a more than insignificant penalty (IFRS 16.B34) on the part of the lessee.

Step 4:

Considering all relevant facts and circumstances, the lessee determines the lease term to be 11 years. This consists of the non-cancellable period of five years, plus six of the seven years that extend beyond the point in time in which both the lessee and the lessor have a mutual termination option. This is because after six years, the leasehold improvements have a remaining useful life of only one year, therefore, the lessee determines that at that point in time, the economic value of the leasehold improvements would be such that they would no longer be reasonably certain to continue utilising the leases space. The lessee would amortise the leasehold improvements over the 11 year lease term as they have to be abandoned if the property is vacated.

The assessment of lease term in the above example would change if the contract or laws in the local jurisdiction did not provide for renewal of the lease after the end of the non-cancellable period. If the non-cancellable period is five years with no extension option, the enforceable period and the lease term would be five years. Despite the fact that the lessee has installed leasehold improvements with a useful life significantly longer than the lease term, the lessee has no enforceable rights to remain in the retail space beyond the non-cancellable period. The lessee would amortise the leasehold improvements over the five-year lease term as they have to be abandoned if the property is vacated.

Example 4.5-2 – Determination of lease term – termination option only to the lessor

A lessee enters into a lease for retail space where the lessee is unable to cancel the contract until the end of four years. The lessor is able to terminate the lease any time after three years with no contractual penalties owing to the lessee. At the end of four years, if not terminated earlier by the lessor, the lessee must return the retail space to the lessor. The lessee has installed leasehold improvements with a useful life of four years that would have to be abandoned if it vacated the property. The retail space is also a 'flagship' location for the lessee, in a city where obtaining a similar property would be costly and difficult. If the lessor were to terminate the lease, the lessor would be able to lease the space to a new lessee with little to no cost.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes the rights and obligations applicable to determining the lease term.

Step 2:

The non-cancellable period is four years. Despite the fact that the lessor can terminate the lease at any time after year three, IFRS 16.B35 states that the non-cancellable period of a lease includes the period covered by a lessor-only termination option. This lessor-only termination option is effectively disregarded for purposes of determining the lease term.

Step 3:

The enforceable period is four years because a mutual termination option does not exist until the end of year four, and the non-cancellable period is four years; the enforceable period cannot be less than the non-cancellable period. At the end of year four, the rights and obligations arising under the contract end.

Step 4:

The lease term is four years as the non-cancellable period and the enforceable period are both four years. Despite the fact that the lessor can remove the lessee at any time after three years, this does not affect the determination of the lease term. From the perspective of the lessee, the lessor has the ability to enforce the contract for four years, without the cooperation or consent of the lessee.

Example 4.5-3 - Determination of lease term: Rights and obligations arising from customary business practices

A lessee uses an office building that is owned by its parent company. The subsidiary and the parent have no documented lease agreement in writing, however, a monthly amount is paid by the subsidiary to the parent for use of the office space. The subsidiary has used the office for a number of years and has an established head office at that location. If the lessee were to vacate the space, the parent would be able to lease the space to a new lessee with little to no additional cost.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

While no written lease contract exists, the definition of a contract is 'an agreement between two or more parties that creates enforceable rights and obligations'. The guidance in IFRS 15.10 states that a contract may be 'written, oral or implied through customary business practices.' The customary business practices in this situation give rise to the relevant enforceable rights and obligations.

Step 2:

The non-cancellable period is zero years, as both parties may terminate the agreement at any point in time.

Step 3:

An entity considers all relevant facts and circumstances, including the cost of relocating its head office, the availability of similar office space, etc. and determines the lessee would suffer a more than insignificant penalty if it were to terminate the lease before the end of year 10. The lessor would not suffer an insignificant penalty at any time, however, the enforceable period extends until both the lessee and lessor would suffer no more than an insignificant penalty.

Step 4:

An entity applies judgment and considers all relevant facts and circumstances and concludes that the lease term is eight years. In doing so, an entity considers the factors noted in IFRS 16.B37-B40. The lease term is less than the enforceable period in this case because the lessee assessing whether they are reasonably certain to continue exercising the tacit renewal options is a different threshold compared to the assessment of 'penalties' which is required in assessing the enforceable period.

Example 4.5-4 – Determination of lease term: lease of land with building constructed by the lessee

A lessee enters into a lease of land for a period of 10 years. At the end of 10 years, the lease terminates with no renewal or extension options in the contract or prescribed by law. By the end of year one, the lessee has constructed a building on the land with a useful life of 50 years. As the lease was being negotiated, the lessor was aware of the lessee's plans to construct the building on the land.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes the rights and obligations applicable to determining the lease term. In light of the fact that the lessee constructed an asset on the land with a useful life significantly longer than the land lease, discussions between the lessee and lessor during the lease negotiation should also be considered in determining the rights and obligations in the contract.

Step 2:

The non-cancellable period is 10 years, as neither party may terminate the lease until this time.

Step 3:

The enforceable period of the lease is likely to be longer than 10 years, despite the fact that the written contract terminates after 10 years with no extension options provided by contract or common law. As the lessor was aware that the lessee would be constructing a building on the land, which makes it economically unfeasible for the lessee to return the land at the end of the 10 year non-cancellable period, the agreement between the lessee and lessor is implicitly for a period longer than 10 years. Applying judgment, and considering all relevant facts and circumstances, an entity determines that both the lessee and lessor would continue to suffer a more than an insignificant penalty until the end of year 50.

Step 4:

Applying judgment, and consideration all relevant facts and circumstances, an entity concludes that the lease term is 45 years.

Example 4.5-5 – Determination of lease term: More than an insignificant penalty to the lessor

Lessee operates a mine site in a remote area, which is costly to access and supply. Lessee enters into a lease contract with a lessor to rent extraction equipment with a useful life of five years. The lease has a one-year non-cancellable period. Based on the provisions of the lease contract, after one year, the contract renews monthly unless either party cancels it. The contract has no contractual penalties for cancellation. The lessee has alternative equipment it could lease from other suppliers who have equipment available near the mining site, therefore, shipping costs would be minimal. If the lessor were to terminate the lease, it would be responsible for the shipping and handling costs to bring the equipment back to the lessor's warehouse. These costs would be significant.

Assessment

The assessment of lease term would involve the following steps:

Step 1:

The lease contract establishes the rights and obligations applicable to determining the lease term.

Step 2:

The non-cancellable period is one year, as neither the lessee nor the lessor may terminate the lease over this period of time.

Step 3:

The enforceable period is five years because it is not until this point in time that the lessee and the lessor both would suffer no more than an insignificant penalty by terminating the lease. At the end of year one, the lessee may cancel the lease and it would not suffer a significant penalty because it could obtain the equipment from another vendor with little cost incurred. The lessor would continue to suffer an economic penalty throughout the useful life of the equipment as lessor cancelling the lease would result in the lessor being required to pay significant shipping and handling costs to move the equipment back to its warehouse.

Step 4:

The non-cancellable period (minimum) is one year and the enforceable period (maximum) is five years, therefore, the lease term is between one and five years. IFRS 16.B37 states that 'an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease…', meaning an entity determining the lease term in this situation, whether it be the lessee or the lessor, must assess the lessee's likelihood of exercising its termination options, which exist continuously between the end of year one and year five. Applying judgment and considering all relevant facts and circumstances, the lease term is assessed as three years. This is based on the criteria noted in IFRS 16.B37, which provides guidance on assessing lessee-only options in a lease contract. Entities would consider, for example, the extent to which the existing equipment is integrated into the lessee's operations and the cost of lease payments compared to current market rates for similar equipment.

4.6 Revisions to the Lease Term

A lessee is required periodically to reassess whether it is reasonably certain to exercise extension and termination options and to revise the lease term if there is a change. The lease term may also change due to modifications to the lease contract.

Reassessment of reasonable certainty of exercising or not exercising an option

The requirement to reassess the reasonable certainty of exercising an extension option or not exercising a termination option apply to a lessee and not to a lessor.

Changes in the lease term may occur due to a change in an entity's intentions, the entity's business practice, and other circumstances unforeseen since it was first estimated.

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

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

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

On its own, a favourable or unfavourable change in market rental rates therefore does not trigger a reassessment as changes in market rental rates are not 'within the control of the lessee'.

Significant events or changes in circumstances requiring a reassessment of the lease term include:

- Significant leasehold improvements not anticipated at the commencement date that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- A significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
- The inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- A business decision of the lessee that is directly relevant to exercising, or not exercising, an option (for example, to dispose of a business unit within which the right-of-use asset is employed).

Example 4.6-1 – Reassessment of lease term: Event not within the control of the lessee

Entity A obtains a retail space on lease from Entity B. The non-cancellable period of the lease is five years and the lease provides an option to Entity A to extend the lease for a further period of five years.

The retail space is in a central location with high visibility. At the commencement of the lease, Entity A determines that it is reasonably certain to exercise the extension option. Accordingly, Entity A determines the lease term to be 10 years.

Scenario A:

Three years after the lease commencement, Entity A's competitor opens a large retail outlet near Entity A's premises. However, it is not expected to significantly affect Entity A's business plans as Entity A has undertaken mitigating actions including further diversification.

Assessment

It should be noted that a change in circumstances is not in and of itself a triggering event for lease term reassessment. Entities may need to reassess the reasonable certainty of exercising renewal or termination options as a result of their actions undertaken in response to the change in circumstances.

In this case, the change in circumstance i.e. opening of the competitor's outlet, is not within Entity A's control. Entity A does not expect a change in its business plans as a result of the change in circumstances and has not taken any action in response to the change. Therefore, Entity A does not reassess the lease term at the end of three years.

Scenario B:

Three years after the lease commencement, Entity A's competitor opens a large retail outlet near Entity A's premises, which adversely affects consumer traffic to Entity A and revenue generation. As a result, Entity A's management has decided to relocate the store to another part of town and this is demonstrable in its business plans.

Assessment

In this case also, the change in circumstance i.e. opening of the competitor's outlet, is not within Entity A's control. However, Entity A has taken action in response to the change i.e. it has decided to relocate the store to another part of town. This action by Entity

A would trigger a reassessment of the renewal option and the lease term.

Example 4.6-2 – Reassessment of lease term: Event within the control of the lessee

Entity A obtains an office building on lease from Entity B for a period of 10 years with a non-cancellable period of five years. After five years, Entity A has an option to terminate the lease with a three-month notice. At the commencement of the lease, Entity A is reasonably certain not to exercise the option to terminate the lease and accordingly determines the lease term to be 10 years.

At the end of three years, Entity A divests a major business division, which results in a substantial reduction in its staff. Entity A needs a smaller office space than the current office building after the divestiture.

Assessment

Divestiture of the business division is a significant event that is within the control of Entity A and affects whether Entity A is reasonably certain not to exercise the termination option. Therefore, Entity A reassesses the lease term at the end of year three. It concludes that it is reasonably certain to exercise the termination option at the end of five years and the lease term is reassessed to be five years. The lease liability and the right-of-use asset are accordingly remeasured.

The requirement to reassess the reasonable certainty of options being exercised upon the occurrence of a significant event or change in circumstances are not applicable to the lessor. Therefore, Entity B does not reassess the lease term at the end of three years. Entity B revises the lease term if there is a change in the non-cancellable period of the lease.

Therefore, assuming that Entity B had determined the lease term to be 10 years at commencement, it will revise the lease term to five years when Entity A gives notice to Entity B of exercising the termination option.

Reassessment of lease term due to change in the non-cancellable period

The requirement to reassess the lease term due to a change in the non-cancellable period applies to both the lessee and the lessor.

If there is a change in the non-cancellable period of the lease, the entity is required to revise the lease term. Following are examples where the non-cancellable period of the lease will change:

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

It should be noted that the lessee is required to reassess the likelihood of whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

The lessor is not required to reassess the reasonable certainty of the lessee exercising an extension option or not exercising a termination option. The lessor reassesses the lease term when the lessee actually exercises an option not previously included in the determination of the lease term or does not exercise an option previously included in the determination of the lease term.

Revisions to original estimates of the lease term resulting from reassessments as to the likelihood of exercising options result in remeasurement of the carrying value of leased assets and liabilities. This is discussed in sections 5.6 and 5.7 below.

Remeasurements due to Modifications to the Lease Contract

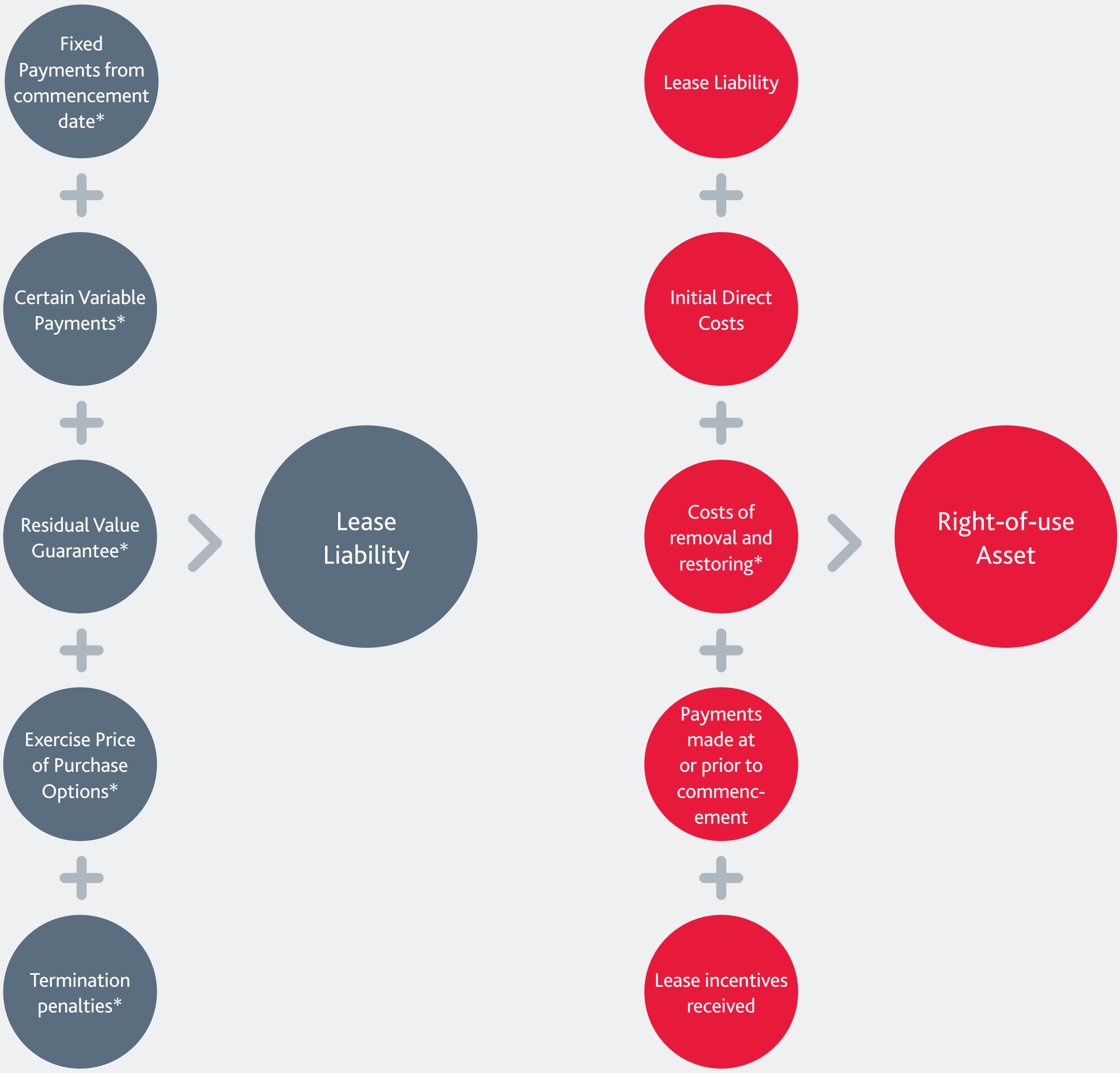
The lease term may be changed if the lessee and lessor agree to modify the lease contract (as distinct from re-estimating the lease term due to revising judgments about whether options will be exercised). Contract modifications, which also result in remeasurement of the lease assets and liabilities, are discussed in section 5.7 below.

Section 5.6

Section 5.7

5. LESSEE ACCOUNTING - RECOGNITION AND MEASUREMENT

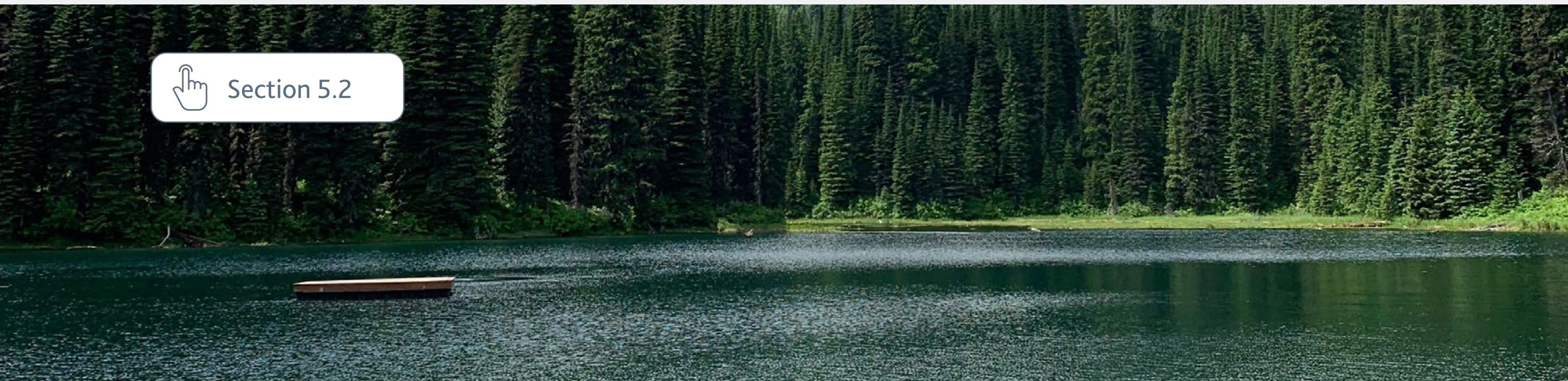
At the commencement date of a lease, i.e. the date on which the lessor makes an underlying asset available for use by a lessee, the lease liability and right-of-use asset comprise the items noted below. It should be emphasised that a lease is recognised as at the commencement date. A lease is not recognised until this point in time, therefore, a lessee entering into a lease agreement with a lessor does not trigger the recognition of assets and liabilities until the commencement date of the underlying lease contract.



Fixed Payments from commencement date* + Certain Variable Payments* + Residual Value Guarantee* + Exercise Price of Purchase Options* + Termination penalties* > Lease Liability

Lease Liability + Initial Direct Costs + Costs of removal and restoring* + Payments made at or prior to commencement + Lease incentives received > Right-of-use Asset

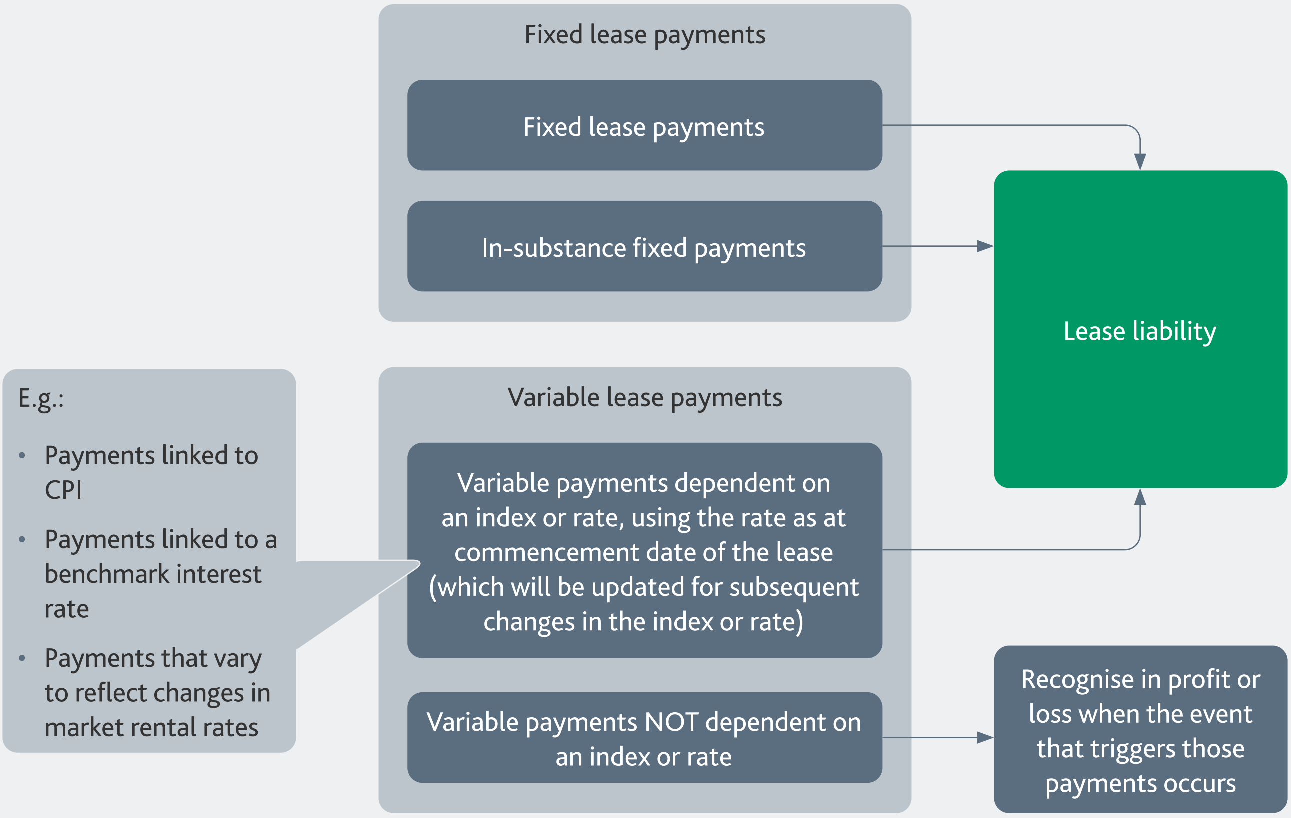
*Discounted payments (see Section 5.2 – Discount Rate on Initial Recognition)



Section 5.2

5.1 Lease Liability – Initial Recognition

The initial measurement of the lease liability is made up of several components, as illustrated in the flowchart below:


Fixed lease payments
Fixed lease payments
In-substance fixed payments
Lease liability
E.g.:
• Payments linked to CPI
• Payments linked to a benchmark interest rate
• Payments that vary to reflect changes in market rental rates
Variable lease payments
Variable payments dependent on an index or rate, using the rate as at commencement date of the lease (which will be updated for subsequent changes in the index or rate)
Variable payments NOT dependent on an index or rate
Recognise in profit or loss when the event that triggers those payments occurs

All components of the liability (fixed lease payments, in-substance fixed payments and variable payments dependent on an index or rate) are summed and discounted at an appropriate rate (see section 5.2).

The following components are included in lease liability to the extent that they arise over the lease term (as defined in Section 4):

Section 4

Section 5.2

Fixed Payments

These include the set payments outlined in the lease contract. Some payments may be structured in a way such that they appear to have variability, but based on their nature or circumstance are unavoidable and therefore are 'in-substance fixed lease payments'. In-substance fixed lease payments may take several forms:

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

Example 5.1-1 – In-Substance Fixed Payments

Below are several examples of scenarios in which it is considered whether variable payments are in-substance fixed payments.

Scenario #1 – Low minimum payments

Lessee enters into a 15-year lease of retail space in a shopping centre. The minimum rent is CU100 per annum, unless sales exceed CU1,000 per annum. If sales revenue exceeds CU1,000 per annum, the lease payments are CU50,000. The lessee has historically generated sales revenue at its retail locations of between CU150,000 and CU250,000 per annum. The store must operate within certain specified regular operating hours.

Analysis – the lease contract technically specifies variable payments in that rental payments can be either CU100 or CU50,000. However, it is not realistically possible that the lessee will have less than CU1,000 in sales per annum given its history with past retail locations. In this case, there is no true variability in the lease payments as only one outcome is realistically probable to occur. The lessee would include the lease payments of CU50,000 per annum in its initial measurement of the lease contract.

Scenario #2 – Payments entirely based around sales

Lessee enters into a 15-year lease of retail space in a shopping centre. There are no fixed lease payments. Lease payments are 5% of annual sales. The lessee demonstrated to the lessor in negotiating the contract that it generates at least CU125,000 per annum at each location, and on average, CU150,000.

Analysis – Although there is a high degree of certainty that the lessee will incur a lease expense of at least CU6,250 (CU125,000 * 5%) per annum, variable lease payments that are linked to the future performance or use of an underlying asset are excluded from the definition of lease payments. Consequently, no liability is recognised for those variable lease payments.

BDO comment

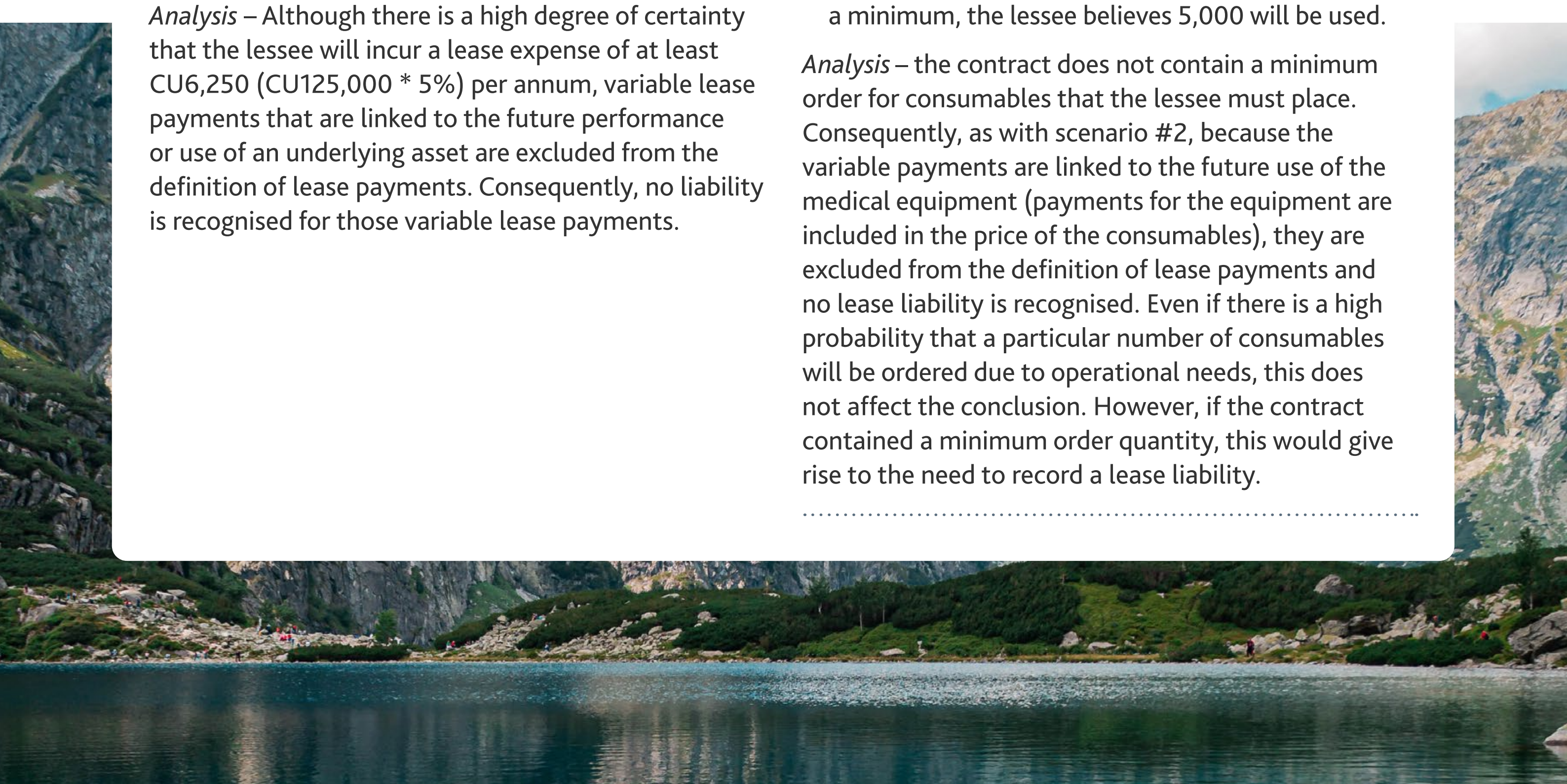
In reaching the decision that variable lease payments that are linked to the future performance or use of an underlying asset should be excluded from the definition of lease payments, some IASB Board members considered that these variable payments do not meet the definition of a liability for the lessee until the performance or use occurs. Other IASB Board members considered that all variable lease payments meet the definition of a liability for the lessee, with the decision to exclude them from lease liabilities being made purely for cost benefit reasons (for example, to avoid the potential need for lessees with turnover based lease payments to make estimates of sales far into the future), and in response to concerns expressed by constituents about the high level of measurement uncertainty that would arise and the large number of leases held by some lessees.

Scenario #3 – Consumables contract attached to a lease

Lessor leases medical equipment to hospitals and sells consumables used in the operation of the equipment. Lessor grants the lessee (a hospital) the right to use the equipment at no cost for a period of 10 years. However, in return, the customer agrees to the following:

- The lessee is not obligated to a minimum purchase of consumables, but lessor must be the exclusive supplier of consumables if the lessee chooses to purchase them.
- The price per consumable ordered is CU10.
- Based on past experience, the lessee estimates consumption of 25,000 consumables per annum. At a minimum, the lessee believes 5,000 will be used.

Analysis – the contract does not contain a minimum order for consumables that the lessee must place. Consequently, as with scenario #2, because the variable payments are linked to the future use of the medical equipment (payments for the equipment are included in the price of the consumables), they are excluded from the definition of lease payments and no lease liability is recognised. Even if there is a high probability that a particular number of consumables will be ordered due to operational needs, this does not affect the conclusion. However, if the contract contained a minimum order quantity, this would give rise to the need to record a lease liability.



Variable Payments

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

The treatment of variable lease payments is summarised as:

Variable payments that depend on an index or a rate	Other variable payments
• Include in the initial measurement of the lease using the index or rate as at the commencement date. • Remeasure lease in the period the rate or index changes (see section 5.6).	• Do not include in the initial measurement of the lease. • Recognise in profit or loss (or in the carrying value of another asset as required by another Standard) when the event or condition that triggers the payments occur.

Section 5.6

For variable payments that depend on an index or rate, IFRS 16.27(b) provides (emphasis added):

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

(a) ….

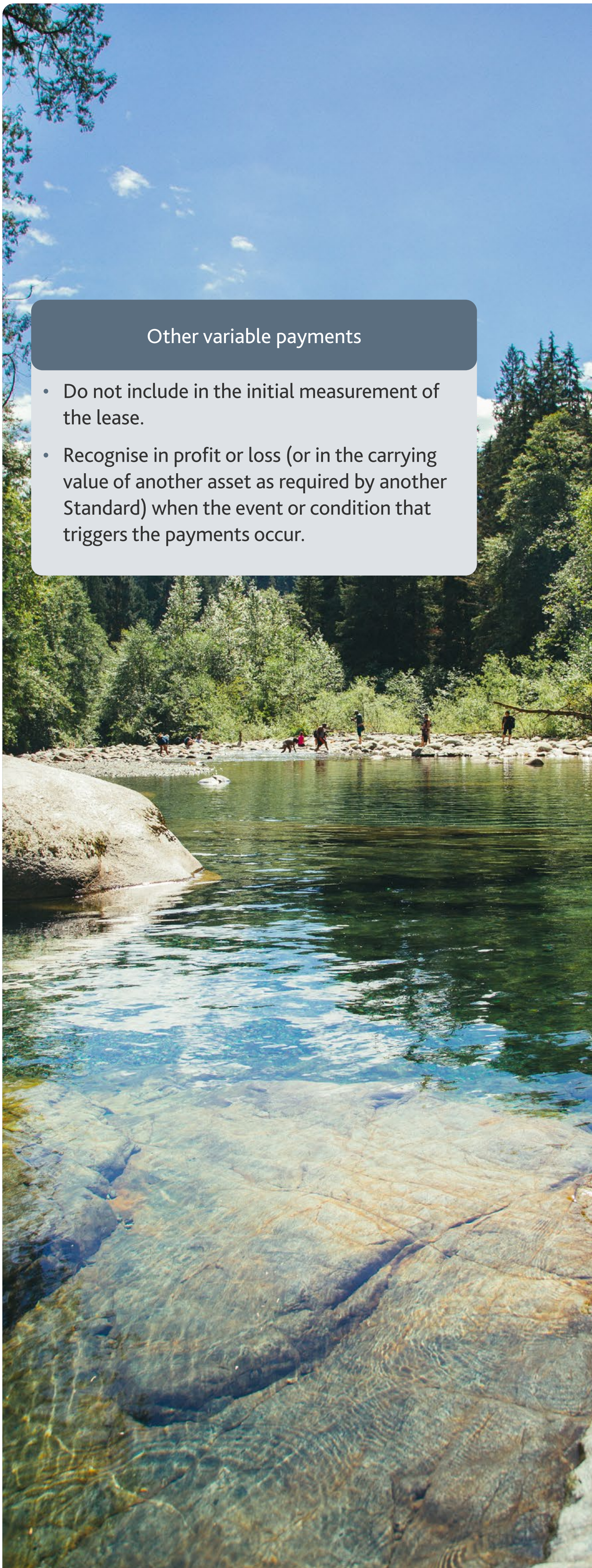
(b) variable lease payments that depend on an index or a rate, **initially measured using the index or rate as at the commencement date** (as described in paragraph 28)

(c) …

(d) …

(e) …

It should be noted that, for the purpose of initial measurement of lease liability, lessees are not required or permitted to estimate future changes in the index or rate on which the variable payments depend.



Example 5.1-2 – Variable Lease Payments indexed to an interest rate

Lessee enters into a lease contract for a lease term of five years with annual lease payments of CU100,000 per annum. These payments are indexed to a published benchmark interest rate in the jurisdiction in which the lessee operates, such that the lease payments for each year will be based on the interest rate as at the end of the previous calendar year (i.e. the interest rate as at 31 December 20x0 will determine the lease payments 20x1). As at the commencement of the lease, the applicable interest rate was 5%.

If the published benchmark interest rate remained at 5% over the five-year lease term, the cash flows would be as follows:

Year	Cash flows (rounded)
1	100,000
2	105,000 (100,000 * 1.05)
3	110,250 (105,000 * 1.05)
4	115,762 (110,250 * 1.05)
5	121,551 (115,763 * 1.05)
Total	552,563

Assessment

The lease agreement provides for escalation in lease payments based on the index rate and not movement in the index rate. As required by IFRS 16.27(b), variable lease payments that depend on an index or rate will be initially measured using the index or rate at the commencement date.

In this example, the published benchmark index rate at commencement date is 5%. Even if there is no change in the benchmark interest rate during the entire period of the lease term and it remains at 5%, as per the terms of the agreement, the lease payments will increase at a rate of 5%. Therefore, for initial measurement of lease liability, the lessee needs to consider lease payments escalating at 5%, which is the interest rate at the commencement date. The lessee is not required or permitted to forecast future interest rates for initial measurement of lease liability.

Example 5.1-3 – Variable Lease Payments indexed to movement in interest rate

Lessee enters into a lease contract for a lease term of five years with annual lease payments of CU100,000 per annum. These payments are indexed to movement in published benchmark interest rate in the jurisdiction in which the lessee operates, such that the lease payments for each year will be based on the proportionate increase or decrease in interest rate as at the beginning of the current calendar year compared to the previous calendar year. For example, if the interest rate as at 1 January 20X1 is 6% and at 1 January 20X0 is 5%, and if the lease payment for the calendar year 20X0 is CU100,000; the lease payment for 20X1 will be CU100,000 * 6%/5% = CU120,000.

As at the commencement of the lease, the applicable interest rate was 5%.

Assessment

In this case, variable lease payments depend on movement in published benchmark interest rate. If the published benchmark interest rate remained constant at 5% throughout the lease term, there will not be any change in the lease payments and the payments will remain at CU100,000.

Therefore, for initial measurement of lease liability, the lessee considers lease payments at CU100,000 for five years. The lessee is not permitted to estimate what it expects lease payments to be over the lease term.

Example 5.1-4 – Variable Lease Payments indexed to Consumer Price Index

Year One – Beginning of Lease

Lessee enters into a 10-year lease of property with annual lease payments of CU50,000 payable at the beginning of each year. The contract specifies that lease payments will increase every two years in line with the increase in the Consumer Price Index for the preceding 24 months. The Consumer Price Index at the commencement date is 125.

The lessee has determined the appropriate rate to discount lease payments is 5% (see Section 5.2 for a discussion on how to determine the appropriate discount rate.)

Section 5.2

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

Assessment

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

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

In measuring the lease liability, Lessee does not make any estimate of how future changes in CPI will impact future lease payments. Rather it assumes the initial lease payment will remain constant during the lease term.

Example 5.1-5 – Interaction Between Index-Linked Lease Payments and Rent Escalation Clauses

Entity K enters into a five-year lease with a base rental cost of CU200 per annum payable in advance. The rent will escalate at a fixed rate for the first three years as follows:

Year 1	200
Year 2	202
Year 3	204

This escalation is meant to approximate increases in CPI; however, the increases are fixed and are not variable lease payments dependent on an index or rate.

For years four and five, the payments will be determined based on the CPI for the immediately preceding year (i.e. year four's lease payment will be based on the year three payment adjusted for the increase/decrease in CPI during year three, as determined on the first day of year four).

There are no floors or ceilings in the contract, therefore, the payments in years four and five may go up or down relative to year three depending on the movement in the CPI for year three.

The issue is which amounts for years four and five should be included in the measurement of the lease liability as at the commencement date.

Assessment

The lease payments in years one to three are fixed, and are therefore included in the measurement of the lease liability.

The lease payments in years four and five are 'variable lease payments that depend on an index or rate' (IFRS 16.27(b)), and are therefore included in the measurement of the lease liability, but they are initially measured using the index or rate as at the commencement date.

One approach is that, applying IFRS 16.27(b) literally, the lessee is required to base the years four and five payments on the index or rate as at the commencement date, which is a lease payment of CU200. However, in our view this is not appropriate.

IFRS 16.42(b) provides guidance on how the measurement of a lease contract functions when the change is due to a change in index or rate. It states that 'a lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.'

Illustrative Example 14A in IFRS 16 demonstrates that when a lease is remeasured due to the cash flows of one or more periods being affected by a change in index or rate, the subsequent periods are remeasured based on the year whose applicable index or rate has now been resolved. This is demonstrated in example 5.6-3.

The fixed escalation clause and the escalation due to changes in CPI are 'linked' in that the payment in year four will be based on how movements in CPI affect the fixed payment in year three, which is 204.

When IFRS 16.27(b) states that variable lease payments that depend on an index or rate are initially measured using the index or rate as at the commencement date, we believe that it should be read to mean that the fixed payments that exist as at the commencement date are used, not necessarily the payment in the first period of a lease contract. Therefore, since year three's lease payment is fixed as at the commencement date, and it will be the base for remeasurement in year four once the movement in CPI for year three is known, then year three's fixed payment should be used to initially measure the lease contract for years four to five.

Consequently, the following payment profile is required to be used in measuring the lease liability as at the commencement date.

Year 1	200
Year 2	202
Year 3	204
Year 4	204
Year 5	204

Example 5.1-6 – Measurement of Lease Liability for 'Interest-Only' Leases

Lessee enters into a seven-year lease where the notional capital of the underlying lease asset is CU10,000. Annual payments are based on EURIBOR multiplied by the notional capital amount (e.g. EURIBOR * CU10,000), payable annually in arrears, and the notional amount is due at the end of the lease term. EURIBOR as at the commencement date of the lease is 3%. The issue is whether any amount other than the CU10,000 due at the end of the lease should be included in measurement of the lease.

Assessment

IFRS 16.27(b) requires the lease liability to include 'variable lease payments that depend on an index or rate, initially measured using the index or rate as at the commencement date'. The only unknown element in the formula to determine the lease payments from years one to six is the EURIBOR rate, however, IFRS 16.27(b) requires the lessee to use the rate as at the commencement date for initial measurement. Therefore, the lessee would include a payment of CU300 (3% of CU10,000) for years one to six and a payment of CU10,300 for year seven, discounted using an appropriate rate. The lessee would be required to remeasure the lease at each reporting date as EURIBOR changes (see Section 5.6).

Section 5.6

BDO comment

Forecasting Indices and Rates

The IASB considered whether IFRS 16 should require entities either to forecast an estimate of what the index or rate will be at each repricing date over the lease term, or to assume the index or rate in effect as at commencement date would be constant over the lease term). Ultimately, the IASB rejected both of these approaches as they could require lessees to make estimates using macroeconomic data that may not be readily available and the costs may outweigh the benefits to users of the statements (IFRS 16.BC166). Therefore, the final standard does not require a lessee to make assumptions or obtain forecasts about the future. Instead, it requires the lessee to measure lease liabilities using lease payments that assume no changes to passing rent over the remainder of the lease term.

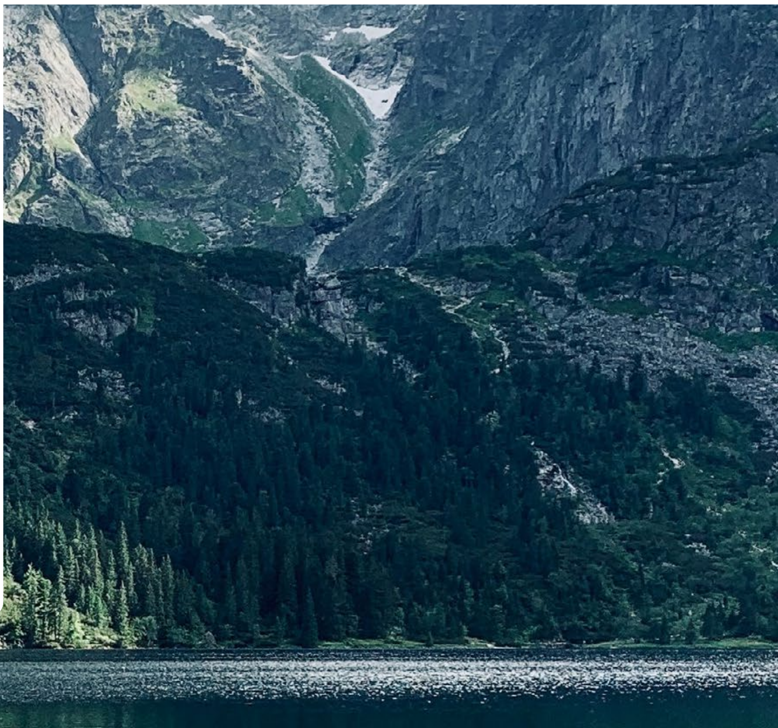
However, as and when the amount of rent payable changes as a result of lease payments being linked to a rate or index, leased assets and liabilities have to be remeasured. Long-term real estate leases often contain lease escalations linked to indexes such as the consumer price index, inflation rates posted by government agencies or periodic uplifts to market rent. Section 5.6 below covers such remeasurements in more detail.

Common Area Maintenance Costs and Variable Lease Payments

As discussed in Section 3, lease contracts for multi-unit real estate (e.g. office buildings, shopping centres) often include common area maintenance costs, under which lessees are charged for their proportionate share of common costs, which may include utilities, security, cleaning, etc. These common area maintenance costs may be in the form of a percentage of rent, a fixed fee per square foot occupied, or as estimated 'instalment' payments, which are compared to final, actual costs on a regular basis.

As discussed in Section 3, lessees may elect, as a practical expedient by class of underlying asset, to include non-lease components in the measurement of lease liabilities. In making this accounting policy choice, lessees should consider whether non-lease component payments would fall within the scope of 'other variable payments' (see above) and therefore not be included in the measurement of lease liabilities. This is illustrated in example 5.1-7 below.

Section 3



Example 5.1-7 – Common Area Maintenance Costs

Lessee has entered into two real estate leases for retail locations in two different shopping centres.

Location A has common area maintenance costs which are charged as a set percentage of rent, which is pre-determined over the term of the lease. There is no comparison of actual costs to fees collected from tenants; all payments are final.

Location B has common area maintenance costs charged based on an estimated amount per square foot occupied, which is then compared to actual costs incurred every 6 months, with either a credit being issued to the tenants or an additional payment being required by tenants, depending on whether fees collected were sufficient to cover costs.

Assessment

Location A's common area maintenance costs are fixed, as they are set based on a portion of the rental payment each period. If Lessee elects the practical expedient to include non-lease components in the measurement of lease liabilities, then these common area maintenance costs would be included in the measurement. If Lessee elects to not include the common area maintenance costs in the measurement of the lease liability, then Lessee would need to determine whether the split between rental cost and common area maintenance fees approximates their standalone values. If they do not, then Lessee would be required to reallocate the payments between the lease and non-lease components.

Location B's common area maintenance costs are variable in nature, as they have true variability based on the amount of the costs that occur for the shopping centre in total for the period, and that variability does not arise from an index, rate or market rent review. Regardless of whether Lessee elects to utilise the practical expedient to include non-lease components in the measurement of lease liabilities, these common area maintenance costs would not be included in the measurement of the lease contract as they are variable payments that do not depend on an index or rate. Instead, the maintenance costs would be expensed in the period to which they relate.

If Lessee elects to not separate non-lease components, then it must determine how it accounts for the 'instalment payments' of common area maintenance costs for Location B. As the payments are not linked to an index or rate, and they have no floor or minimum value, the entire payment is accounted for as a variable payment until the variability is resolved (i.e. when the lessor assesses the final costs for the relevant period). Payments of common area maintenance costs prior to this event are accounted for as prepayments by the Lessee.

Example 5.1-8 – Co-tenancy Clauses

Lessee enters into a non-cancellable, five-year lease in a commercial shopping centre. Lease payments are CU10,000 per month for years one to three and CU12,000 per month for years four to five ('base rent').

The lease contains a 'co-tenancy' clause, which adjusts the amount of lease payments downwards if an 'anchor tenant' vacates the shopping centre. Anchor tenants are large tenants that drive significant numbers of customers to the shopping centre (e.g. large department stores).

Under the co-tenancy clause, if the anchor tenant leaves, the base rent payments are replaced by an amount equal to 5% of sales revenue arising from the lessee's location in the shopping centre. If the anchor tenant space becomes re-occupied, the payments revert to the base rent.

At the beginning of year two, the anchor tenant vacates its space, which triggers the co-tenancy clause.

There are two issues:

1. As at the commencement date of the lease, how should the lease liability be measured (i.e. are the base rent payments 'fixed lease payments' or, because the payments could be changed to 5% of sales revenue, are they all variable lease payments not dependent on an index or rate which would be excluded from the lease liability)?
2. At the beginning of year two, when the co-tenancy clause is triggered, what is the effect on the measurement of the lease?

Assessment

Issue #1

The lease liability is measured based on conditions that exist as at the lease commencement date. Consequently, because the anchor tenant is in place at that date, the lease liability is measured on the basis of the fixed base rent amounts. These fixed amounts meet the definition of 'lease payments' in IFRS 16 - Appendix A.

The co-tenancy clause is designed to be protective in nature for the lessee and is only activated upon the occurrence of an uncertain future event that is not within the control of the lessee.

Issue #2

The triggering of the co-tenancy clause at the beginning of year two does not meet the requirements in IFRS 16.39-43 to be accounted for as a reassessment (i.e. an adjustment to the lease liability and ROU asset) because it does not result from any of the situations set out in IFRS 16.40 or 42 (that is, a change in whether the lessee is reasonably certain to exercise, or has exercised, an extension or termination option or there is a change in the assessment of an option to purchase the underlying asset, or a change in either the amount expected to be payable under a residual value guarantee or a change in lease payments resulting from a change in an index or rate that is used to determine those payments). The requirements for lease modifications do not apply, because there has been no change to the contractual terms of the lease.

Consequently, the lease liability is not remeasured. Instead, the amount actually paid (5% of sales revenue arising from the location in the shopping centre) reduces the lease liability. The lease liability is also reduced for the difference between that amount and the fixed base rent amount with a corresponding credit to profit or loss (IFRS 16.38(b)). As a result, the changes in lease payments are accounted for as negative variable lease payments in the periods to which they relate.

It is not appropriate to apply by analogy the requirements of IFRS 16.B42(a)(ii), which applies when payments that are initially structured as variable lease payments linked to the use of an underlying asset subsequently become fixed for the remainder of the lease term. This is because the fixed base rent payments do not become variable 'for the remainder of the lease term'. The co-tenancy is reversible in the future, and therefore the variable payments (5% of revenue) could at some point revert to the fixed base rent payments.

Example 5.1-9 – Variable Lease Payments not included in the Initial Measurement of the Lease

Assume the same facts as Example 5.1-4 except that Lessee is also required to make variable lease payments for each year of the lease, which are determined as 1 per cent of Lessee's sales generated from the leased property.

Assessment

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in Example 5.1-4. This is because the additional variable lease payments are linked to future sales rather than to a rate or index. Consequently, those payments are not included in the initial measurement of the leased asset and liability, and so will be recognised in each period in addition to the depreciation and interest charges arising from the amounts recorded on balance sheet.

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

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

Residual Value Guarantees

Some leases require the lessee to guarantee the value of an asset when it is returned to the lessor. These create an incentive for the lessee to maintain the asset properly and provide regular maintenance and upkeep, and mean the lessor is not exposed to risks of obsolescence thereby giving it greater assurance over the return it will earn over the period of the lease. The excess of the guaranteed value over the expected fair value of the asset at the end of the lease would result in the lessee having to make an additional payment to the lessor. Any amounts that a lessee expects to pay under residual value guarantees are included in the initial measurement of the lease liability.

Example 5.1-10 – Residual value guarantee included in lease payments

A lessee enters into a lease of a car with a lessor for a period of five years. The lease agreement contains a residual value guarantee under which the lessee guarantees that the car will have a fair value of CU10,000 at the end of the lease.

At the lease commencement date, the lessee estimates that the fair value of the car at the end of the lease will be CU6,000.

Assessment

The amount of residual value guarantee exceeds the expected fair value of the asset at the end of the lease by CU4,000, which the lessee will need to pay to the lessor at the end of the lease. The lessee includes CU4,000 in the initial measurement of the lease liability.

If the lessee's estimate of the fair value changes subsequently, the lease liability will be required to be remeasured.

Purchase and Termination Options

Amounts that a lessee expects to pay to either purchase an underlying asset or to terminate a lease by exercising a termination option, and which have therefore been included in the determination of the lease term, are also included in the initial measurement of the lease liability.

BDO comment

Determining whether a lessee is reasonably certain to exercise a purchase option at the end of a lease term may have a significant effect on the initial measurement of the lease liability and right-of-use asset recognised in the financial statements.

The amount of judgement involved in this assessment is especially high for lease contracts with a significant lease term, as uncertainties and assumptions inherently increase when the period of time covered by forecasts increases. It may therefore be appropriate to disclose the judgements and estimates made in accordance with IFRS 16.B50 and additional information required by paragraph 125 of IAS 1 *Presentation of Financial Statements*.

Other Consideration

A lease may include amounts payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease. Such amounts do not give rise to a separate component of the contract, but are considered to be part of the total consideration. This is common in leases of real estate, which require payments for items that do not transfer a separate service, such as property taxes and insurance. The treatment of these payments would differ from payments made for maintenance costs (such as common area maintenance costs in multi-unit property leases), which do transfer a service to the lessee and are in the scope of IFRS 15. The lessee first needs to determine whether there are certain payments that relate specifically to a particular (lease or non-lease) component of the contract. This entails careful consideration and the exercising of judgment. Payments that cannot be directly attributed to the individual (lease or non-lease) components are then allocated on a relative stand-alone basis to the lease and non-lease components.

However, for additional costs that are considered to form part of the lease payments, it is also necessary to determine whether these constitute variable lease payments and, if so, whether they are based on an index or rate.

Example 5.1-11 – Non-refundable value-added taxes (VAT)

A lessee enters into a lease of a property for 10 years for annual lease payments of CU3 million, payable quarterly in advance. In addition, the lessee will pay a 10% value-added tax (VAT) to the lessor, who must remit the tax to the applicable government. As the lessee operates in a specific industry, based on the applicable tax law, 50% of the VAT is non-recoverable.

Assessment

The payment of the VAT to the lessor could be viewed as not being a 'lease payment' as it is not a payment relating to the right to use an underlying asset; it is a charge levied by a government relating to goods and services with the lessor acting as collection agent for the government. Under this approach, the VAT can be viewed as being within the scope of IFRIC 21, Levies, as it is a payment imposed by a government. The VAT would not be included in the measurement of the lease liability or right-of-use asset.

Another view might be that the VAT is an initial direct cost of the right of use asset. However, the obligation to pay the VAT would only arise at the related tax point (often the invoice date), meaning that only the first quarter's VAT would be capitalised.

This issue of scoping would not be relevant if all of the VAT were recoverable/refundable to the lessee, as the entire payment would be recorded as a receivable or a reduction of VAT payable. For the non-refundable portion, it would be expensed when the underlying transaction occurs (i.e. the scheduled lease payment that gives rise to the VAT).

In 2021, the IFRS Interpretations Committee (the Committee) received a request about whether a lessee includes non-refundable VAT as part of lease payments for a lease. In its outreach and in the comment letters on the Committee's tentative agenda decision, the Committee found limited evidence that non-refundable VAT on lease payments is material to affected lessees and that the accounting followed is diverse. Therefore, the Committee did not conclude on the accounting to be followed in these cases.

Embedded Derivatives in Leases

Although IFRS 16 provides guidance for variable payments linked to an index like CPI, this guidance does not apply to embedded derivatives. Consequently, embedded derivatives are required to be accounted for separately from the lease in accordance with IFRS 9 *Financial Instruments* (IFRS 9). An embedded derivative needs to be separated if its economic characteristics and risks are not closely related to the host contract.

IFRS 9 states that an embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is:

(i) an inflation related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment);

(ii) variable lease payments based on related sales; or

(iii) variable lease payments based on variable interest rates.

In cases of leases denominated in foreign currency, a lessor's finance lease receivable or a lessee's lease liability is treated as a financial instrument for purposes of IAS 21. The payable or receivable is a monetary item within the scope of IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Therefore, a lease denominated in a foreign currency will generally not be considered to contain an embedded foreign currency derivative requiring separation.

In case of an operating lease for a lessor and a short-term lease or a lease of low-value items for a lessee denominated in foreign currency, assessment of separation of embedded derivative will be required. This is because such leases are not recognised in the balance sheet, meaning that changes in payments as a result of foreign exchange rates is not reflected by applying IAS 21.

Generally, the embedded foreign currency derivative will be closely related to the host contract if the foreign currency is one of the following:

a. The functional currency of any substantial party to the lease contract;

b. The currency in which the price of such leases is routinely denominated in commercial transactions around the world; or

c. A currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place.

Example 5.1-12 – Embedded derivatives in Leases

Company B has entered into several multi-year operating leases of buildings as a lessee. The rental payments are denominated in US dollars and are adjusted as follows.

During the first eight years, the annual increase in rent is determined by multiplying the change in the consumer price index by a factor of 1.85, subject to a floor of 2.5% for the first three years. Beginning in year nine until the end of the lease term, the increase in rent will be determined by multiplying the index by 1.5.

Assessment

Although adjustments for inflation indices in lease contracts are common, floors and multipliers on those rates are not. The adjustment to lease payments occurring is linked to CPI, which may be viewed as closely related to the risks of the host lease contract. However, the contract includes a multiplier on the index and a floor, both of which affect the lease payments in ways that decouple the cash flows from the risks inherent in the lease asset.

These characteristics of the contract would be an embedded derivative not closely related to the host lease contract, and would therefore require separation from the lease contract. Separated embedded derivatives would be accounted for in accordance with IFRS 9.

In this case, the host contract will be the multi-year lease of buildings, with US dollar denominated payments, with annual increase in rent linked to the consumer price index (without the multiplier and the floor).

The embedded derivative will be a contract to pay/receive an amount equivalent to the lease payments multiplied by the change in CPI multiplied by a factor of 0.85 for first eight years (subject to a floor of 2.5% for first three years) plus lease rent multiplied by CPI multiplied by 0.5 for the remaining lease term.

The lessee will measure the lease liability and right-of-use asset considering lease rentals linked to the CPI, without the multiplier and the floor. The embedded derivative will be accounted in accordance with IFRS 9 by the lessee.

Example 5.1-13- Embedded derivative - Lease denominated in foreign currency

A lessee enters into a 9-month lease with a lessor commencing on 1 January 20X1, with quarterly lease payments due in arrears. The lease does not contain any extension or renewal options. The functional currency of the lessee and the lessor is CU. Quarterly lease payments are FC100,000, with FC being a foreign currency. Foreign currency FC is not a currency in which the price of such leases is routinely denominated or a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the lease takes place.

On 1 January 20X1, the CU:FC spot rate was 2:1. The CU:FC forward rates for 31 March 20X1, 30 June 20X1 and 30 September 20X1 are 2.1:1, 2.15:1, 2.18:1.

Assessment

Scenario 1: Lessee elects to use the short-term lease exemption

As the lease term is 9-months, the lessee can elect to use the short-term lease exemption.

The embedded foreign currency derivative is not closely related to the host lease contract as currency FC is not the functional currency of either the lessee or the lessor, FC is not a currency in which the price of such leases is routinely denominated or a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the lease takes place.

Therefore, separation of the embedded derivative is required.

Accounting for the host contract

The lessee will account for the host lease contract considering lease payments at the forward exchange rates i.e. lease payments of CU210,000, CU215,000 and CU218,000 due on 31 March 20X1, 30 June 20X1 and 30 September 20X1. The lease payments will be recognised as an expense over the lease term on a straight-line basis or another systematic basis.

The lessor will similarly account for operating lease income over the lease term.

Accounting for the embedded derivative

The embedded derivative for the lessee is a contract to pay FC100,000 and receive CU210,000; CU215,000 and CU218,000 on 31 March 20X1, 30 June 20X1 and 30 September 20X1 respectively.

The embedded derivative for the lessor is a contract to receive FC100,000 and pay CU210,000; CU215,000 and CU218,000 on 31 March 20X1, 30 June 20X1 and 30 September 20X1 respectively.

This embedded derivative will be accounted for in accordance with IFRS 9 by the lessee and the lessor.

Scenario 2: Lessee elects not to use the short-term lease exemption

If the lessee does not elect to use the short-term lease exemption, the lessee recognises the right-of-use asset and lease liability using the CU:FC spot rate as at 1 January 20X1.

The lease liability is a monetary item within the scope of IAS 21, which will be translated using the closing rate at the end of each reporting period.

Separation of the embedded derivative is not required.

If in the example above, the lease is finance lease, the lessor will measure net investment in the lease considering lease payments as measured in the example above. The net investment in the lease is a monetary item within the scope of IAS 21. Therefore, separation of embedded derivative is not required.

Example 5.1-14 – Embedded derivatives in Leases – Lease payments indexed to CPI with a cap and a floor

Entity A enters into a 20-year lease of a property with Entity B. The lease payments are linked to the movement in CPI, with a floor of 0% and a cap of 5%.

At the commencement of the lease, inflation is 3%.

Assessment

As required by IFRS 9.B4.3.8(f), an embedded derivative in the form of an inflation related index in a host lease contract is considered to be closely related to the host lease contract if the lease is not leveraged and the index relates to inflation in the entity's own economic environment.

In this case, the embedded derivative is an inflation related index, being linked to movement in CPI.

However, the contract also provides for a cap and a floor on the indexation.

IFRS 9.B4.3.8(b) state as follows (emphasis added):

> *An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the* ***cap is at or above the market rate*** *of interest and the* ***floor is at or below the market rate*** *of interest* ***when the contract is issued****, and the cap or floor is* ***not leveraged*** *in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.*

Analogising these requirements, an embedded cap and a floor on the inflation rate in a lease contract are considered closely related to the host lease contract if the cap is at or above the inflation rate and the floor is at or below the inflation rate on the date of commencement of the lease.

The floor of 0% is below the inflation at the commencement of the lease (3%) and the cap of 5% is above the inflation at the commencement of the lease. Therefore, the embedded derivative is considered closely related to the host lease contract and is not required to be separated.

At the commencement of the lease, Entity A will measure the lease liability at the present value of the lease payments, without considering future increases on account of inflation (refer example 5.1-4).

Had the inflation at commencement been 7%, the embedded cap would not be considered closely related to the host lease contract and would need separation.

5.2 Discount Rate on Initial Recognition

All the components of the lease liability as described in Section 5.1 are required to be discounted to reflect the present value of the payments. The discount rate to use is the rate implicit in the lease, unless this cannot readily be determined, in which case the lessee's incremental borrowing rate is used instead.

Section 5.1

The definition of the lessee's incremental borrowing rate states that the rate should represent what the lessee 'would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.' In applying the concept of 'similar security', a lessee uses the right-of-use asset granted by the lease and not the fair value of the underlying asset. This is because the rate should represent the amount that would be charged to acquire an asset of similar value for a similar period. For example, in determining the incremental borrowing rate on a five year lease of a property, the security for the portion of the asset being leased (i.e. the five year portion of its useful life) would be likely to vary significantly from the outright ownership of the property, as outright ownership would confer rights over a period of time that would typically be significantly greater than the five-year right-of-use asset contained in the lease.

In practice, judgement may be needed to estimate an incremental borrowing rate in the context of a right-of-use asset, especially when the value of the underlying asset differs significantly from the value of the right-of-use asset.

An entity's weighted-average cost of capital ('WACC') is not appropriate to use as a proxy for the incremental borrowing rate because it is not representative of the rate an entity would pay on borrowings. WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings. The use of WACC would therefore result in the carrying amounts of both lease liabilities and right-of-use assets being understated.

BDO comment

Use of rate implicit in the lease vs. incremental borrowing rate

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

Allowing the incremental borrowing rate to be used acknowledges that a lessee is often not able to determine the implicit rate. A lessor often does not disclose the rate in the contract, or may offer a rate as being promotional (i.e. a below market interest rate), but also charge above-market lease rentals to compensate for the low interest rate). Ultimately, to calculate the rate implicit in the lease requires not only information about the fair value of the leased asset at the start of the lease, but also its 'unguaranteed residual value' (the fair value at the end of the lease if the residual value is not being guaranteed). However, in many leases it will not be possible to make a reliable estimate of this, particularly where the lease term is less than the leased asset's useful economic life.

Therefore, it is likely that many lessees will use their incremental borrowing rate for a wide variety of leases.

Interest rate implicit in the lease for lease and non-lease components

If a lessee uses the interest rate implicit in the lease to measure leases (not the lessee's incremental borrowing rate), the lessee must also consider lease and non-lease components. While IFRS 16 contains a practical expedient that permits lessees to combine lease and non-lease components in the measurement of a lease contract (e.g. an automobile lease payment with built in maintenance services), in our view, lessees still must bifurcate these payments for purposes of determining the rate implicit in the lease.

In determining the interest rate implicit in the lease, lessees must still comply with the definition, which states that it is 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 term 'lease payments' is defined as 'payments made by a lessee to a lessor relating to the right to use an underlying asset…', meaning that the input into the determination of the rate implicit in the lease relates only to lease components, not non-lease components.

This creates additional complexity for entities using the rate implicit in the lease for the measurement of lease contracts.

Timing of the determination of the discount rate

The timing of the determination of the discount rate may affect lease measurement if there is a delay between contract inception and the commencement of the lease. This can arise in situations where significant events occur between the inception and commencement dates, which would affect either the lessee's incremental borrowing rate or the rate implicit in the lease. For example, credit deterioration of the lessee would affect the incremental borrowing rate and significant geopolitical or technological events could affect the fair value of the underlying asset, which would in turn impact the rate implicit in the lease.

In our view, the determination of the discount rate from the lessee's perspective is at the commencement date of the lease, as IFRS 16.23 requires a lessee to measure the right-of-use asset at the commencement date. The applicable discount rate is a component of the measurement of the lease, therefore, it is determined at the same time as other components of the measurement of the lease.

For lessors, the guidance differs, as IFRS 16.66 states that lease classification between operating and finance type occurs at the inception date. The applicable discount rate is a component in determining how a lease is classified, as it affects the criteria used to analyse whether a lease is finance or operating. Consequently, the discount rate is determined at the inception of the lease contract for lessors.

Discount rate for leases acquired in a business combination

IFRS 3 includes the following requirements for the measurement of leases acquired in a business combination when the acquiree is a lessee (emphasis added):

28A The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with IFRS 16 in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

(a) leases for which the lease term (as defined in IFRS 16) ends within 12 months of the acquisition date; or

(b) leases for which the underlying asset is of low value (as described in paragraphs B3–B8 of IFRS 16).

28B The acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) ***as if the acquired lease were a new lease at the acquisition date.*** The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.

This raises the question of whether, in a transaction where a business combination is effected through the acquisition of a separate legal entity (e.g. a corporation), when applying IFRS 3.28B, does the acquiring entity determine a discount rate from its own perspective (i.e. the acquirer) or from the perspective of the acquiree? Note that if a lease is acquired by the acquirer in a business combination through methods other than the acquisition of a separate entity (i.e. a trade and asset purchase, which requires the acquirer to amend the underlying lease contract to make the acquirer the new lessee), then the lease is a new contract at the acquisition date, and the applicable discount rate would be determined from the perspective of the acquirer.

This affects the measurement of the lease contract when the lessee's incremental rate of borrowing is used, as the effects of various economic factors (in particular credit risk) are included when the rate is determined.

In a business combination where the lease liability and right-of-use asset are measured at an amount equal to one another, this will not have a net impact on goodwill. However, when leases have 'off-market' terms, then this will impact the determination of goodwill in the business combination because the off market terms will be reflected in the measurement of the right-of-use asset.

IFRS 3.28B requires the acquirer to apply IFRS 16 in measuring the acquired lease as if it were a new lease as at the commencement date. In measuring a new lease, entities must consider all relevant information in determining inputs such as the lease term, lease payments, etc.

In determining the discount rate used to measure the lease liability, assuming that the interest rate implicit in the lease is not available and the lease is not restructured at the date of the business combination, then the lessee's incremental rate of borrowing is determined from the perspective of the party to the contract (i.e. the lessee / acquiree in the business combination). This is consistent with IFRS 16.BC160:

> *'The IASB's objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced.'*

Regardless of the fact that the lease acquired is a new lease from the perspective of the acquirer, the initial recognition is still driven by the guidance in IFRS 16, therefore, the 'lessee' remains the acquiree in the business combination. This means that the subsidiary cannot default to the parent IBR.

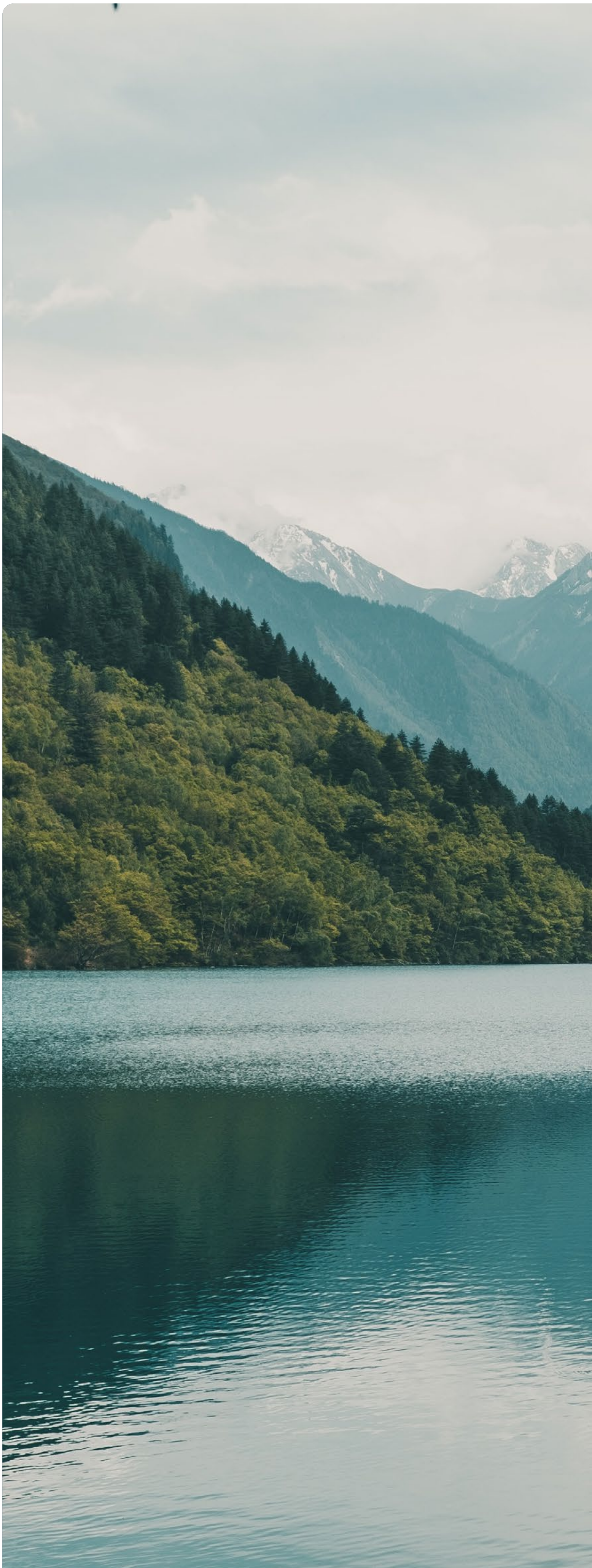
However, the acquirer's incremental rate of borrowing may be relevant if the leases acquired in the business combination are simultaneously restructured at the time of the business combination to include the addition by the new parent of credit enhancements to the lessee (e.g. a guarantee provided by the parent to the lessor). In such cases, the credit enhancement is considered in the determination of the incremental rate of borrowing, and hence in the initial measurement of the lease contracts in the acquirer's purchase price allocation.

Determining the incremental borrowing rate

IFRS 16 does not contain significant guidance on how to determine the incremental borrowing rate beyond the definition provided (emphasis added):

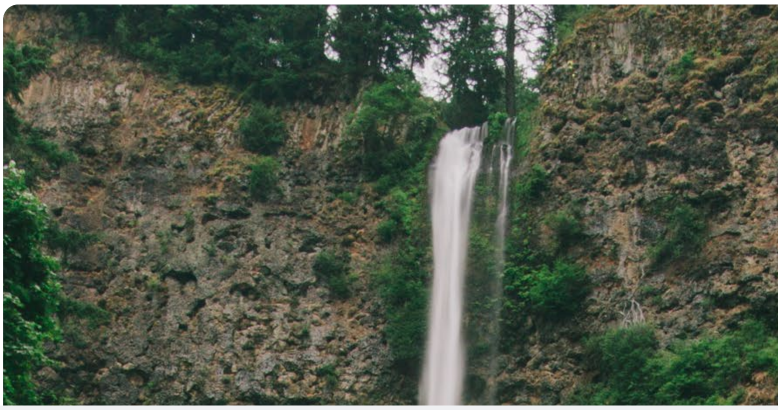
> *'The rate of interest that a **lessee would have to pay to borrow** over a **similar term** and with **similar security**, the funds necessary to obtain an asset of **similar value** to the right-of-use asset in a **similar economic environment**.'*

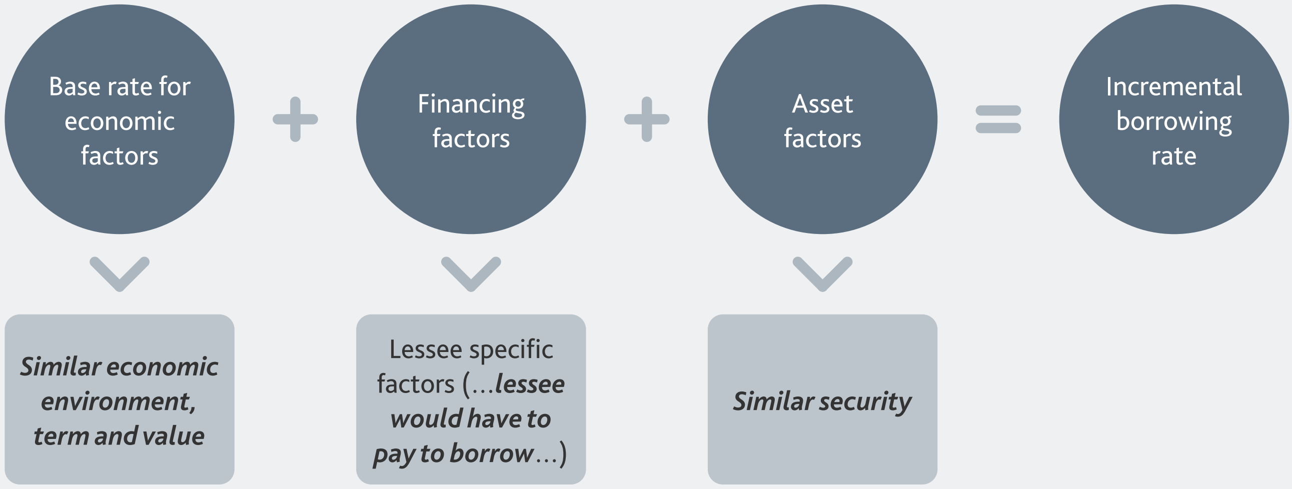
In the absence of specific requirements in IFRS, preparers will have to apply judgment in determining the incremental borrowing rate. For entities with relatively small lease portfolios that are not material in the context of the entity's financial statements, then the work effort involved in determining the incremental borrowing rate for those leases may be lower. For entities with significant lease portfolios, the determination of the discount rate may have a very material impact on the statement of financial position as well as financial performance.



Determining the incremental borrowing rate is more complex than simply determining the weighted rate that an entity pays on its current borrowings. Such borrowings may have economic characteristic entirely dissimilar to the definition of the lessee's incremental borrowing rate as noted above.

In our view, the following methodology may provide a reasonable base for determining the incremental borrowing rate for a lease, as it incorporates the key elements denoted above in italics:





Base rate for economic factors + Financing factors + Asset factors = Incremental borrowing rate

Base rate for economic factors: ***Similar economic environment, term and value***

Financing factors: Lessee specific factors (…***lessee would have to pay to borrow***…)

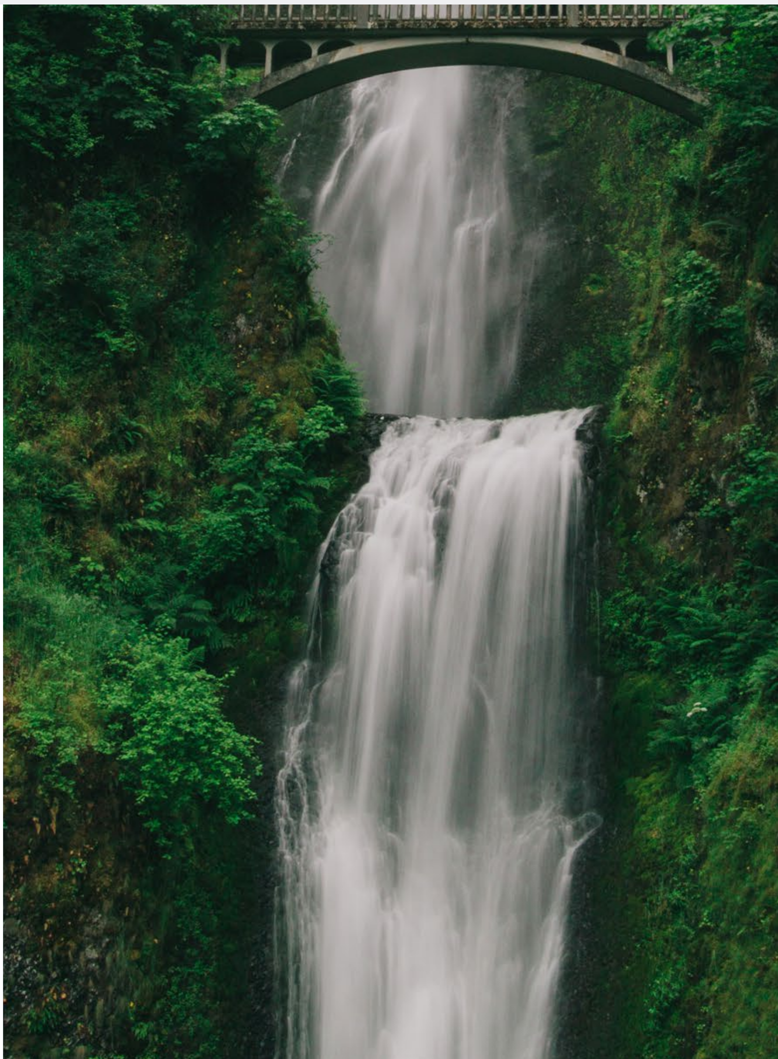
Asset factors: ***Similar security***

Base rate for economic factors: similar economic environment, term and value

The starting point in estimating the incremental borrowing rate is a 'base rate', which may be a risk-free rate derived from government bonds or other types of low risk financing. To achieve a 'similar economic environment', this rate should consider the applicable geographic location where the lessee operates. For example, the risk-free rate in the United States of America and sub-Saharan Africa would be very different.

The base rate should also consider the term of the lease, as risk-free rates differ depending on the period of time of the lending arrangement. For example, the risk-free rate for a three-year lease of equipment would differ from the risk-free rate for a 20-year real estate lease, as the cost of borrowing tends to increase as the period of time increases.

An issue arises in developing this base rate, as there are often significant differences in the timing of cash flows between risk-free rates and leases. Low risk lending arrangements, such as government bonds, tend to have cash flows heavily weighted towards the



end of the term (i.e. a 'bullet loan'). In some cases, all cash flows, including interest, may be deferred until this point in time. In contrast, most leases have period cash flows that occur over the lease term on a weekly, monthly, or annual basis. However, IFRS 16 does not contain specific guidance for the determination of the incremental borrowing rate.

At its September 2019 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of determining the lessee's incremental borrowing rate. In its agenda decision, the Committee observed that an entity must apply judgment in determining its incremental rate of borrowing. The Committee observed that it would be consistent with the Board's objective for an entity to refer to readily observable rates for loans with similar payment profiles in developing the entity's incremental borrowing rate for a lease. Many lease contracts are amortising in nature with regular payments, meaning that an appropriate approach would be to use readily observable rates for loans that would also be amortising in nature (e.g. an amortising government bond with similar payment profile to the underlying lease).

One approach could be to use the yield curve for government bonds (which have a bullet repayment on maturity), with an appropriate rate being used to discount each of the lease payments. This would result in the determination of a 'base rate' which reflected the capital repayment profile of the lease.

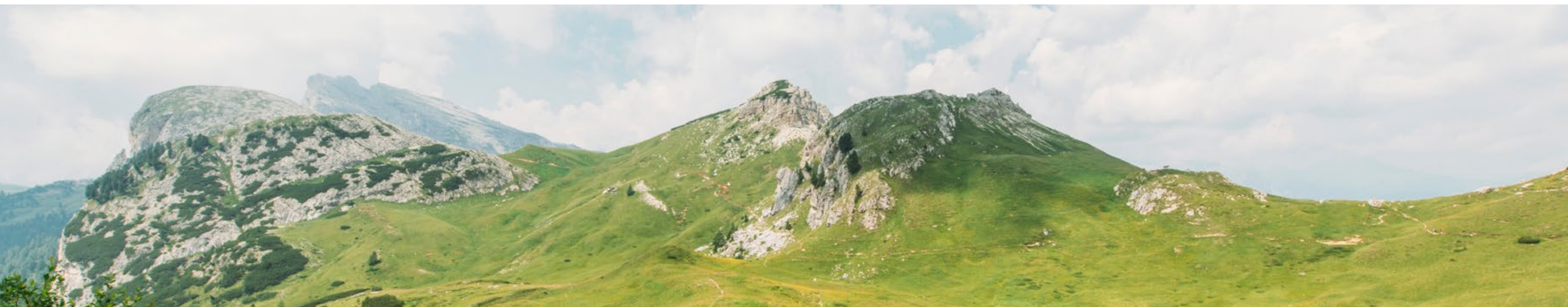
An alternative approach which may be acceptable to account for this difference in the timing of cash flows (depending on the contractual payment terms of the lease) would be for entities to select reference bonds with cash flows that approximate the weighted cash flows for the underlying lease. For example, the rate attributable to a 10-year property lease with monthly cash flows may be satisfactorily represented by a five-year bond with a bullet capital repayment on maturity. The weighted cash flows of the bond would be approximately five-years. However, this may not always be an appropriate approach, for example where rates are low for the initial five year period but increase sharply for years five to ten.

Financing factors

IFRS 16 is clear that the intention of the discount rate guidance is to ensure the discount rate reflects how the contract is priced. As the 'base rate' discussed above represents a risk-free rate of borrowing, it must be adjusted to consider the credit risk of the entity. Entities may consider using readily observable rates for loans with similar payment profiles as a starting point.

Once an appropriate base rate is determined, it must be adjusted for characteristics of the lease that are dissimilar from the reference rate. This may be accomplished by obtaining credit spread information for the entity itself from recent borrowings; however, obtaining this information specific to one particular entity may be difficult in practice. Entities may also consider utilising industry data and making adjustments for the entity's specific credit risks relative to industry composites.

It should be noted that in group structures where central treasury functions obtain financing for groups across multiple jurisdictions, special considerations may apply. It is common for conglomerates and large corporate entities to centralise their borrowing function in order to lower borrowing costs for the group as a whole through economies of scale. In determining an appropriate incremental borrowing rate, entities must consider that it would generally not be appropriate to use a 'consolidated' borrowing rate for the group as a whole. This is because a group borrowing rate generally considers the blended credit characteristics of all entities in the group, which will normally differ from the terms of a lease obtained in each individual subsidiary. For example, a group treasury rate for a revolving credit facility may consider guarantees and diversification adjustments, which lower the rate for the group as a whole and not for each separate subsidiary. Upon consolidation of many entities within a corporate group, the incremental borrowing rate may differ significantly across different entities that operate in different geographic regions and industries, even if the underlying leased asset is similar.



Special consideration: foreign currency leases

Entities may enter into lease agreements in currencies other than their functional currency. For example, an entity may have a functional currency of Euro, and enter into leases for aircraft, which are routinely denominated in US dollars worldwide. In our view, entities should determine their incremental borrowing rate based on the rate of interest they would have to pay in the same currency in which the lease payments are denominated.

In some situations, an entity may utilise foreign currency derivatives in order to achieve a similar economic outcome as borrowing in the foreign currency itself. Using the example noted above, the entity may acquire a loan in Euros and then acquire a cross-currency swap to economically modify the payments to be in US dollars. In a situation where an entity routinely enters into such arrangements, then depending on the precise facts and circumstances, it may be appropriate to use this 'swapped' borrowing rate in determining the incremental borrowing rate for a lease in the swapped currency. Factors to consider include the approach that an entity actually uses in practice for borrowing USD and which approach would give a lower cost of borrowing.

Special consideration: use of 'real' discount rates and interrelationship with inflation

In some jurisdictions, lease payments are adjusted on a regular basis to reflect the accumulated inflation of the past twelve months. This may be more common in jurisdictions with relatively high rates of inflation. This results in the lease having variable payments that are dependent on an index or rate. This raises the question of whether a nominal or a real rate should be used in determining the lessee's incremental rate of borrowing.

A nominal discount rate does not consider inflation, whereas a real discount rate does. A real discount rate aims to remove the effects of inflation to reflect the real cost of debt to the borrower and thus is lower than the nominal discount rate.

The lessee's incremental borrowing rate is defined 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 rate a lessee 'would have to pay to borrow' funds would be a nominal rate, not a real rate.

Therefore, in our view, a nominal rate should be used for discounting

However, for leases that have inflationary increases (e.g. variable lease payments dependent on CPI or inflation), an alternative view may be acceptable. If the cash flows considered for measurement of lease liability reflect real cash flows, an entity may consider use of real discount rate.

Asset factors

In determining how the type of asset affects the incremental borrowing rate, entities should consider that a lease is in substance a 'secured loan', in that the lessor typically has recourse to repossess the underlying asset (which includes the lessee's right of use asset) if a lessee defaults.

IFRS 16 intends the incremental borrowing rate to represent the rate that would be charged to purchase the right of use asset. However, there are conceptual differences in achieving this in practice. For example, a lessor is typically exposed to residual value risk in leasing to an entity, which it would be expected to incorporate into the rate implicit in the lease. In our view, it would not be appropriate for the lessee to incorporate an asset risk premium for residual value risk because this is not consistent with the definition of the incremental borrowing rate. While the incremental borrowing rate and the rate implicit in the lease share many characteristics, exposure to residual value risk via an asset risk premium is not the same as security risk that a lender bears through the term of a borrowing arrangement.

In our view, it would still be appropriate to adjust the rate by a value that considers a borrower's view as to the risk of the type of asset that is being leased (e.g. the risk related to repossessing right of use assets for laptop computers compared to commercial office space would differ substantially). Significantly different costs would exist for these two examples, and the ability of a lender to realise a residual amount from the underlying collateral would differ substantially.

Example 5.2-1 – Determination of Discount Rate for a Portfolio of Similar Leases

Note: this example illustrates the concepts discussed above in determining the discount rate for lease contracts. Additionally, this example illustrates how a lessee may make materiality decisions concerning the discount rate in measuring lease contracts. Such decisions must be made by management with appropriate analysis to support the simplifications used. The decisions noted below may not be appropriate to every entity; careful analysis of the facts and circumstances in each case is required.

Entity L is a new freight and logistics firm that has entered into a large number of leases for railcars in order to transport its customers' goods. It has also entered into a number of leases for smaller equipment such as automobiles and forklifts. The interest rate implicit in the leases is not readily determinable, therefore, Entity L will discount the lease liability upon initial recognition of the leases using its incremental borrowing rate. In determining the discount rate to apply to the total portfolio of leases, Entity L elects to utilise the practical expedient to apply IFRS 16 to a portfolio of leases with similar characteristics.

Entity L's major lease portfolio consists of two major types of railcars: heavy rail and light rail, therefore, Entity L will determine the discount rate for these portfolios of leases separately. These portfolios are hereafter referred to as the 'heavy portfolio' and 'light portfolio'. The smaller equipment lease portfolio (e.g. automobiles and forklifts) is referred to as the 'minor equipment portfolio'.

For all leases, Entity L will make quarterly payments in advance of equal amounts over the related lease term.

Entity L applies the methodology discussed in the previous section to determine the discount rate for these three portfolios.

Base rate for economic factors: similar economic environment, term and value

Heavy portfolio: Entity L analyses its portfolio of leases and notes that the lease terms vary between four and six years, with the leases being evenly dispersed over that period (in number and value). Consequently, Entity L concludes that the weighted average lease term is five years.

Entity L then reviews interest rates applicable to high quality bonds in its jurisdiction and notes that:

- The bonds pay interest quarterly and have 'bullet' capital repayments on maturity (in contrast to the lease liabilities which are amortising balances)
- Interest rates for bonds with maturities of between one and five years rise evenly over the four-year period

Consequently, Entity L concludes that a reasonable approximation of the 'base' rate will be obtained by referring to the interest rate for bonds with a 2.5 year duration. Utilising instruments with a duration equal to 50% of the weighted average lease term accounts for the fact that the referenced bonds are bullet loans with 'back loaded' cash flows compared to the cash flows of the lease, which are evenly dispersed. The base rate is determined to be 3.10%.

If the lease portfolio had been different, then additional analysis would have been required. For example, Entity L might have found that while the average lease term is five years, there are a significant number of leases in this portfolio with lease terms of 18 months – 2 years compared to another large number of leases with terms of seven-eight years. While the applicable reference bonds for these more granular segments carry different interest rates, Entity L would need to carry out a sensitivity analysis to determine whether the use of a single 2.5 year reference rate would potentially have a material impact in the measurement of the lease contracts.

In addition, if an approximation is used, it is necessary to revisit the approach as and when additional leases are added in future to determine whether the approximation remains acceptable.

Light portfolio: Entity L performs an analysis similar to above, noting that the average lease term in the light portfolio is three years. The applicable rate after referencing a series of high quality bonds in the applicable jurisdiction is 2.65%.

Minor equipment portfolio: The minor equipment portfolio is made of many different types of equipment with various lease terms ranging from one to four years, with lease terms and values evenly spread in this range. Entity L notes that the minor equipment portfolio is immaterial in comparison to its railcar portfolios and to the financial statements as a whole. Consequently, Entity L considers that it is acceptable to use a 3.00% discount rate for the minor equipment portfolio of lease contracts, rather than determining different rates for various sub-portfolios of different types of equipment with different lease terms. Entity L performs a sensitivity analysis and notes that a reasonably possible shift in the discount rate would not result in a material difference in the measurement of this portfolio. Although financing factors are also considered, an adjustment for asset factors is not considered necessary as its effect would be immaterial.

Financing factors

Heavy portfolio: to adjust the base rate for credit risk factors, Entity L refers to the spread between the credit rating of bonds in the reference portfolio compared to Entity L's own credit risk. The credit rating for the bonds in the reference portfolio were AAA, meaning they have a low risk of defaulting on the payments. Entity L consults with several banks in its jurisdiction and obtains a number of different interest rate 'spreads' between AAA borrowers and Entity L for loans of 2.5 years in duration. The average of these spreads is 1.75%.

Light portfolio: Entity L performs an analysis similar to above, however, for a reference portfolio with an average duration of 1.5 years (i.e. half of the light portfolio's weighted average lease term). The average of these spreads is 1.25%.

Minor equipment portfolio: Entity L considers the range of lease terms in this portfolio and the credit spreads for the heavy and light portfolios. It concludes that a reasonable approximation of the credit spread applicable to the minor equipment portfolio is 1.50%.

Asset factors

Heavy portfolio: the base rate and credit spread determined above relate to an unsecured borrowing position. Entity L notes that the security in its leases is the underlying right-of-use asset, therefore, an adjustment to the borrowing rate should take this into account. Entity L consults with several banks on the adjustment to the rate on a secured borrowing position. Entity L notes that in discussions with banks, they note that the underlying asset provides less relevant security than say, commercial real estate in a major city centre, since realising on the underlying security (rail cars) is more difficult and would include more significant costs. The adjustment for the asset factors is -0.45%.

Light portfolio: Entity L performs an analysis similar to above, however, the nature of the security (light rail cars) differs slightly. The banks that Entity L consults that light rail cars are used less frequently and have shorter useful lives, therefore, the nature of the security provides a lower adjustment than the heavy portfolio. The adjustment for the asset factors is -0.35%.

Minor equipment portfolio: Entity L performs an analysis similar to that of the heavy portfolio. As the minor equipment has a relatively short useful life, Entity L believes the adjustment for asset factors is minor. The adjustment for asset factors is -0.10%.

Conclusion

Combining the relevant factors together results in the following discount rates:

Heavy portfolio =	base rate + financing factors + asset factors
Heavy portfolio =	3.10% + 1.75% + (-0.45%)
Heavy portfolio =	4.40%
Light portfolio	base rate + financing factors + asset factors
Light portfolio =	2.65% + 1.25% + (-0.35%)
Light portfolio =	3.55%
Minor equipment portfolio =	base rate + financial factors + asset factors
Minor equipment portfolio =	3.00% + 1.50% + (-0.10%)
Minor equipment portfolio =	4.40%

Example 5.2-2 – Negative Implicit Interest Rates

Entity M leases a unit in a shopping centre for five years. Lease payments are fixed at CU150,000 per annum plus a 5% variable payment dependent on Entity M's annual sales revenue. The lessee's incremental borrowing rate is 8%. The unit in the shopping centre has a current fair value of CU1,300,000 and an unguaranteed residual value of CU350,000. Initial direct costs are nil.

Assessment

IFRS 16 first requires the rate implicit in the lease to be used, if it is readily determinable. As Entity M knows the fair value of the property at the commencement of the lease and has estimated the fair value of the asset at the end of the lease, the rate implicit in the lease agreement can be calculated.

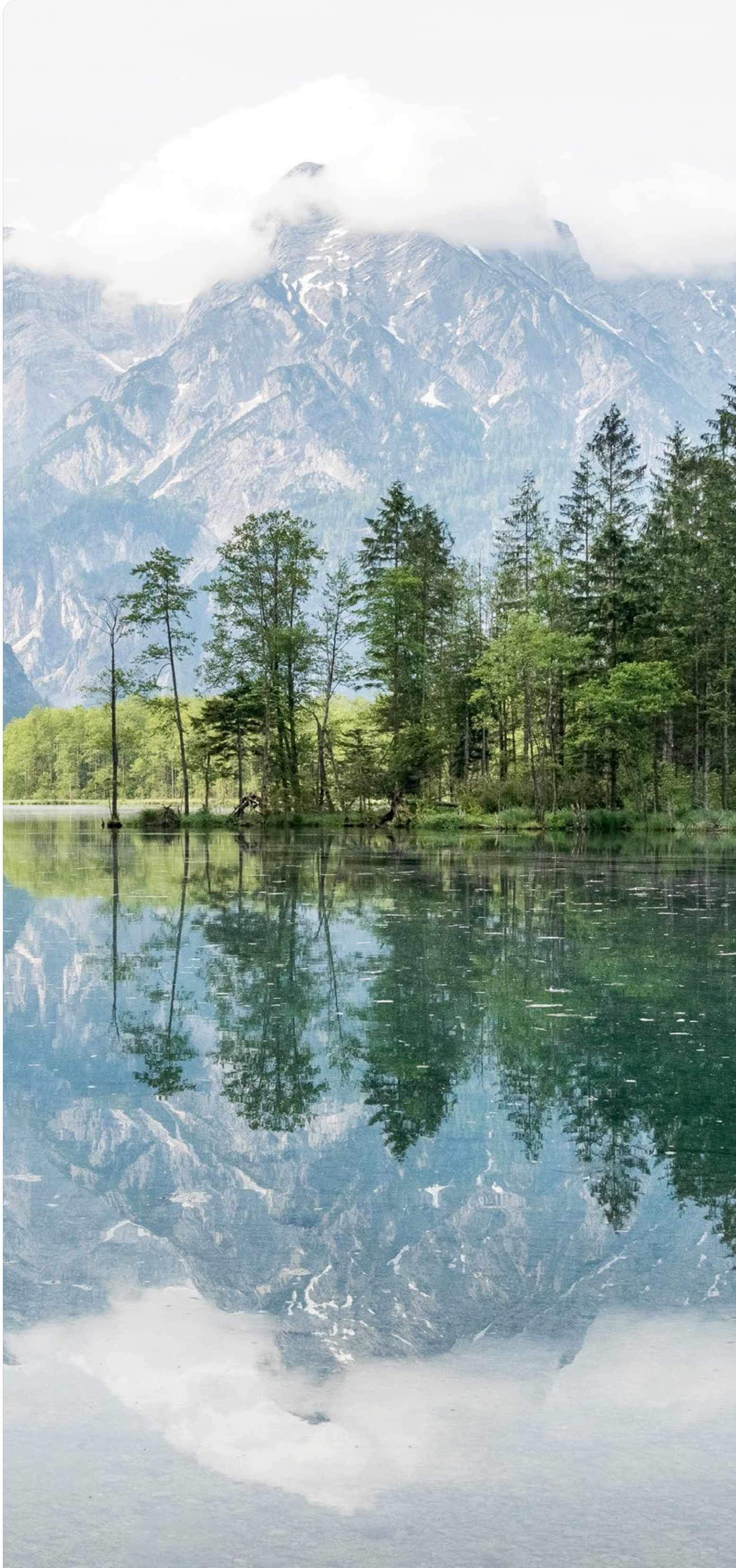
IFRS 16 defines the 'interest rate implicit in the lease' as:

> *'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.'*

Based on the facts provided above, the discount rate that causes the present value of (a) and (b) to equal the sum of (i) and (ii) is **minus** 4.43%. If this were used it would result in the lessee recognising interest income rather than interest expense over the lease term.

If the fair value of the property at the beginning and end of the lease are reasonably determinable and a significant portion (or all) of the lease payments are variable (and therefore not included in the measurement of the lease liability), the rate implicit in the lease may be negative. This is because the lease payments in (a) exclude the variable payments equal to 5% of sales revenue and therefore do not reflect what the lessor ultimately anticipates to be the 'true' return over the lease term.

The use of a negative discount rate in such circumstances is not appropriate, because it does not reflect the objective which is to reflect how the contract is priced. In addition, it will be very rare that a lessee will have information about the lessor's direct costs and other expectations that would be required to calculate the rate implicit in the lease. Consequently, the lessee will use its incremental borrowing rate to discount the lease payments.



5.3 Right-of-Use Asset – Initial Recognition

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

Initial Direct Costs

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

BDO comment

IFRS 16 emphasises that direct costs must be 'incremental' in the context of each individual lease (and not on the basis of a portfolio of leases). This precludes an entity from making an allocation of administrative costs relating to obtaining a lease, such as a portion of finance and management salaries. Such costs would not be incremental as they would be incurred regardless of whether an entity enters into a specific lease.

Shipping and installation expenses are common costs that lessees incur to be able to use underlying lease assets. For example, leased manufacturing equipment may require significant costs to install into a pre-existing assembly line.

The definition of 'initial direct costs' states that they are the cost of 'obtaining a lease'; it is unclear as to whether this means costs strictly related to executing the lease agreement (e.g. legal costs), or if this may include costs associated with the underlying asset itself.

In our view, it is preferable for a lessee to capitalise costs associated with the physical underlying asset (e.g. shipping and installation), as this produces consistency with the outcome if the lessee had purchased the asset outright. Despite this, since IFRS 16 is unclear, we believe it is also acceptable for a lessee to expense initial direct costs that are associated with the underlying physical asset.

Removal and Restoration Costs

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

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

Example 5.3-1 – Initial Recognition of a Lease

Entity Z (the lessee) enters into a five-year lease of a floor of a building, with an option to extend the lease for a further five years. Lease payments are CU50,000 per annum during the initial term and CU55,000 per annum during the optional period, all payable at the beginning of each year. To obtain the lease, Entity Z incurs initial direct costs of CU20,000 (CU15,000 to the former tenant occupying the floor and CU5,000 for real estate commissions). The lessor agrees to reimburse the lessee the real estate commission of CU5,000.

At the commencement date, Entity Z concludes that it is reasonably certain to exercise the option to extend the lease. Therefore the lease term is 10 years.

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

Assessment

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

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

DR right-of-use asset	CU423,200[1]
CR lease liability	CU373,200[2]
CR cash	CU50,000

1: CU50,000 in advance plus PV of 4 payments at CU50,000 and 5 payments at CU55,000, discounted at 5%.

2: PV of 4 payments at CU50,000 and 5 payments at CU55,000, discounted at 5%.

To record the initial direct costs:

DR right-of-use asset	CU20,000
CR cash	CU20,000

To record lease incentive (the reimbursed real estate commission) relating to the lease:

DR cash	CU5,000
CR right-of-use asset	CU5,000

Lease Incentives

It is common in many leases for the lessee to receive a lease incentive at the commencement of a lease. These are commonly in the form of cash. Such incentives are deducted from the value of the right-of-use asset, as in the example above. However, an issue can arise where all lease payments are variable (meaning that it is possible that no lease liability will be recorded) and a lease incentive is received. This is illustrated in the following example.

Example 5.3-2 – Lease Incentives that Exceed Right-of-use Asset

Entity U enters into a 10-year lease contract for retail space where all of the lease payments are variable and do not depend on an index or rate (e.g. lease payments are based on a percentage of sales generated from using the retail space).

At the time of lease commencement, the lessee receives a CU100,000 incentive from the lessor. There are no repayment conditions for the incentive.

Entity U measures the lease liability at zero as of the commencement of the lease, as the lease has no fixed payments, residual value guarantees, purchase options or in-substance fixed payments.

The lessee measures the right-of-use asset at an amount equal to the lease liability (i.e. zero), but must also apply IFRS 16.24(b) and deduct the lease incentive from the carrying value of the right-of-use asset.

Assessment

IFRS 16 does not contain specific guidance for circumstances in which a right-of-use asset might be recorded at a negative carrying amount. However, applying the requirements of IFRS 16.24 results in a negative asset being recorded, which is subsequently accounted for applying the cost model (assuming the lessee is not using the revaluation model and the lease does not meet the definition of investment property).

Therefore, the lessee is required to record a 'negative right-of-use asset' and amortise the resulting credit to profit or loss over the shorter of the lease term and the useful life of the underlying asset (see Section 5.5 for discussion of the subsequent measurement of right-of-use assets).

Section 5.5

Note that this example assumes the lease incentive is received in cash as at lease commencement. In our view, the conclusion would not change if the lease incentive were receivable as at commencement, assuming there are no conditions related to receipt of the lease incentive.

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

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

If a lessee incurs costs relating to the construction or design of an underlying asset, the lessee is required to account for those costs applying other applicable IFRS Accounting Standards, such as IAS 16 or IAS 38 and not IFRS 16 as these are not payments made by the lessee for the right to use the underlying asset. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments.

Refundable security deposits

Lessees are often required to pay security deposits to the lessors, which are refundable at the end of the lease term. Generally, the deposits do not carry any interest and are repayable subject to the leased asset being maintained in the condition as required by the lease agreement.

The entire amount of the deposit is not a lease payment as it is refundable to the lessee at the end of the lease.

The deposit is a financial asset within the scope of IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments*. IFRS 9.5.1.1 requires financial assets to be measured on initial recognition at their fair value, except for trade receivables that do not contain a significant financing component. In case of interest free refundable security deposits, fair value is normally measured by discounting the amount of security deposit using a discount rate that reflects a lending arrangement between the lessee and the lessor for the lease term, as the lessee is effectively lending the amount of security deposit to the lessor for the lease term. It should be noted that the discount rate to be used is not the rate implicit in the lease or the lessee's incremental borrowing rate.

IFRS 9 provides guidance on accounting for the difference between the transaction price and the fair value of the financial instrument at initial recognition. IFRS 9.B5.1.1 requires such difference to be accounted as an expense or a reduction of income unless it qualifies for recognition as some other type of asset. That is if part of the consideration is considered to be for something other than the financial instrument itself, the difference between the transaction price and the fair value would be accounted for based on the requirements of other applicable IFRS Accounting Standards. The lease deposit paid to the lessor arises in the context of a lessee-lessor relationship. Consequently, this difference would be an adjustment of the consideration paid by the lessee to the lessor. Economically, the lessee has provided an interest-free loan to the lessor, the benefit of which accrues to the lessor, therefore, this benefit forms part of the cost of the right-of-use asset (i.e. the benefit provided is an in-substance lease payment).

The financial asset would be classified by applying the guidance under IFRS 9. Assuming that there are no terms that violate the contractual cash flow test (i.e. solely payments of principal and interest or 'SPPI') and the asset is used in a hold to collect business model, then the financial asset would be classified at amortised cost. The rate used to discount the CU1,000 would be the effective interest rate and therefore give rise to finance income over the term of the deposit. The financial asset would also be subject to the expected credit loss ('ECL') requirements of IFRS 9.

The adjustment to the right-of-use asset would be accounted for by applying the subsequent measurement guidance in IFRS 16.

Example 5.3-3 – Refundable interest-free security deposit

Entity A enters into a lease of office space with a lessor for a period of five years with annual lease payments of CU2,000 paid in advance. The lease agreement requires Entity A to pay a security deposit of CU1,000 on the commencement date of the lease. The deposit is refundable to the lessee without interest at the end of the lease term as long as the property is maintained in the condition as required by the lease agreement. If damage is done to the property by the lessee that is beyond normal 'wear and tear', the lessor has the right to use some or all of the deposit to repair the damage at the end of the lease term. The repayment of the deposit is not dependent on the change in value of the building itself.

The rate implicit in the lease is not readily determinable. Entity A's incremental borrowing rate is 6%. The interest rate for a similar lending arrangement between Entity A and the lessor is 5%.

Assessment

Entity A is required to recognise a financial asset for the security deposit at fair value. The fair value of the security deposit would be CU784, being the present value of CU1,000 cash in-flow discounted for five years at a discount rate of 5%. Discounting is at the interest rate that reflects a lending arrangement between the lessee and the lessor, which is 5% in this case.

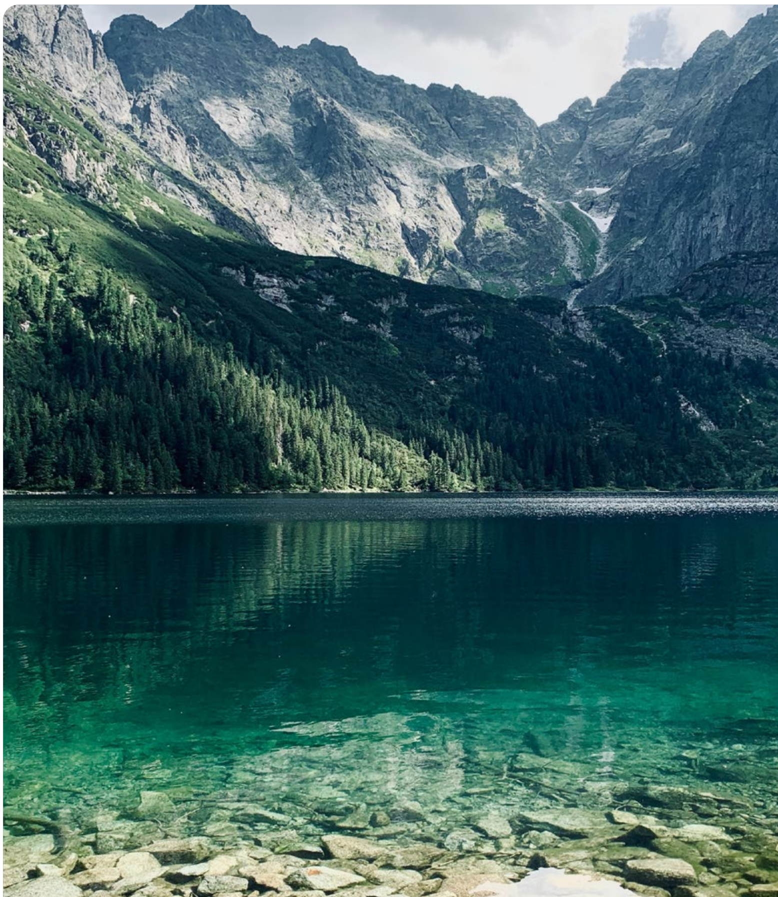
CU216, which is the excess of the transaction price (CU1,000) over the fair value (CU784), forms part of the cost of the right-of-use asset.

Entity A will pass the following journal entry on the lease commencement date:

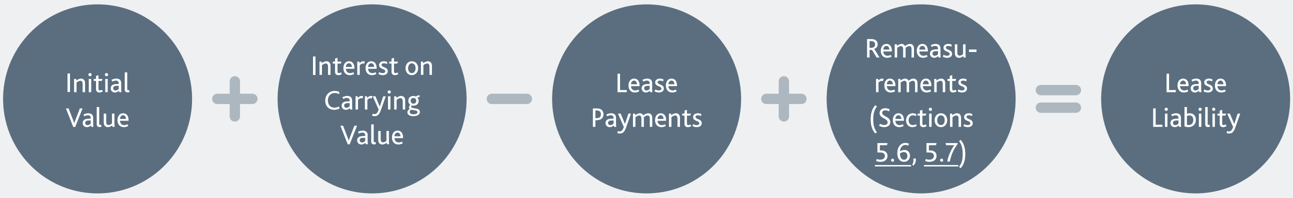
DR Right-of-use asset	216	
DR Financial asset	784	
CR Cash		1,000

The financial asset would be subsequently measured in accordance with IFRS 9.

The adjustment to the right-of-use asset would be amortised as required by the subsequent measurement guidance in IFRS 16.



5.4 Lease Liability – Subsequent Measurement



Initial Value + Interest on Carrying Value − Lease Payments + Remeasurements (Sections 5.6, 5.7) = Lease Liability

Interest on the lease liability is recognised in profit or loss, unless it is included in the carrying amount of an asset as required by another standard (e.g. IAS 23).

BDO comment

IAS 23 *Borrowing Costs* was consequentially amended to clarify that interest in respect of lease liabilities recognised in accordance with IFRS 16 are 'borrowing costs'. Therefore, the amount of borrowing costs that are subject to the requirements of IAS 23 (i.e. potential capitalisation) may increase as a consequence of IFRS16.

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

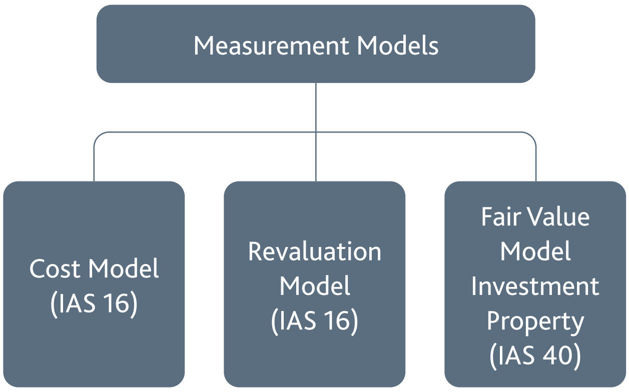
- the production of inventory;
- the construction of property, plant and equipment and investment property; and
- the development of intangible assets.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.

Appendix C

5.5 Right-of-Use Asset – Subsequent Measurement

Subsequent to initial recognition, an entity may apply three potential models to account for right-of-use assets:

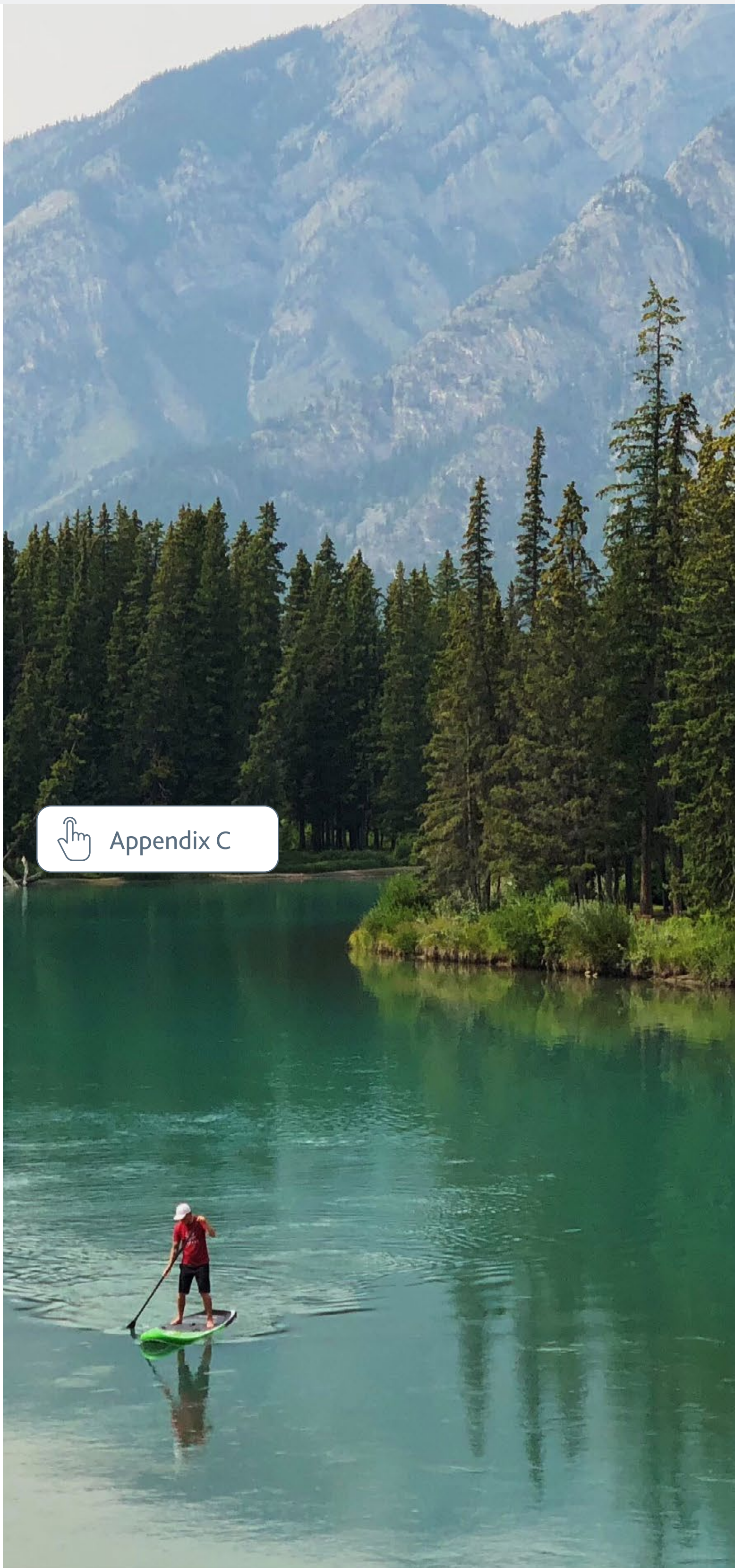


Measurement Models

Cost Model (IAS 16)

Revaluation Model (IAS 16)

Fair Value Model Investment Property (IAS 40)



BDO comment

IFRS 16 references IAS 16 and IAS 40 for guidance on subsequent measurement, but it does not state that the right-of-use asset in a lease contract is property, plant and equipment or investment property.

Right-of-use assets are, therefore, a class of asset distinct from both property, plant and equipment and investment property. Section 6 below discusses how right-of-use assets should be presented in the statement of financial position.

Cost Model

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

- Cost measured in accordance with section 5.3 above;
- Less accumulated amortisation (recognised in accordance with the depreciation requirements of IAS 16) and accumulated impairment losses (recognised in accordance with IAS 36);
- Adjusted for remeasurements (see sections 5.6 and 5.7).

The right-of-use asset is amortised over the lease term (see section 4 above), unless the initial recognition contemplates the exercise of a purchase option or the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. In those cases, the right-of-use asset is amortised over the useful life of the underlying asset.

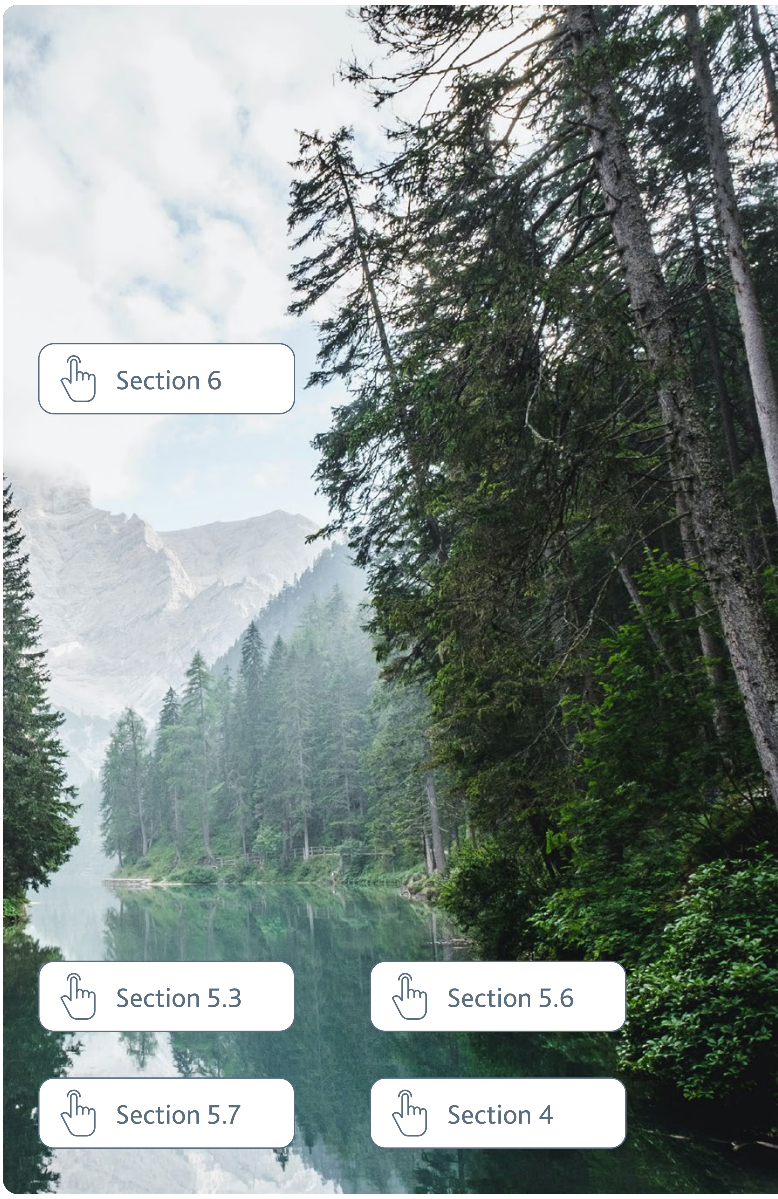
Please refer to BDO's publication *IFRS in Practice: IAS 36 Impairment of Assets* for guidance on application of IAS 36 requirements. The publication may be accessed here.

Example 5.5-1 – Amortisation of a ROU asset when Lease Payments are Initially Variable

Company W is the lessee of retail space for a period of three years and the lease does not contain any extension, termination or purchase options. Lease payments are as follows:

- Year 1: 5% of the lessee's sales using the retail space;
- Years two and three: higher of CU300 and 5% of the lessee's sales in the year

Ignoring the effect of discounting, Company W recognises a lease liability and right-of-use asset of CU600, which represents the contractual minimum to be paid in years two and three (CU300 per year).


Section 6
Section 5.3
Section 5.6
Section 5.7
Section 4

Actual sales are as follows:

- Year 1: CU6,500
- Year 2: CU6,240
- Year 3: CU6,160

Therefore, Company W pays CU325, CU312 and CU308 in each of the years (5% of sales, as this figure exceeds the contractual floor of CU300 established in years two and three).

The issue is whether the right-of-use asset of CU600 should be amortised on a straight-line basis over the three year term (approach 1 in the table below), or should the depreciation be re-allocated to account for the fact that year one's total expense is 'front loaded' (approach 2 in the table below)?

	Approach 1			Approach 2		
	Variable lease expense	Amortisation	Total	Variable lease expense	Amortisation	Total
Year 1	325	200	525	325	Nil	325
Year 2	12**	200	212	12	300	312
Year 3	8**	200	208	8	300	308
Total	345	600	945	345	600	945

***Only the amount of the payment that exceeds the contractual minimum of CU300 is included in profit or loss in the period in which the payment comes due, as the contractual minimum was included in the measurement of the lease as at the commencement date.*

In approach 1, the requirements of IFRS 16 result in the right-of-use asset being amortised on a straight line basis over the three year term. This results in much higher expense in year one, since one third of the total amortisation is recorded in that period in addition to the variable lease amount, since year one's payment is based entirely on a percentage of sales.

In approach 2, since the total expense in year one does not reflect the underlying economics of the transaction (i.e. that the benefit of the retail space in the lease is being consumed evenly), amortisation is modified to 'smooth' the total expense across the periods. Amortisation in year one is set to nil such that the total expense in year one is more in line with approximately one third of the total cash payments expected over the lease term (CU945 /3 = 315).

Assessment

IFRS 16's requirements relating to the subsequent measurement of right-of-use assets under the cost model are clear that the right-of-use asset is amortised based on the requirements of IAS 16, subject to the requirements in IFRS 16.32. IFRS 16.32 states that the period of amortisation is the shorter of the lease term and the useful life of the underlying asset, assuming that no reasonably certain to be exercised purchase options exist. As the useful life of the retail space exceeds three years, the amortisation period of the right-of-use asset is three years. There is no conceptual basis for charging reduced amounts in particular reporting periods and reallocating the amortisation expense to different reporting periods in order to achieve a 'smoothing' effect. Therefore, in our view, Company W is required to follow Approach 1.

BDO comment

Componentisation of right-of-use assets

IFRS 16 directs entities to record amortisation based on the requirements of IAS 16, and IAS 16.43 requires each item with a cost that is significant in relation to the total cost be amortised separately. In our view, similar accounting is required for right-of-use assets with significant components when the lessee is required to incur the cost of replacing or maintaining such components. Componentising right-of-use assets into distinct units of account for amortisation purposes would create significantly different amortisation expense for underlying assets that have differing useful lives for sub-components.

For example, aircraft leases often contain clauses requiring lessees to perform major overhaul and maintenance of aircrafts based on specific increments of time and/or flight hours. If an aircraft lease contained a 10-year lease term, but the engines in the aircraft would require replacement after four years at the cost of the lessee, then the engines should be amortised separately over their four-year useful life. Determining the basis for componentising significant leased assets may require significant judgment.

Timing of commencement of amortisation

IFRS 16 states that entities apply IAS 16's guidance relating to how ROU assets should be amortised, subject to the requirements of IFRS 16.32. Lessees may enter into leases that require 'fit out' periods where the underlying asset will take a period of time to be ready for the ultimate intended use by the lessee. For example, a lessee may lease office space where the first few months of the lease are spent installing leasehold improvements and preparing the space to be used by the lessee's employees. The question arises as to whether the lessee would be permitted to defer the commencement of amortisation of the ROU asset until the asset is ready for its intended use, which would be a 'usage based' amortisation model, which is permitted by IAS 16 in some situations.

In our view, while IFRS 16 directs entities to IAS 16 for amortisation requirements, this is still subject to the requirements of paragraph 32 of IFRS 16, which states that '…the lessee shall depreciate the right-of-use asset from the commencement date…'. Therefore, the commencement of amortisation cannot be deferred to a period later than the commencement date of the lease. This is because the entity is benefiting from its right to use the underlying asset during the fit out period, regardless of whether the underlying asset is being used for its ultimate intended purpose.

Non-consecutive lease terms and amortisation impact

In amortising the right-of-use asset, special consideration should be made for leases with non-consecutive periods of use. For example, a lessee enters into a lease where it will utilise retail space in a shopping centre for 3 months in each calendar period (i.e. 15 months in total). Based on the initial recognition requirements of IFRS 16, the lessee recognises the lease liability and right-of-use asset as at the commencement date of the lease as CU150,000. In each period of use (i.e. each 3 month period when the retail space is utilised), the lessee would recognise CU10,000 of amortisation expense (150,000 / 15 months of total use). The lessee would not record amortisation expense in the periods when the retail space is not utilised, as IAS 16.60 states that the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed. As no economic benefit is consumed in the period when the retail space is not utilised, amortisation is only recorded during the periods of use by the lessee. However, in contrast to the depreciation expense which is based on the periods in which the asset is available for use, the lessee would recognise a finance expense in all months in each calendar year.

Restricted use of lease asset – impact on amortisation

In some situations, use of a leased asset is restricted. In such cases, the right-of-use asset continues to be amortised, as the leased asset is being used, although in a limited way. However, if the use of the leased asset is entirely halted for a certain duration of time, this is considered to be similar to non-consecutive lease terms discussed above and the amortisation of the right-of-use asset is suspended during the period when the use of the leased asset is halted.

For example, during the COVID-19 pandemic, a government passes a law requiring closure of shopping centres for an indefinite period. The rights and obligations under associated lease contracts are suspended for this period. During the period of closure, the lessee cannot carry out any renovation work on the stores or use them as a warehouse for online sales. However, the inventory already in the store will remain there, and does not need to be moved to another storage facility.

IAS 16.55 requires that

> *'Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.'*

In the above example, although the store is not being used to sell goods, it is being used as a warehouse to store goods. Consequently, the store is still being used, albeit in a rather limited way, and the related right of use asset continues to be depreciated.

However, if the lessee had been required to remove all of its inventory during the period of closure, the answer would be different. This is because there would be absolutely no use of the store by the lessee. In that fact pattern, the right-of-use asset is considered to have non-consecutive periods of use and is not depreciated when the lessee is unable to use the underlying asset (the store) at all.

Revaluation Model

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

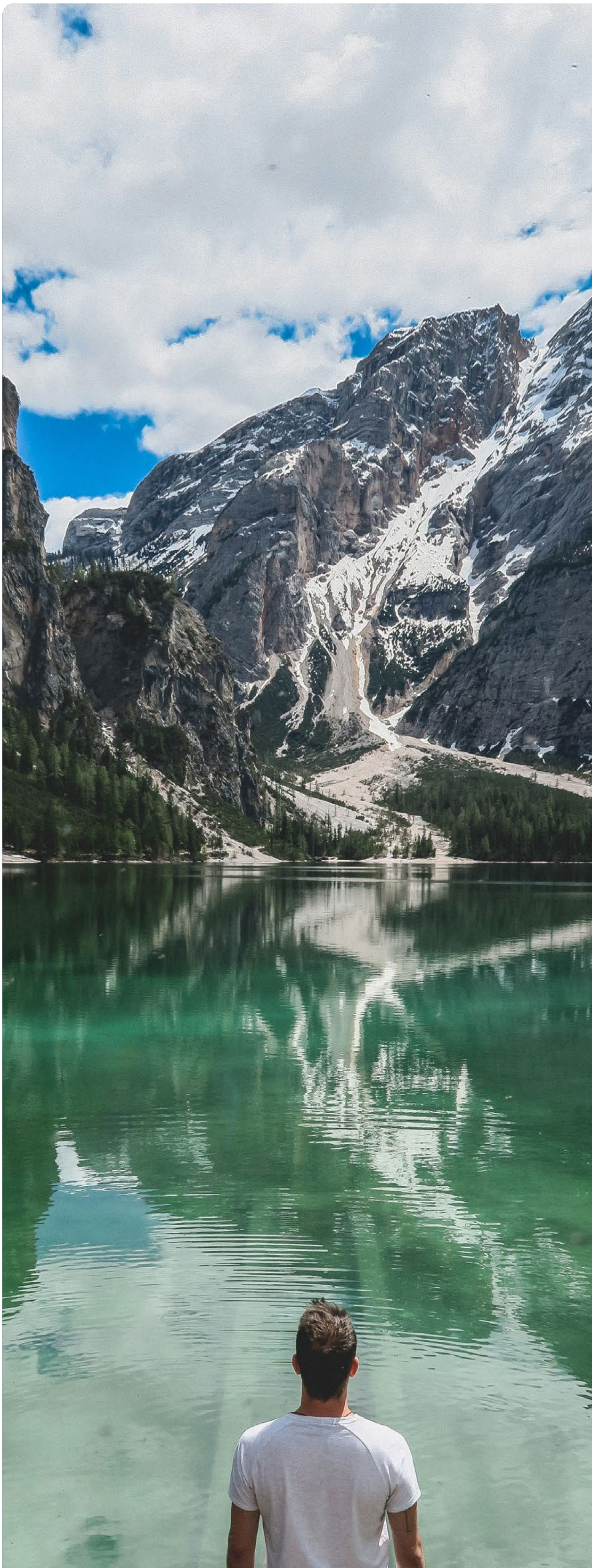
BDO comment

The option to apply the revaluation model for right-of-use assets where the same class of property, plant and equipment is revalued under IAS 16 results in the potential for inconsistency because an entity is not required to apply the revaluation model to those right-of-use assets. Therefore, an entity may have a group of owned assets (e.g. land and/or buildings) to which it applies the revaluation model, whilst applying the cost model to property leases.

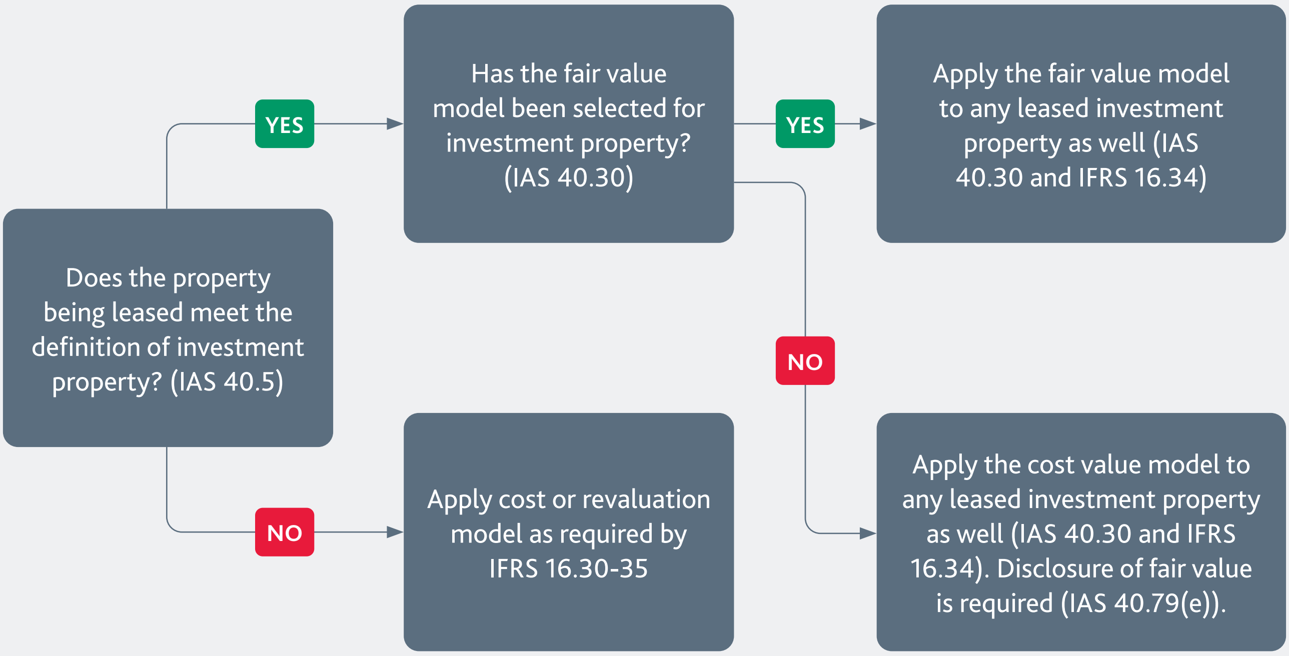
Fair Value Model

If an entity applies the fair value model in IAS 40, the same model must also be applied to right-of-use assets that meet the definition of investment property, regardless of the accounting policy that is applied (cost model or fair value model).

Right-of-use assets may meet the definition of investment property in cases where the entity leases a property as a lessee and then sub-leases portions of the property under leases classified as operating from the perspective of the intermediate lessor (e.g. an apartment complex).



This flowchart summarises how a lessee determines the accounting for leases of property:


Does the property being leased meet the definition of investment property? (IAS 40.5)
YES
Has the fair value model been selected for investment property? (IAS 40.30)
YES
Apply the fair value model to any leased investment property as well (IAS 40.30 and IFRS 16.34)
NO
Apply the cost value model to any leased investment property as well (IAS 40.30 and IFRS 16.34). Disclosure of fair value is required (IAS 40.79(e)).
NO
Apply cost or revaluation model as required by IFRS 16.30-35

BDO comment

In contrast to the revaluation model, which may be used if applied to the same class of property, plant and equipment, the fair value model must be applied to right-of-use assets meeting the definition of investment property where a lessee applies the fair value model in IAS 40 to owned investment property.

Leased Investment Property and Determination of Fair Value when Lease contains Variable Lease Payments not based on an Index or Rate

The initial measurement of a right-of-use asset that meets the definition of investment property is the same as other, non-investment property leases. It is based on the measurement of the lease liability, adjusted for certain items such as initial direct costs, etc. Included in the lease liability are fixed lease payments and variable lease payments based on an index or rate. Variable lease payments not based on an index or rate (e.g. based on a percentage of rental income earned on the underlying property) are excluded. Therefore, if a lease contained only variable lease payments based on a percentage of rental income earned on the underlying property, the right-of-use asset and lease liability would both be measured at zero at initial recognition.

If the entity elects to account for investment property using the fair value model, subsequent to initial recognition of the lease, the lessee is required to measure the right-of-use asset at its fair value. The issue is whether in applying IFRS 13 to determine the fair value of the right-of-use asset, would a 'day 2' gain be possible since the fair value of the right-of-use asset would consider the variable lease payments that are not based on an index or rate, while the lease liability would not.

In our view, a 'day 2' gain on a right-of-use asset that is classified as an investment property would not be appropriate. While IFRS 16 specifies that it is the right-of-use asset being measured at fair value (not the underlying property itself), the lessee would typically be unable to transfer the right-of-use asset without also transferring the underlying lease liability. Therefore, in determining the fair value of the right-of-use asset, a market participant would also make assumptions concerning the transfer of any contractual cash flows associated with the lease liability, regardless of whether they are recognised as liabilities in the statement of financial position.

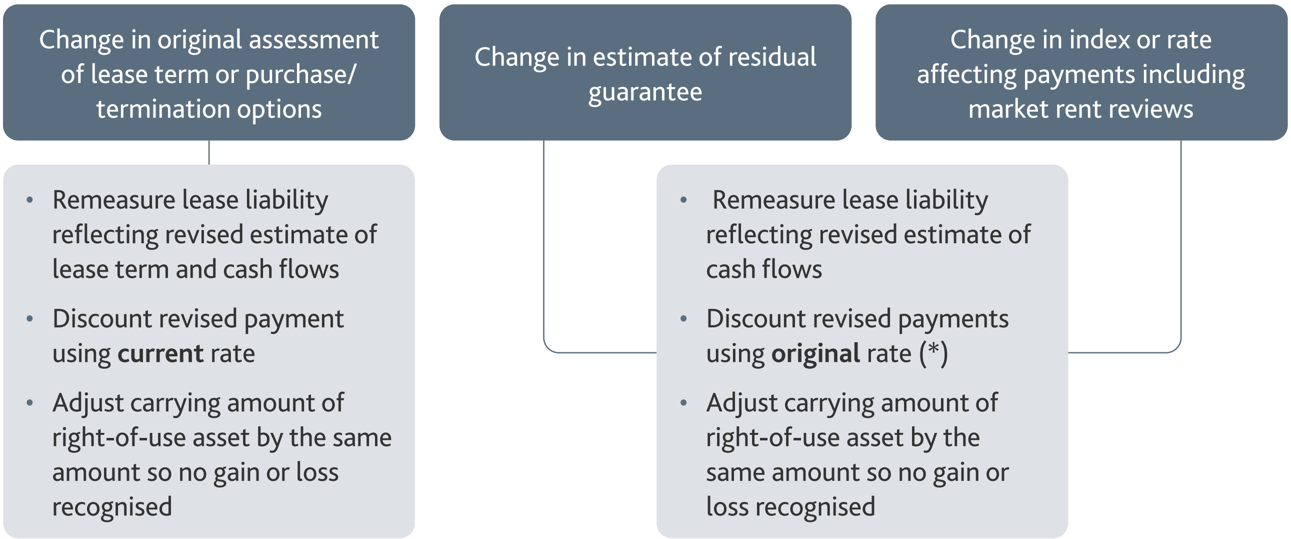
In addition, IAS 40.41 is clear that the remeasurement of a right-of-use asset from cost to fair value should not give rise to any gain or loss on initial recognition. In addition, IAS 40.50(d) clarifies that the fair value of an investment property which is held as a right-of-use asset reflects expected cash flows which include all lease payments as well as receipts. In order to arrive at the carrying amount of the investment property using the fair value model, it is then necessary to add back any recognised lease liability to the fair value of the net cash flows that have been included in the initial valuation.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.

Appendix C

5.6 Remeasurement of Leases

Lease liabilities and right-of-use assets are remeasured in the following situations:



Change in original assessment of lease term or purchase/ termination options

Change in estimate of residual guarantee

Change in index or rate affecting payments including market rent reviews

- Remeasure lease liability reflecting revised estimate of lease term and cash flows
- Discount revised payment using **current** rate
- Adjust carrying amount of right-of-use asset by the same amount so no gain or loss recognised

- Remeasure lease liability reflecting revised estimate of cash flows
- Discount revised payments using **original** rate (*)
- Adjust carrying amount of right-of-use asset by the same amount so no gain or loss recognised

(*) If the change in lease payments results from a change in floating interest rates, the lessee shall use a revised discount rate that reflects changes in the interest rate. (Refer Example 5.6-7 below – Remeasurement of a lease in case of lease payments that depend on a floating interest rate.)

In most cases of a reassessment the carrying amount of the right-of-use asset is adjusted by the same amount as the adjustment to the carrying value of the lease liability. Therefore, there is no immediate gain or loss; rather the impact of the revised cash flows impacts the income statement over the remaining term of the lease. Exception to this general principle is when a reduction in the carrying value of the lease liability is greater than the carrying value of the related right-of-use-asset at the point of remeasurement, in which case the asset is reduced to nil and the excess is recognised in profit or loss.

Note that prior period figures are not adjusted, with all of these remeasurements being accounted for prospectively.

Example 5.6-1 – Unresolved Rent Review as at Reporting Date – timing of remeasurement

Lessee entered into a three year real estate lease commencing on 1 January 20x1. The lease has a two year extension option, at which time a market rent review takes place. The market rent review modifies the lease payments for years four to five and applies with effect from 1 January 1 20x4 (the first day of the extended period). Rent reviews can take up to 18 months to complete and, as at 31 December 20x4 the rent review for the lease has not yet been completed. The lessee paid the year four rent based on the year three amount, although an adjustment will be required once the rent review is completed in mid 20x5. As at 31 December 20x4, the lessee can make a reliable estimate of the retrospective 'top-up' payment that will be required for 20x4.

The issue is whether the lessee must remeasure the lease liability on the basis of its estimate of the revised rent prior to the rent review occurring, since the effect of the review is retrospective.

Assessment

The lessee should not remeasure the lease prior to the rent review being completed, since IFRS 16.42(b) states that a lessee is required to remeasure a lease liability if 'there is a change in the future lease payments… including for example a change to reflect changes in market rental rates following a market rent review.' As at 31 December 2014, the year four and five lease payments have not changed as the rent review has not been completed. Consequently, the lease is not remeasured until the rent review is complete.

Example 5.6-2 – Renewal Terms at Negotiated Rental Rates

Lessee Z enters into a 15 year lease of land with fixed payments of CU10 million per annum. Lessee Z and the lessor are unrelated parties and are dealing at arm's length.

Lessee Z constructs an apartment building on the land. At the end of the 15 year fixed term, the lease contains a clause that states the lessee can extend the lease for additional five year periods of time, at amounts to be negotiated on each extension date. If the lessee and lessor cannot agree on an amount, arbitration will commence and an independent arbitrator will determine the amount of rental payments based on a market study.

Since Lessee Z has constructed an apartment building on the leased land, it is considered reasonably certain to exercise the options to extend the lease up to a total term of 50 years, which is the useful life of the apartment building.

The issue is whether the yet to be negotiated lease payments are 'variable lease payments based on an index or rate'. The consequence is that if they are, they would be included in the measurement of the lease liability and right-of-use asset.

Assessment

IFRS 16.28 states that 'variable lease payments that depend on an index or rate' include payments that vary to reflect changes in market rental rates. This is commonly interpreted to include market rent reviews, which are contractual terms that require a market study of a property to be performed in order to determine the revised rental payment.

While Lessee Z's lease does not explicitly require a market rent review to be performed by a third party, Lessee Z and the lessor are unrelated parties dealing at arm's length, and therefore have no realistic alternative but to negotiate what would be considered a 'market rent'. Negotiations between the parties would inherently reflect changes in market rental rates.

Therefore, Lessee Z's lease of land has a lease term of 50 years, consisting of:

1. 15 year initial, non-cancellable term; plus

2. 35 years of reasonably certain to be exercised lessee

extension options up until the end of year 50 (these lease extension options are reasonably certain to be exercised as Lessee Z has invested significant amounts into building an investment property on the land).

Lease payments included in the initial measurement of the lease as of the commencement date include 15 years of CU10 million payments, plus another 35 years of CU10 million payments ('variable payments based on an index or rate'). The 35 years of payments under the reasonably certain to be exercised extension options will be remeasured each year from years 15-50 as the annual renewals are renegotiated between Lessee Z and the lessor.

Example 5.6-3 – Timing of Remeasurement of Leases with Variable Lease Payments based on an Index or Rate

Lessee W enters into a lease for a five-year term with a lessor for a retail building, commencing on 1 January. Lease payments are payable annually in advance (i.e. at the beginning of the year, 1 January). The lease contract states that lease payments will increase each year on the basis of the increase in the CPI from the period 1 December – 30 November. The updated CPI is published on 15 December. That is to say, at the beginning of each calendar year, the lessee makes a payment based on the reference amount stated in the lease contract, adjusted by the movement in the CPI from 1 December – 30 November of the previous year.

The issue is whether the lessee should remeasure the lease liability for years 2-5 on 15 December of year one since all variability for year two has been resolved at that point, as the CPI index affecting the lease payments were published on 15 December. Alternatively, should the Lessee remeasure the lease on 1 January of year two, which is the point at which the cash flow change takes effect (i.e. the revised payment is made to the lessor)? IFRS 16.42(b) states that the lessee remeasures the lease liability to reflect revised lease payments only when there is a change in the cash flows (i.e. when the adjustment to the lease payments take effect), therefore, the issue is how one should interpret when the adjustment has 'taken effect'.

Assessment

The change in payments for year two take effect when all variability relating to them is resolved; at this point they become in-substance fixed. As the revised payment that will be made on 1 January for year two is known once the CPI index is published on 15 December, the revised payment has 'taken effect' on 15 December. If the revised payment were not known until after the balance sheet date (i.e. payments were based on a calendar year CPI movement, which is published on 15 January of the following year), then it would not be appropriate to remeasure the lease liability until the applicable rate is published, as the revised lease payments would not have been known as of the reporting period year-end. That is to say, the revised lease payments would not have 'taken effect' in that case.

Remeasuring lease liabilities based on indices or rates published subsequent to the balance sheet date could result in two entities with identical leases reporting different lease liabilities depending on when they issue their financial statements, which we do not believe is consistent with the objective of IFRS 16. Therefore, in our view, the condition required to remeasure the lease liability is that the revised lease payment must be known before the lease can be remeasured.

Example 5.6-4 – Effect of Multiple Rent Reviews Within a Single Lease

Lessee enters into a 15-year lease for office space. The payments at the commencement of the lease are set at CU10,000 per annum (the current market rent). Market rent reviews occur twice throughout the term of the lease at the start of years 6 and 11. Based on these rent reviews, the rental payment may increase or decrease.

For initial measurement of the lease liability, the lessee uses the current market rent of CU10,000 for 15 years (IFRS 16.27(b) – variable lease payments that depend on an index or rate as at the commencement date of the lease).

The rent included in the liability is adjusted only when the market rent review occurs (i.e. when the adjustment to the lease payments takes effect).

The market rent at the start of year six, at the time of the first review, is CU13,000. The rent review at year six means that the variability has been resolved for years 6-10 and so these cash flows will be updated in the liability calculation, consistent with the remeasurement requirements of IFRS 16.

The cash flows for years 11-15 remain variable – they will not become known until the market rent review in year 11.

The measurement issue is whether years 11-15 are based on the original assumption of CU10,000 per annum in lease payments, or the revised market rate of CU13,000 per annum.

Assessment

In our view, at the time of remeasurement in year six, all remaining years in the lease should be remeasured based on the revised CU13,000 payment, including years 11-15. In remeasuring a lease, IFRS 16.42(b) states that 'a lessee shall determine the revised lease payments for the remainder of the lease term based on the ***revised contractual payments*** (emphasis added), therefore, all remaining payments should reflect this revision to the lease payments based on the market rent review.

Example 5.6-5 – Effect of Multiple Rates or Indices Affecting Lease Payments

A lessee enters into a 10-year lease. The initial payments are CU10,000 per annum, which is the current market rent. There is a market rent review at the start of year six. In other years, the payments increase based on changes in the Consumer Price Index (CPI) in the preceding year.

There is no floor on either the CPI changes or the market rent reviews.

To summarise, the payments are:

Year(s)	Payments
1	CU10,000
2-5	CU10,000 adjusted for CPI changes since the start of year 1
6	Market rent at the start of year six
7-10	Market rent at the start of year six adjusted for CPI changes since the start of year six

For initial measurement of the lease liability, the lessee uses the current market rent of CU10,000 for 10 years.

Assume that CPI increases by 3% in the first year and therefore the payment for year two will be CU10,300.

Consistent with Example 5.6-4, the cash flows for years two to five will be updated to CU10,300 to reflect the revised cash flows.

The cash flows for years 6-10 remain variable since they will not become known until the market rent review occurs in year six.

The measurement issue is whether at the time of the remeasurement in year two, should the lessee assume the payments in years 6-10 should be calculated as CU10,300 per annum since additional variability exists due to the eventual market rental review to occur in year six.

Assessment

In our view, at the time of the remeasurement in year two due to CPI changes, all remaining nine years of payments should be calculated as CU10,300, the base payment using the revised CPI rate. For the same rationale as discussed in Example 5.6-4, when a remeasurement occurs, IFRS 16.42(b) states that it is required to be based on the revised contractual payments. The fact that multiple drivers of variability exist in the lease contract does not remove this requirement.

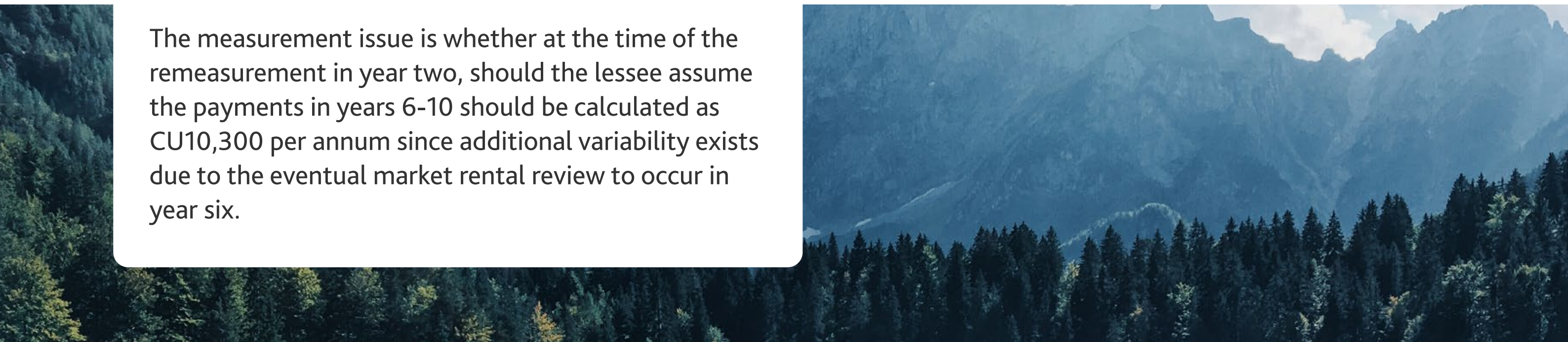
Example 5.6-6 – Remeasurement of a Lease due to Reassessment of an Option

Entity B entered into a 10 year property lease, with an option to renew for another five years. On initial recognition of the lease Entity B was not reasonably certain that it would exercise this option and so the lease term was estimated as 10 years. At the end of year six of the lease Entity B acquires Entity A. Following the acquisition of Entity A, Entity B determines that it would be more cost effective to relocate Entity A's staff and remain in its current premises for longer than the originally assessed 10 year period

Assessment

Moving Entity A's staff to the same building occupied by the Lessee creates an economic incentive for Entity B to extend its original lease at the end of the non-cancellable period of 10 years.

Consequently, at the end of Year six, Entity B concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Entity A's staff. The remaining lease term is revised to nine years (i.e. the period from the end of year six to the end of year 15) and so Entity B remeasures its lease liability to reflect nine years of future lease payments discounted at its incremental borrowing rate at that date (assuming the interest rate implicit in the lease is not readily determinable). The resulting increase in the carrying amount of the lease liability is added to the right-of-use asset. The revised carrying amount of the right-of-use asset is then depreciated over the revised remaining lease term of nine years.



It should be noted that the circumstances above that resulted in the remeasurement of the lease liability and the right-of-use asset did not arise from any modification to the contractual terms agreed between the lessor and the lessee. Instead they arose from revisions to estimates and judgements made on the initial recognition of the lease. The accounting for lease modifications is addressed in section 5.7.

Section 5.7

Example 5.6-7 – Remeasurement of a lease where lease payments depend on a floating interest rate

Entity D enters into a lease of a property for five years on 1 January 20X1. The lease payments are payable annually in advance. The lease payment for the first year is CU100,000. The lease payments escalate every year at the rate of 12-month EURIBOR at the beginning of the year.

The interest rates for the first two years are as below:

	12-month EURIBOR	Incremental borrowing rate
1 January 20X1	4%	6%
1 January 20X2	5%	7%

The rate implicit in the lease is not readily determinable.

Assessment

The lease agreement provides for escalation in lease payments based on the index rate (12-month EURIBOR). Therefore, these variable lease payments will be included in the measurement of lease liability.

At the commencement of the lease, the lease liability is measured at the present value of variable lease payments using the index at the commencement date i.e. the 12-month EURIBOR on 1 January 20X1. The present value is calculated using Entity D's incremental borrowing rate as on 1 January 20X1 as below:

Date	Lease payment (CU)	Discounting factor @ 6%	Present value (CU)
1 January 20X1	100,000	1.00	100,000
1 January 20X2	100,000 * (1.04) = 104,000	0.94	98,113
1 January 20X3	104,000 * (1.04) = 108,160	0.89	96,262
1 January 20X4	108,160 * (1.04) = 112,486	0.84	94,446
1 January 20X5	112,486 * (1.04) = 116,986	0.79	92,664
	Lease liability		**481,485**

At the beginning of year two, the 12-month EURIBOR is 5%. The lease liability needs to be remeasured as per the revised index rate. As the change in lease liability results from a change in floating interest rates, a revised discount rate needs to be used for remeasurement of lease liability.

The lease liability will be remeasured on 1 January 20X2 considering the lease payments based on the index on the date of remeasurement discounted at the incremental borrowing rate (7%) at the remeasurement date, as below:

Date	Lease payment (CU)	Discounting factor @ 7%	Present value (CU)
1 January 20X2	100,000 * (1.05) = 105,000	1.00	105,000
1 January 20X3	105,000 * (1.05) = 110,250	0.93	103,037
1 January 20X4	110,250 * (1.05) = 115,763	0.87	101,111
1 January 20X5	115,763 * (1.05) = 121,551	0.82	99,222
	Lease liability		**408,370**

The lease liability before remeasurement is CU404,374, being the opening liability of CU481,485 less lease payment of CU100,000 as on 1 January 20X1 plus interest accretion @ 6% on CU381,485 of CU22,889.

The difference between the lease liability before remeasurement of CU404,374 and the remeasured lease liability of CU408,370 amounting to CU3,997 will adjust the carrying amount of the right-of-use asset.

Example 5.6-8 – Lessee's accounting for termination penalties paid by the lessor

Lessee enters into a five-year lease for 2,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The lease contract includes a termination option with a penalty that is exercisable at the option of Lessor during year two. The termination option includes a notification period of one year such that, once exercised, the lease contract will terminate in year three. The termination penalty is CU40,000 and is payable in year three. As only the lessor has the right to terminate the lease, the lease term is determined to be five years at inception (IFRS 16 B35).

At the beginning of Year two, the lessor exercised the option to terminate the lease.

Assessment

In our view, the adjustment of the lease term and the payment due from the Lessor should be accounted for as adjustments to the right-of-use asset and the lease liability. At the time the termination notice is received by the Lessee, CU100,000 of payments remain (the year three lease payment). Lessee would adjust the lease liability to include the receipt of the lessor's termination penalty at the end of year three (CU100,000 – CU40,000 = CU60,000 net payments remaining) and discount this net amount using a newly determined discount rate. The offsetting effect of this adjustment would be recorded against the right-of-use asset, with any excess being recorded in profit or loss.

This accounting achieves the same effect as if the Lessor's penalty was in the form of an adjustment to the remaining lease payment of CU40,000. If this had been the case, using IFRS 16's remeasurement accounting model would be clear as the remaining lease payments had been modified by the exercising of the Lessor option. The underlying economics of the two variations of case facts are identical; therefore, we consider that there should be similar accounting outcomes.

Example 5.6-9– Remeasurement of lease liability in case of surrender premium

A lessee and lessor enter into a lease for office space. The lease payments are fixed and due each month in advance.

The lease agreement contains a break clause that provides the lessee with an option to terminate the lease early with 3 months' notice if a surrender premium is paid. The surrender premium is a fixed amount of cash payable upon exercising the option. Once the option is exercised, only the surrender premium and 3 months of lease payments are payable. Both the lessee and the lessor consider that the break clause is not reasonably certain to be exercised. The lease term, as determined at the commencement of the lease, is 10 years, which is the non-cancellable period, assuming the break clause will not be exercised.

The lessee accounts for the right-of-use asset using the cost model (refer section 5.5 for guidance on subsequent measurement of right-of-use assets) and the lessor classifies the lease as an operating lease.

Section 5.5

At the beginning of year six, the lessee experiences significant financial difficulty and, as a result, the lessee reassesses its business plan and exercises the break clause.

Assessment

Lessee accounting

As at the commencement of the lease, the lease liability is initially measured at the present value of the 10 years of fixed lease payments. As the break clause is not considered reasonably certain to be exercised, the period covered by the break clause is included in the lease term.

At the beginning of year six, the lessee is required to reassess whether it is reasonably certain to exercise the termination option. This is required because the change in business plan caused by the significant financial difficulty is a significant event or change in circumstance that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise the break clause.

Upon the reassessment of the lease term, the lessee is required to determine the revised lease payments. The revised lease payments would consist of the exercise price of the surrender premium that is payable upon the break clause being exercised and 3 months of remaining lease payments.

The lease liability would then be adjusted to reflect the revised payments, discounted using a revised discount rate, with the offsetting entry being recognised as an adjustment to the ROU asset. If the carrying amount of the ROU asset was reduced to zero by this remeasurement and there was a further reduction in the measurement of the lease liability, that further reduction would be recognised in profit or loss.

Note that the reassessment of the lease term and the resulting remeasurement may occur earlier than the date on which the break clause is exercised. For example, if at the end of year five the lessee considered that it was reasonably certain to exercise the break clause in year six of the lease based on its revised business plan, then the lessee would be required to reassess the lease term at that time and remeasure the lease.

Lessor accounting (refer to section 8 for lessor accounting)

Section 8

As at the commencement of the lease, the lessor would recognise operating lease income on a straight-line or another systematic basis (if appropriate). The period of time over which operating lease income is recognised would be the lease term as determined as at commencement i.e. 10 years.

IFRS 16.20 requires only lessees (not lessors) to reassess lease options upon the occurrence of a significant event or significant change in circumstances, therefore, it does not apply to lessors.

IFRS 16.21 requires an entity (i.e. both lessees and lessors) to revise the lease term if there is a change in the non-cancellable period of a lease, which includes, for example, a lessee exercising an option not previously included in the entity's determination of the lease term (IFRS 16.21(a)).

Therefore, when the break clause is exercised, the lessor is required to reassess the lease term and the total consideration included in the operating lease accounting. The operating lease is accounted for using the revised lease term and payments on a prospective basis.

To illustrate, if the original lease consisted of monthly payments of CU100 over the 10-year lease term, the lessor would recognise CU100 per month as operating lease income, assuming no initial direct costs.

If at the beginning of year six, the break clause was exercised, with a surrender premium of CU1,000 becoming payable to the lessor, then the lessor would account for the revised remaining consideration of CU1,300 (CU1,000 surrender premium plus 3 months of remaining lease payments) over the revised remaining lease term (3 months). Therefore, CU433.33 (CU1,300 / 3 months) would be recognised as operating lease income over the remaining 3 months of the lease.

Refer Appendix C for a summary of accounting for subsequent changes to existing leases.

Appendix C

5.7 Lease Modifications

Lease modifications arise from changes to the underlying contract agreed between the lessee and the lessor subsequent to commencement of the lease.

IFRS 16 defines a lease modification as:

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

The IASB released Educational Material in April 2020 on *IFRS 16 and COVID-19 - Accounting for covid-19-related rent concessions applying IFRS 16 Leases*. The IASB elaborated and provided explanations on lease modifications in the context of rent concessions granted during COVID-19 pandemic, which are also applicable otherwise.

As explained in the Educational Material, in assessing whether there has been a change in the scope of the lease, an entity considers whether there has been a change in the right-of-use conveyed to the lessee by the contract. For example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term would constitute a change in the scope of the lease. A rent holiday or rent reduction alone is not a change in the scope of a lease.

In assessing whether there has been a change in the consideration for a lease, an entity considers the overall effect of any change in the lease payments. For example, if a lessee does not make lease payments for a three-month period, the lease payments for periods thereafter may be increased proportionally in a way that means that the consideration for the lease is unchanged.

If there is no change in either the scope of the lease or the consideration for the lease, then there is no lease modification.

If there has been a change in either the scope of or the consideration for the lease, an entity next considers whether that change was part of the original terms and conditions of the lease. The entity is also required to consider all relevant facts and circumstances, which may include contract, statutory or other law or regulation applicable to lease contracts. Changes to lease payments that result from clauses in the original contract or in applicable law or regulation are part of the original terms and conditions of the lease, even if the effect of those clauses was not previously contemplated. Such changes are not lease modifications for the purpose of IFRS 16.

For example, lessee and lessor enter into a contract for the lease of retail space for a lease term of five years, with lease payments of CU100 per month. Consider the following three variations on the fact pattern:

Fact pattern	Lease modification?
Scenario A:	
Original lease contract contains a clause that if the shopping centre is shut down due to government-imposed intervention, then the lessee will receive a 75% discount on lease payments for as long as the shopping centre remains closed. Subsequently, government restricts access to the shopping centre on account of the COVID-19 pandemic. As a result, the lessee receives a 75% discount on lease payments during the period of closure of the shopping centre.	This is not a lease modification because the change in consideration results from the original terms and condition of the lease.
Scenario B:	
Original lease contract does not contain the clause as noted in Scenario A. Instead, the lessor negotiates with the lessee that the lessor will forgive 75% of monthly lease payments for the next 3 months.	This is a lease modification because the change in consideration does not result from the original terms and conditions of the lease.
Scenario C:	
Original lease contract does not contain the clause as noted in Scenario A. The local government passes a law requiring lessors to reduce lease payments by 75% for the next 3 months.	This is not a lease modification because the original lease contract is unchanged. The lease contract is subject to the laws and regulations in the applicable jurisdiction, therefore, a change in lease payments due to a change in laws and regulations are considered to be part of the original terms and conditions of the lease. This is so even if the effect of those changes in laws and regulations were not previously contemplated.

If a change in lease payments results in the extinguishment of a part of a lessee's obligation specified in the contract (for example, a lessee is legally released from its obligation to make specifically identified payments), the lessee would consider whether the requirements for derecognition of a part of the lease liability are met applying IFRS 9.3.3.1.

The accounting for the modification depends on whether the modified terms increase or decrease the scope of the lease, and whether increases in scope require consideration to be paid that is commensurate with a 'standalone price' for the new scope of the lease.

IFRS 16 requires that a modification of a lease that is accounted for as a short-term lease (i.e. off balance sheet) to be considered a new lease if:

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

BDO comment

Judgement must be applied to assess whether the extension of lease terms between existing parties are treated as new leases or the modification of the original lease. For example, consider a lease that does not include any renewal option. During the lease term, the parties enter into a new lease for the same identified asset that commences when the original lease ends. This change is not accounted for as a separate lease as it does not convey the right to use additional underlying assets; the asset in question is the same. In our view, this would be accounted for as a lease modification which would be accounted for at the date on which the agreement between the lessee and the lessor is modified. The remeasurement would not be delayed until the end of the term on the original underlying lease since, in substance, this is a modification to the contractual terms of the original lease.

Modifications - Separate Leases

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

- The modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

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

Example 5.7-1 – Lease Modification that is a Separate Lease

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

Assessment

Lessee accounts for the modification as a separate lease, i.e. separately from the original 10-year lease, the accounting for which is unaffected by the lease modification. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the new right is commensurate with its stand-alone price. In this example, the additional right-of-use asset is the extra 3,000 square metres of office space for three and a half years. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year six), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space for three and a half years. Lessee does not make any adjustments to the right-of-use asset or lease liability relating to the original lease of 2,000 square metres of office space which continue to be accounted for as if there had been no modification.

BDO comment

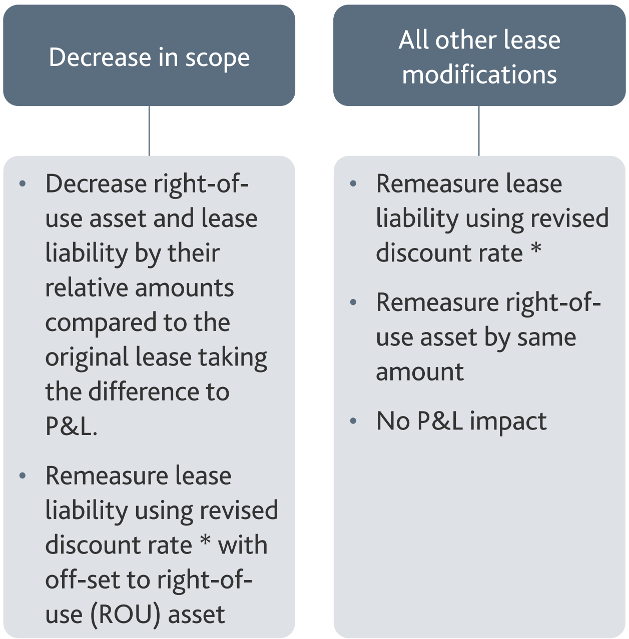
The legal form of a lease agreement may be modified to add additional assets (e.g. additional floors of an office building). In cases where the additional right-of-use assets are added to the contract at a price commensurate with their standalone price, the modification is in substance a new lease contract and the modification is accounted for as a separate lease under IFRS 16.

BDO comment

There may be situations when there is a change in the lessor e.g. when a property is sold by the current lessor and the lease is transferred to the buyer on existing terms and conditions. In such cases, where there is a change only in the counterparty, the change is not treated as a termination of the existing lease and commencement of a new lease. The lessee will continue the accounting for the existing lease.

Modifications – Not Separate Leases

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



Decrease in scope

- Decrease right-of-use asset and lease liability by their relative amounts compared to the original lease taking the difference to P&L.
- Remeasure lease liability using revised discount rate * with off-set to right-of-use (ROU) asset

All other lease modifications

- Remeasure lease liability using revised discount rate *
- Remeasure right-of-use asset by same amount
- No P&L impact

* The prevailing incremental borrowing rate at date of modification is used unless the implicit rate in the lease is readily determinable.

If a lease modification results in the lessee obtaining additional rights to use one or more underlying assets, but not at an amount that is commensurate with the standalone price for the increase in scope, the liability is remeasured by discounting all of the future lease payments as revised in the modified contract at the lessee's incremental borrowing rate at the date of modification (assuming the rate inherent in the lease is not readily determinable). It does not use the discount rate that applied to the pre-modified lease payments. The remeasurement of the lease liability is adjusted against the carrying value of the right-of-use asset such that no gain or loss arises as a result of the modification. The same accounting is applied if the term of the original lease is extended without adding any additional rights to use any more underlying assets.

Example 5.7-2 – Lease Modification that Increases the Lease Term

Entity A has a 10-year lease on 5,000 square metres of office space with annual payments of CU100,000 payable at the end of each year. The rate used to discount the payments is Entity A's incremental borrowing rate of 6% as the implicit rate is not readily determinable. At the beginning of year seven, Entity A and the lessor amend the lease by extending it for an additional four years. The annual payments remain unchanged. At the beginning of year seven, Entity A's incremental borrowing rate is 7%.

Assessment

The modification is not accounted for as a new lease as it does not convey the right to use any additional assets. The lease is for the same underlying property.

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

The lease liability immediately prior to the modification is CU346,511.

Present value of years 7 – 14 (8 years), CU100,000 a year, 7% discount = CU597,130

Adjustment required	= newly remeasured liability – previous carrying value of liability
	= CU597,130 – CU346,511
	= CU250,619

Entry required as a result of the modification:

DR right-of-use asset	CU250,619
CR lease liability	CU250,619

If the modification results in a decrease in scope (e.g. by reducing the lease term or reducing the amount of asset(s) that are being leased) the accounting is more complex. Although the resulting liability is measured in the same way as above by discounting the lease payments in the modified contract at the lessee's prevailing incremental borrowing rate (if the rate implicit in the lease is still not readily determinable), this adjustment is undertaken in two steps:

- Step 1: the carrying amount of the right-of-use asset at the date of modification is reduced to reflect the partial or full termination on the lease, with an equivalent adjustment being made to the lease liability. If there is a reduction in the scope of the asset being leased (for example, a reduction in the area being leased from 5,000 square metres to 2,000 square metres), then the proportionate reduction in the right-of-use asset and lease liability will be the same amount (see Example 5.7-3(a)). If there is a reduction in the lease term, the proportionate change in the right-of-use asset will be different from the proportionate change in the lease liability, because of the effect of discounting the future lease payments that have been eliminated (see Example 5.7-3(b)). The difference between the carrying amount of the right-of-use asset and lease liability derecognised gives rise to a gain or loss.
- Step 2: the carrying amount of the liability resulting from step 1 is adjusted again to ensure its carrying amount equals the future lease payments in the modified contract discounted at the lessee's incremental borrowing rate at the modification date. This second adjustment to the lease liability is accounted for by making a corresponding adjustment to the right-of-use asset. No gain or loss is recognised in this step.

Example 5.7-3(a) – Lease Modification that Decreases Scope

Entity B has a 10-year lease on 5,000 square metres of office space with annual payments of CU50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable. At the beginning of year six Entity B and the lessor agree to reduce the lease to 2,500 square metres and reduce the remaining payments to CU30,000 a year. At the beginning of year six, Entity A's incremental borrowing rate is 5%.

Assessment

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

The lease liability immediately prior to the modification is CU210,618 and the right-of-use asset is CU184,002.

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

Present value of years 6 – 10 (5 years), CU30,000 a year, 5% discount = 129,884

Entry required to adjust the carrying balances to reduce scope (step 1):

DR lease liability	CU105,309	(CU210,618 original * 50%)
CR right-of-use asset	CU92,001	(CU184,002 original * 50%)
CR gain	CU13,308	(remainder)

Entry required to adjust lease liability to the required revised balance of CU129,884 (step 2):

DR right-of-use asset	CU24,575	(corresponds to liability adjustment)
CR lease liability	CU24,575	(CU210,618 - CU105,309 + CU24,575 = CU129,884)

BDO comment

There are two consequences arising from the required accounting for lease modifications that reduce the scope of the lease, but not the lease term itself, that may seem counterintuitive:

- Firstly, a lease modification that reduces the amount(s) of assets being leased will often result in a gain. This is because at any point in time a lease liability will generally be greater than the leased asset as higher interest charges in the earlier years of the lease result in the lease liability being reduced at a lower rate than the straight line depreciation charge that is typically applied to the right-of-use asset. As the adjustment in step 1 results in the pre-modification carrying amounts of the right-of-use asset and lease liability being reduced by the same proportion, generally more of the lease liability will be derecognised than the right-of-use asset. This may

- not be the case if the right-of use asset is not being depreciated on a straight-line basis or the majority of lease payments prior to modification were paid in advance and the reduction in scope was not resulting in a refund of those advance payments
- Secondly, the gain will be the same irrespective of the amount by which future lease payments are being modified. This is because it is step 2 which ensures the carrying amount of the liability reflects the present value of future lease payments, which is only adjusted against the right-of-use asset. No gain or loss arises from step 2.

The accounting for this type of lease modification reflects that the reduction in scope was effected for nil consideration with total future lease payments being recognised as an expense over the remaining term of the lease. Consequently, any change in the lease cost that relates to future periods will be reflected in depreciation and interest expenses in those future periods.

For modifications that reduce the lease term, whether a gain or loss is recorded will depend on a number of factors, in particular the point at which in the original lease term the reduction takes place. This is because the reduction in the right-of-use asset will typically be calculated on a straight-line basis, while the reduction in the lease liability will be equivalent to the discounted present value of lease payments that are being eliminated.

Example 5.7-3(b) – Lease Modifications that Reduce the Lease Term Only

In contrast to Example 5.7-3(a), this example demonstrates how a lease modification is accounted for when the only change is a reduction in the lease term.

Entity B has a 10-year lease of 5,000 square metres of office space with annual payments of CU50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable. At the beginning of year six, Entity B and the lessor agree to reduce the lease term to eight years in total (three years remaining as of the beginning of year six). At the beginning of year six, Entity A's incremental borrowing rate is 5%.

Assessment

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

The lease liability immediately prior to the modification is CU210,618 and the right-of-use asset is CU184,002.

The remeasurement takes place with two steps:

- Step 1: remeasure based on the decrease in scope (i.e. the decrease in the lease term)
- Step 2: remeasure based on the change in discount rate.

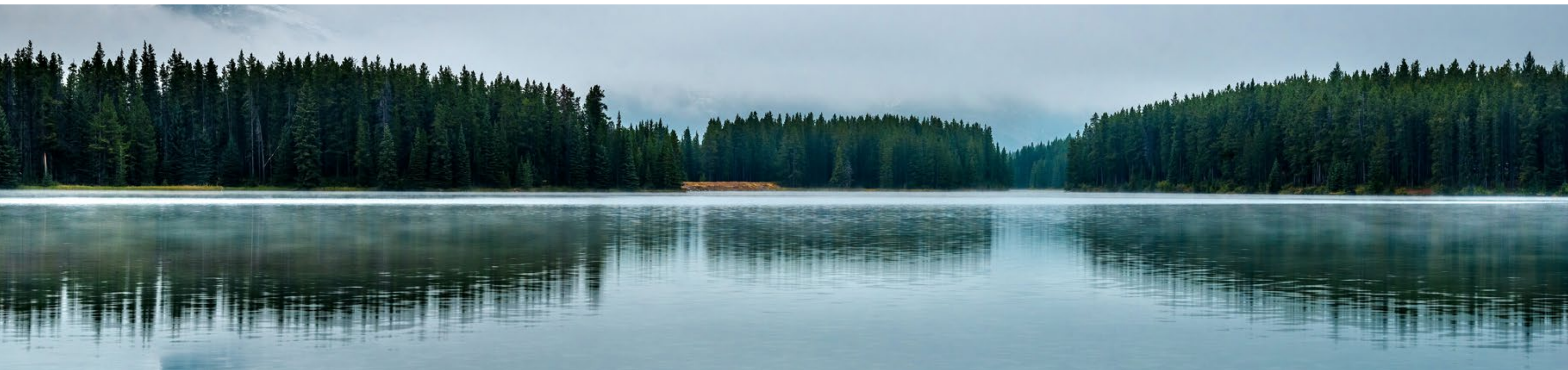
Step 1: Remeasurement for Decrease in Scope

DR lease liability	CU76,967[1]
CR gain	CU3,366[2]
CR right-of-use asset	CU73,601[3]

[1] The lease liability is remeasured as the difference between its carrying value immediately prior to the modification (CU210,618) and its carrying value based on the revised, shorter lease term, using the original interest rate. The remeasurement related to the change in the discount rate is reflected in Step 2. Three payments of CU50,000 occurring in arrears, discounted at 6% (the original discount rate) equals CU133,651. CU210,618 less CU133,651 results in a remeasurement of CU76,967.

[2] The gain is the difference between the adjustment to the lease liability and right-of-use asset (i.e. the balancing entry).

[3] The right-of-use asset is remeasured based on the change in scope of the lease. As the remaining lease term has been reduced from five years to three years, the reduction in scope is calculated as the carrying value of the right-of-use asset immediately prior to the modification (CU184,002) / 5 * 3.



Step 2: Remeasurement for the Change in Discount Rate

DR right-of-use asset	CU2,511[1]
CR lease liability	CU2,511[2]

[1] The right-of-use asset is adjusted at an amount equal to the lease liability.

[2] After Step 1, the revised carrying value of the lease liability is its original carrying value (CU210,618) less the remeasurement of CU76,967, resulting in a revised value of CU133,651. The lease liability now needs to be remeasured to reflect the change in the lessee's incremental rate of borrowing, as the adjustment of CU76,967 was calculated using an unchanged discount rate. Three payments of CU50,000 occurring in arrears, discounted at 5% equals CU136,162. The difference between the revised lease liability of CU136,162 and the previous value of CU133,651 is CU2,511.

BDO comment

In contrast to example 5.7-3(a), in which the scope of the lease was decreased by the number of square feet occupied being reduced, example 5.7-3(b) reduces the scope of the lease by only reducing the remaining lease term. This difference creates a different result in profit or loss, as a reduction in the lease term may result in a gain or a loss, whereas a reduction in scope other than the lease term will often result in a gain.

A reduction in lease term may result in a gain or a loss because of the difference in how the lease liability and right-of-use asset are remeasured in step 1 of the 2-step remeasurement process.

The right-of-use asset is remeasured based on the proportion of the previous carrying value that will remain, based on straight line amortisation. In this example, the revised, remaining lease term is three years instead of the original five, therefore 2/5th of the previous carrying value of the right-of-use asset is eliminated. However, the lease liability is remeasured to eliminate the present value of lease payments that are no longer payable due to the reduction in lease term (discounted at the lessee's original incremental borrowing rate).

Example 5.7-4 – Lease Modification that both increases and decreases the scope of the lease

Entity A enters into a 10-year lease for 2,000 square metres of office space with Entity B. The annual lease payments are CU100,000 payable at the end of each year. The rate used to discount the payments due is Entity A's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable.

At the beginning of year six, Entity A and Entity B agree on the following amendments:

a) Inclusion of additional 1,500 square metres of space in the same building starting from the beginning of year six; and

b) Reduction of the lease term from 10 years to eight years.

The annual fixed payment for the 3,500 square metres is CU150,000 payable at the end of each year (from year six to year eight). Lessee's incremental borrowing rate at the beginning of year six is 7 per cent per annum.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract, as the lease payment per square metre for the original 2,000 square metres of space was CU50 and the lease payment per square metre for additional space of 1,500 square metres is CU33.33 (CU50,000 / 1,500 square metres).

Assessment

As the consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase, Entity A does not account for the increase in scope as a separate lease.

At the commencement of the lease, the lease liability and right-of-use asset are measured at CU736,009, being the present value of lease payments of CU100,000 for ten years discounted at 6%.

At the beginning of year six, the pre-modification lease liability and right-of-use asset are:

(Amounts in CU)

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

A. Decrease in the lease term

- Decrease in right-of use asset

The proportionate decrease in the right-of-use asset is calculated as below:

	Amount (CU)
Pre-modification right-of-use asset, at the beginning of year 6	368,004
Right-of-use asset for the original 2,000 square metres of office space for a reduced term of remaining three years, instead of the original five years	368,004 * 3/5 = 220,802
Reduction in right-of-use asset	368,004 – 220,802 = 147,202

- Decrease in lease liability

The proportionate decrease in the lease liability is calculated as below:

	Amount (CU)
Pre-modification lease liability, at the beginning of year six	421,236
Revised lease liability for the original 2,000 square metres of office space (present value of annual lease payments of CU100,000 for three years, discounted at the original discount rate of 6%)	267,301
Reduction in lease liability	421,236 – 267,301 = 153,935

Difference between the reduction in lease liability and the reduction in right-of-use asset (CU153,935 – CU147,202 = CU6,733) is recognised as a gain in profit or loss at the effective date of the modification i.e. at the beginning of year six, as below.

DR Lease liability	CU153,935	
CR Right-of-use asset		CU147,202
CR Profit or loss		CU6,733

After recognising the reduction in lease liability as above, the remaining lease liability is remeasured using the revised discount rate of 7% at the effective date of the modification. The remeasured lease liability is CU262,431 (present value of three annual payments of CU100,000 discounted at 7%). The difference on remeasurement of CU4,870 (CU267,301 – CU262,431), is recognised as an adjustment to the right-of-use asset as below.

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

B. Increase in leased space

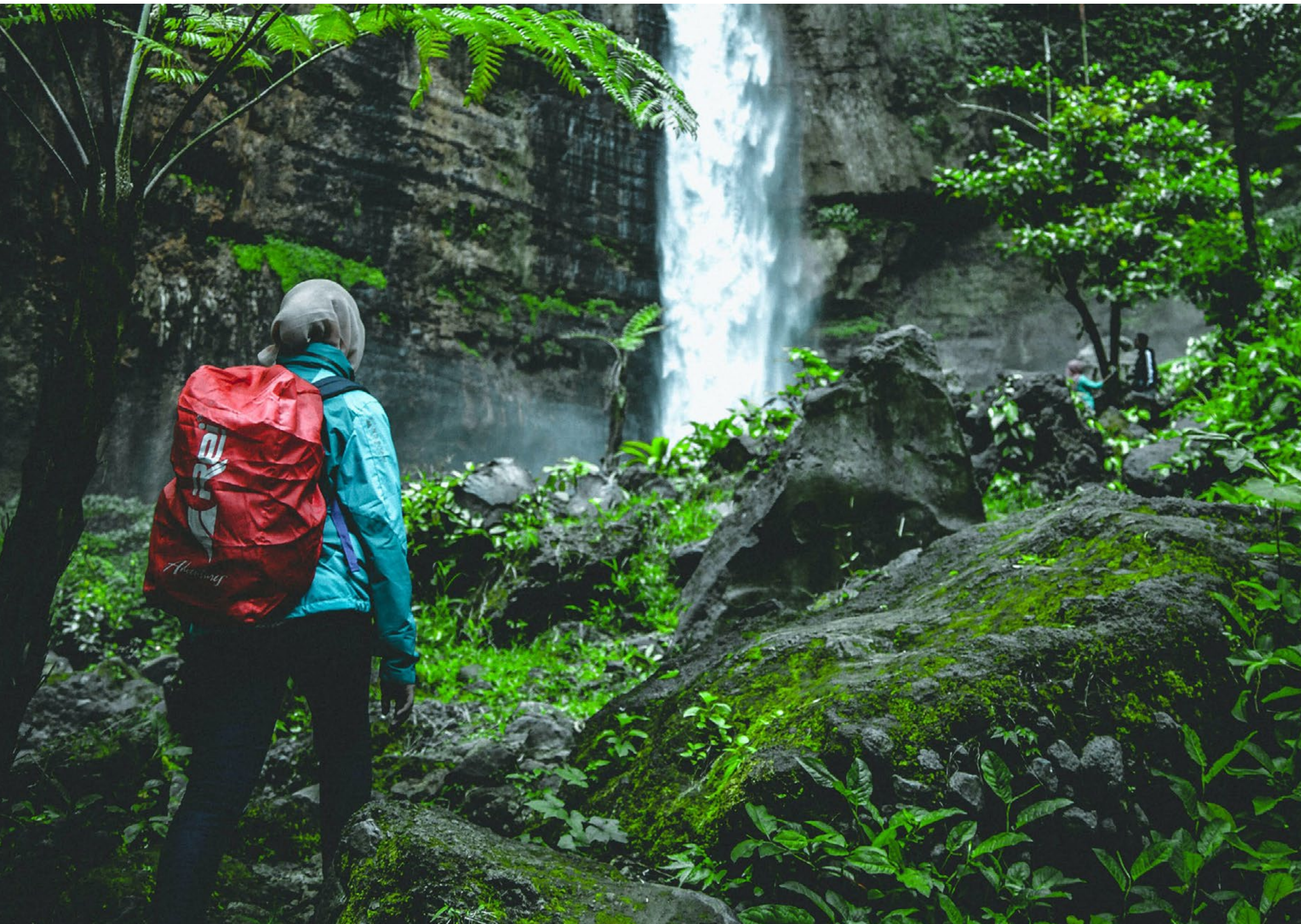
At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year six), Entity A recognises the increase in the lease liability related to the increase in scope of CU131,216 (i.e. present value of three annual lease payments of CU50,000, discounted at the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

DR Right-of-asset	CU131,216
CR Lease liability	CU131,216

After accounting for the increase in scope, the modified right-of-use and the modified lease liability are as follows:

(Amounts in CU)

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



Example 5.7-5 – Purchase of underlying asset by the lessee

On 1 January 20X1, Entity A enters into a property lease with Entity B for a period of 10 years for a fixed monthly rental. The contract does not provide for an extension, termination or purchase option.

On 31 December 20X5, Entity A agrees to purchase the property from Entity B for CU10 million. At that date, the carrying value of the lessee's right-of-use asset and lease liability is CU5 million and CU5.5 million respectively.

Assessment

There are no specific requirements in IFRS 16 applicable for this situation.

In our view, an acceptable approach to account for this transaction would be to consider lease termination as an integral part of the purchase of the underlying asset.

The payment of CU10 million is treated as an early settlement of the lease liability of CU5.5 million and a purchase of the residual interest for an amount of CU4.5 million (CU10 million – CU5.5 million).

Therefore, on purchase, the property asset will be recognised at the purchase price of CU10 million less the difference between the lease liability and right-of-use asset of CU0.5 million, i.e. CU9.5 million.

Following accounting entry is recorded for the transaction:

DR Lease liability	CU5.5 million	
DR Property asset	CU9.5 million	
CR Right-of-use asset		CU5.0 million
CR Cash		CU10.0 million

No gain or loss is recognised on the date of purchase.

This treatment is consistent with the outcome if the lessee and the lessor had agreed to modify the lease by inserting a purchase option which is then exercised.

An alternative approach may be to allocate the purchase price on the basis of relative fair value between the settlement of lease liability and purchase of residual interest. In this case, a gain or loss arises to the extent of any difference between the amount allocated to the settlement of the lease liability and its carrying amount. For example, if, on the date of purchase, the fair value of the lease liability exceeds its carrying amount due to a decline in the applicable discount rate, the lessee will allocate an amount exceeding CU5.5 million to the settlement of lease liability and the excess is recognised as a loss. This loss is not part of the cost of the property and would be recognised immediately in profit or loss.

Refer to Appendix C for a summary of accounting for subsequent changes to existing leases.

Appendix C

5.7.1 Accounting for COVID-19 related rent concessions

As a result of the COVID-19 pandemic, different types of rent concessions, such as rent deferrals, rent forgiveness etc., were agreed between the lessees and the lessors. Such rent concessions would often result in a lease modification that required using lease modification accounting discussed above.

As a relief to lessees, on 28 May 2020, the IASB issued an amendment to IFRS 16 that provided a practical expedient to lessees whereby a lessee could elect not to assess whether a rent concession is a lease modification, subject to certain conditions.

Initially, the amendment was applicable for any reduction in lease payments affecting only payments originally due on or before 30 June 2021. In March 2021, the IASB issued a further amendment to IFRS 16 to extend this time limit to 30 June 2022.

It should be noted that the amendments were applicable only for lessees and not for lessors.

BDO has issued IFRB 2020/11 *Accounting for Rent Concessions: Lessee FAQs and IFRB 2021-08 COVID-19 related Rent Concessions beyond 30 June 2021: Extension of Practical Expedient – Additional FAQs* dealing with the amendments. The IFRBs may be accessed here.

5.8 Summary of requirements related to discount rate

The following table summarises the requirements in IFRS 16 with respect to use of original or revised discount rate in case of remeasurement of lease liabilities or lease modifications.

	Discount rate to be used	Section reference
Remeasurement of lease liability		
Change in original assessment of lease term or purchase/termination options	Revised discount rate	Section 5.6
Change in estimate of residual guarantee	Original discount rate (*)	
Change in index or rate affecting payments including market rent reviews	Original discount rate (*)	
Lease modification		
Accounted as a separate lease	Revised discount rate (rate applicable for the leases accounted for separately from the original lease)	Section 5.7
Not accounted as a separate lease	Revised discount rate	

(*) If the change in lease payments results from a change in floating interest rates, the lessee shall use a revised discount rate that reflects changes in the interest rate.

As noted by the IASB in the basis for conclusions, an entity should not reassess the discount rate during the lease term, which is consistent with the approach followed for financial instruments accounted for using the effective interest method. In other Standards in which the discount rate is required to be reassessed, it is typically because the liability to which the discount rate relates is measured on a current value measurement basis. However, in the IASB's view, when there is a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset, the economics of the lease have changed and it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of the lease liability and right-of-use asset.

If the change in lease payments results from a change in floating interest rate, the lessee is required to use a revised discount rate for remeasurement of lease liability. The IASB noted in the basis for conclusions that this approach is consistent with the requirements of IFRS 9 for the measurement of floating-rate financial liabilities subsequently measured at amortised cost.

In case of lease modifications that are accounted for as a separate lease, the discount rate applicable for the new lease (i.e. rate implicit in the separately accounted lease or the incremental borrowing rate for the separately accounted lease) is to be used.

For lease modifications that are not accounted for as a separate lease, the IASB noted in the basis for conclusions, that the use of a revised discount rate reflects that, in modifying the lease, there is a change in the interest rate implicit in the lease (which the discount rate is intended to approximate).

5.9 Deferred Tax Implications of IFRS 16

In many jurisdictions, the recognition of lease liabilities and right-of-use assets will differ from the taxation treatment of leases. For tax purposes, it is common for leases to be included in the calculation of taxable income based on the cash paid in a particular period plus any unpaid, but accrued lease payments.

In many cases, the carrying amount of the right-of-use asset and corresponding lease liability for a lease may equal one another as at the commencement date of the lease. The difference in treatment between IFRS and taxation may give rise to deferred tax balances as the lease liability and right-of-use asset are subsequently reduced due to the subsequent measurement of the balances (e.g. reduction of the lease liability due to lease payments, amortisation of the right-of-use asset, etc.).

On 7 May 2021, the IASB issued amendments to IAS 12 *Deferred Tax related to Assets and Liabilities Arising from a Single Transaction*. These amendments clarify whether the initial recognition exemption applies to certain transactions that often result in both an asset and a liability being recognised simultaneously, such as initial recognition of leases from lessee's perspective.

*IAS 12.15 was amended as below (**emphasis added**):*

A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

a) the initial recognition of goodwill; or

b) the initial recognition of an asset or liability in a transaction which:

(i) is not a business combination;

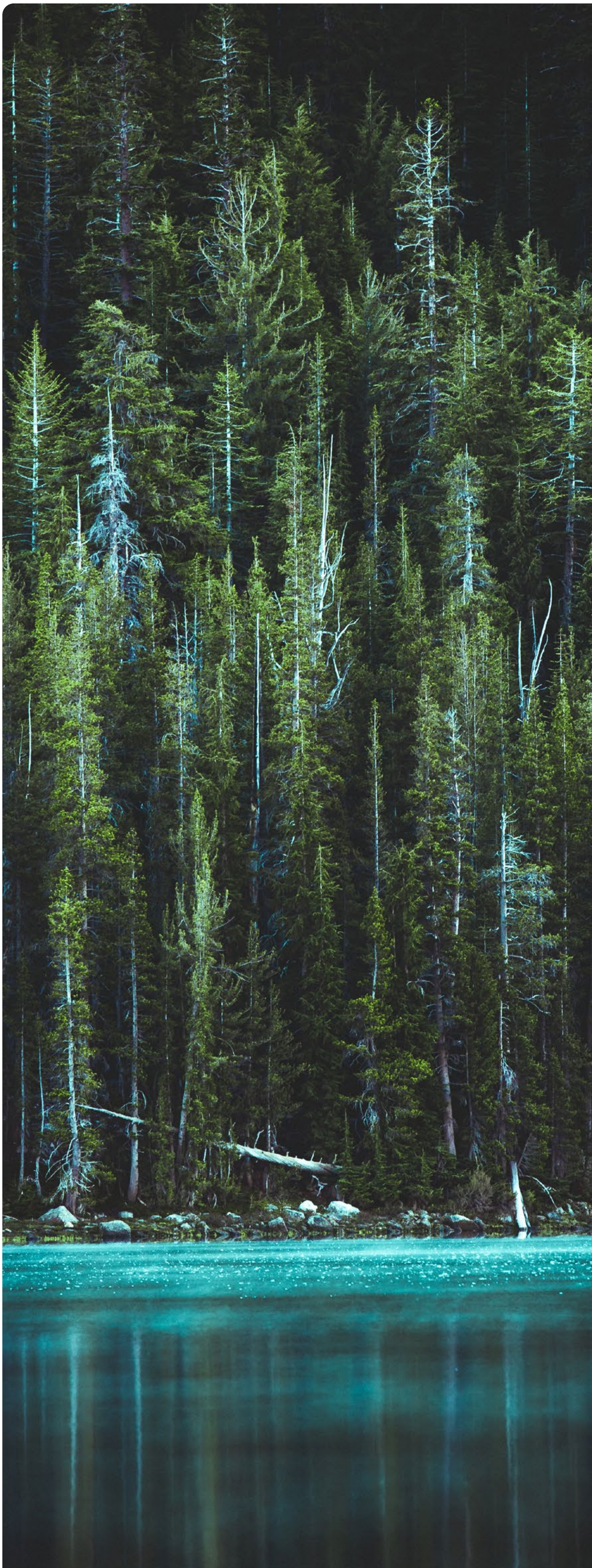
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

*(iii) **at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.***

*IAS 12.24 was amended as below (**emphasis added**):*

A deferred tax asset shall be recognised for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that:

a) is not a business combination;



b) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss); and

c) at the time of the transaction, does not give rise to equal taxable and deductible temporary differences.

The amendments (IAS 12.22A) also clarify that depending on applicable tax law, equal taxable and deductible temporary differences may arise on initial recognition of right-of-use asset and lease liability by the lessee at the commencement date of a lease. The exemption provided by IAS 12.15 and IAS 12.24 do not apply to such temporary differences and an entity recognises any resulting deferred tax liabilities and assets.

Prior to these amendments, the requirements of IAS 12.15 and IAS 12.24 could be interpreted such that for each of the lease liability and right-of-use asset, the initial recognition exemption applies since the recognition of each item individually does not relate to a business combination and the initial recognition does not affect accounting profit or taxable profit at that time. Entities adopting this interpretation recognised no deferred tax in respect of the lease, either on initial recognition or subsequently throughout the lease term. Other entities that interpreted that the initial recognition exemption does not apply in this situation recognised deferred tax. A third approach was followed by some entities in which the right-of-use asset and lease liability were assessed together as a single or 'integrally linked' transaction on a net basis. Entities adopting this interpretation recognised deferred tax on a net temporary difference that arises after the initial recognition and the initial recognition exemption was not considered to apply.

The amendments address these differing interpretations of the requirements of IAS 12. The amendments are effective for annual reporting periods beginning on or after 1 January 2023, with earlier application permitted. Entities are required to apply the amendments to transactions that occur on or after the beginning of the earliest comparative period presented. At the beginning of the earliest comparative period presented, entities are required to recognise deferred tax assets (subject to the recoverability requirements of IAS 12) and deferred tax liabilities associated with right-of-use assets and lease liabilities. The effect of recognising these deferred tax items is reflected as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) as at that date.

BDO has issued IFRB 2021/10 IASB issues amendments to *IAS 12 – Deferred Tax Related to Assets and Liabilities arising from a Single Transaction* dealing with the amendments. The IFRB may be accessed here.

The following example illustrates the requirements of the amendment:

Example 5.9-1 – Measurement of Lease Contract and Deferred Tax

Company V enters into a lease with a lease term of 10 years, with lease payments of CU1,000 paid in arrears. The interest rate implicit in the lease is not readily determinable, therefore, Entity V uses its incremental rate of borrowing, which is 5%. Company V incurs initial direct costs of CU50 and makes an advance lease payment of CU150. At the commencement of the lease, the lease liability is recognised at CU7,722 (measured at the present value of the ten lease payments of CU1,000, discounted at the interest rate of 5% per year). The right-of-use asset is measured at CU7,922 comprising the initial measurement of the lease liability (CU7,722), the advance lease payment (CU150) and the initial direct costs (CU50).

The applicable income tax rate is 25%. In Company V's jurisdiction, the only deduction permissible for leases are those made in cash, including the initial direct costs and advance lease payments. Depreciation of the right-of-use asset and finance expenses on the lease liability are both non-deductible.

Assessment

A. Deferred tax on advance lease payments and initial direct costs

Advance lease payments and initial direct costs are recognised as components of the right-of-use asset.

The tax base of these components is nil because Company V already received tax deductions for the advance lease payment and initial direct costs when it made those payments. The difference between the tax base (nil) and the carrying amount of each component results in taxable temporary differences of CU150 (related to the advance lease payment) and CU50 (related to the initial direct costs).

The advance payments and initial direct costs are analysed for the initial recognition exemption (IRE) as per IAS 12.15 as follows:

IRE criteria	Assessment (all 'yes' responses means the IRE applies)
Does the difference arise from the initial recognition of an asset or liability?	Yes, the advance lease payment and initial direct costs arise from the initial recognition of a lease.
Is the transaction not a business combination?	Yes, entering into the lease contract does not meet the definition of a business combination.
At the time of the transaction, is neither accounting profit nor taxable profit affected?	No, taxable profit is affected at the time of the transaction because the advanced payment and initial direct costs are deducted from taxable profit when paid.
At the time of the transaction, does the transaction not give rise to equal taxable and deductible temporary differences?	Not applicable

Thus, the initial recognition exemption does not apply because the temporary differences arise from transactions that, at the time of the transactions, affect Company V's taxable profit as it receives tax deductions on making advance lease payments and payment of initial direct cost. Therefore, Company V recognises a deferred tax liability of CU50 (CU150*25% + CU50*25%).

B. Deferred tax on lease liability and related component of the right-of-use asset

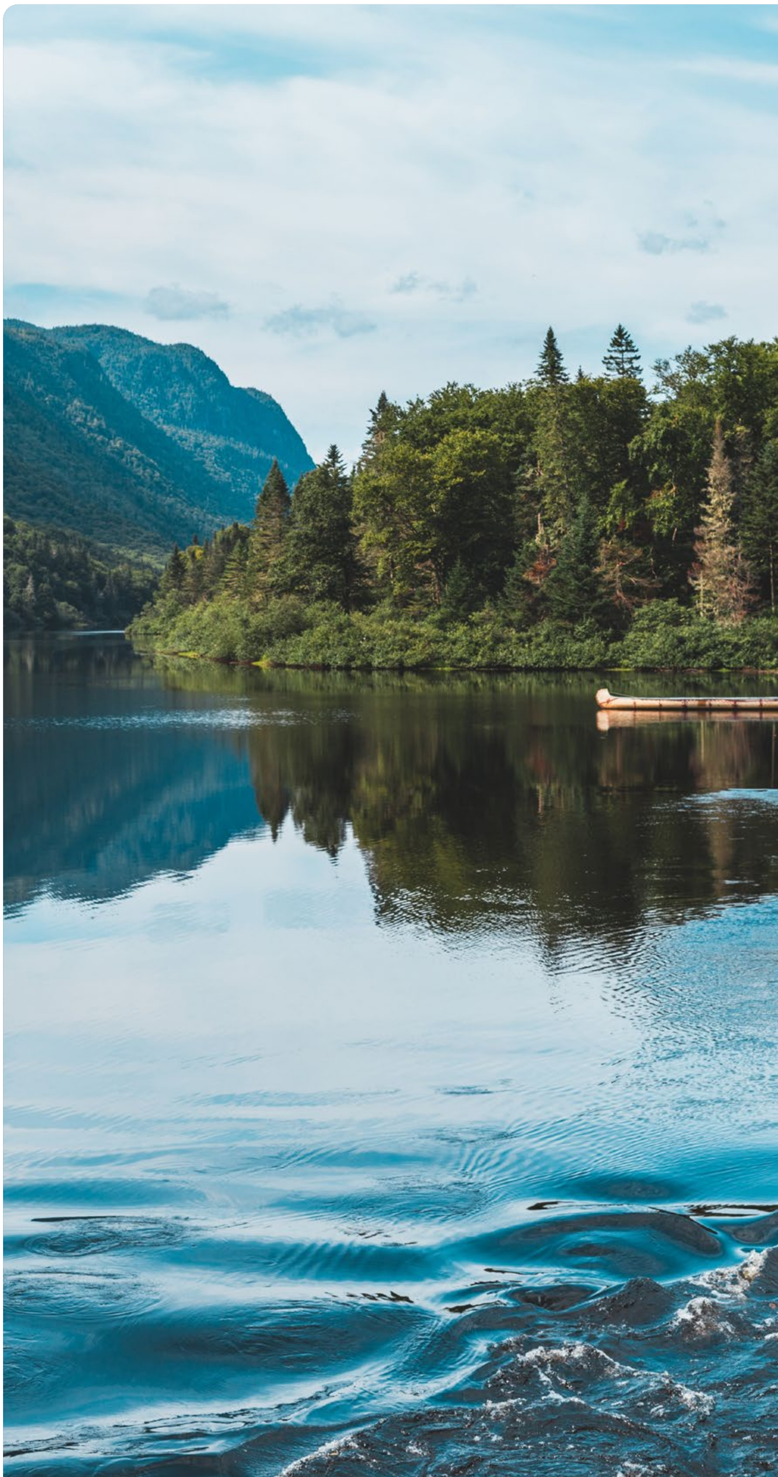
At the commencement date, the tax base of the lease liability is nil because Company V will receive tax deductions equal to the carrying amount of the lease liability (CU7,722). The tax base of the related component of the lease asset's cost is also nil because Lessee will receive no tax deductions from recovering the carrying amount of that component of the lease asset's cost (CU7,722).

The differences between the carrying amounts of the lease liability and the related component of the lease asset's cost (CU7,722) and their tax bases of nil result in the following temporary differences at the commencement date:

(a) a taxable temporary difference of CU7,722 associated with the lease asset; and

(b) a deductible temporary difference of CU7,722 associated with the lease liability.

The lease liability and related component of the right-of-use asset are analysed for initial recognition exemption as per IAS 12.15 and IAS 12.24 as follows:



IRE criteria	Assessment (all 'yes' responses means the IRE applies)
Does the difference arise from the initial recognition of an asset or liability?	Yes, the differences arise due to the initial recognition of the lease. Neither the lease liability nor the corresponding amount of the lease asset's cost have tax basis.
Is the transaction not a business combination?	Yes, entering into the lease contract does not meet the definition of a business combination.
At the time of the transaction, is neither accounting profit nor taxable profit affected?	Yes, neither accounting profit nor taxable profit are affected at the time of the transaction.
At the time of the transaction, does the transaction not give rise to equal taxable and deductible temporary differences?	No, the lease liability and the related component do give rise to equal taxable and deductible temporary differences.

Thus, the initial recognition exemptions do not apply because the transaction gives rise to equal taxable and deductible temporary differences. Company V concludes that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

Therefore, Company V recognises a deferred tax asset and a deferred tax liability, each of CU1,930 (CU7,722 × 25%), for the deductible and taxable temporary differences.

The lease and its tax effects on initial recognition are summarised as follow:

	Carrying amount	Tax base	Deductible/ (taxable) temporary difference	Deferred tax asset (liability)
Lease asset				
• Advance lease payment	150	-	(150)	(38)
• Initial direct costs	50	-	(50)	(12)
• Amount of the initial measurement of the lease	7,722	-	(7,722)	(1,930)
Lease liability	7,722	-	7,722	1,930

6. PRESENTATION

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

Statement of Financial Position

- Right-of-use assets: present in its own line item or combine with property, plant and equipment, with separate disclosure*.
- Lease liabilities: present separately or include with other liabilities and disclose which line item they have been included.

Statement of Profit and Loss

- Interest expense with other finance costs.
- Amortisation of right-of-use assets. **

Statement of Cash Flows

- Cash payments of lease liabilities as financing activities.
- Cash payments for interest in accordance with IAS 7's requirements for interest paid.
- Short-term, low-value and variable lease payments within operating activities.

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

** IFRS 16 does not require separate presentation of amortisation expense of right-of-use assets on the face of the income statement, nor does it mandate which line item the amortisation expense should be included (which will in part be driven by whether the entity presents its expenses 'by function' or 'by nature'). However, the expense does need to be disclosed by class of underlying assets in the notes.

IFRS 16.47(a)(i) states that if an entity wishes to group right-of-use assets with other assets, they must be grouped 'within the same line item as that within which the corresponding underlying assets would be presented if they were owned'. IFRS 16.47(a)(ii) requires the entity to disclose which line items in the statement of financial position include those right-of-use assets. As an exception to this requirement, if a right-of-use asset meets the definition of investment property under IAS 40, then the asset must be presented within the same line item as other investment property (i.e. not combined with other right-of-use assets that do not meet the definition of investment property).

For example, if a lessee had a right-of-use asset relating to a lease of heavy equipment, that right-of-use asset would be grouped with property, plant and equipment in the statement of financial position, unless the lessee elects to present right-of-use assets as a separate line item. The lessee would be required to disclose that the right-of-use asset is included in the line item of property, plant and equipment in the statement of financial position.

Please refer to BDO's publication IFRS in Practice: *IAS 7 Statement of Cash Flows* for guidance on common issues related to leases encountered in statement of cash flows. The publication may be found here.

7. DISCLOSURE

IFRS 16 has extensive disclosure requirements for lessees in both qualitative and quantitative form. Quantitative disclosure requirements by primary statement include the following (some of which may be disclosed in the notes and not in the statement of financial position or the statement of comprehensive income):

Quantitative Disclosure Requirements

Statement of Financial Position

- Additions to right-of-use assets.
- Carrying value of right-of-use assets at the end of the reporting period by class.
- Maturity analysis of lease liabilities separately from other liabilities based on IFRS 7 *Financial Instruments: Disclosures requirements* (using nominal cash flows and not discounted cash flows).

Statement of Profit and Loss

- Depreciation for assets by class.
- Interest expense on lease liabilities.
- Short-term leases expensed (accounted for applying IFRS 16.6)*.
- Low-value leases expensed (accounted for applying IFRS 16.6)**.
- Variable lease payments expensed.
- Income from subleasing.
- Gains or losses arising from sale and leaseback transactions.

Statement of Cash Flows

- Total cash outflow for leases.

IFRS 16 requires most of the above quantitative disclosures to be presented in a tabular format, unless another format is more appropriate. To the extent amounts are included in the carrying amount of other assets (e.g. interest on lease liabilities capitalised into the cost of inventory), this must also be disclosed.

Other disclosure requirements include:

- For right-of-use assets that meet the definition of investment property, the disclosure requirements of IAS 40, with a few exclusions.
- For right-of-use assets where the revaluation model has been applied, the disclosure requirements of IAS 16.
- Where the short-term and/or low-value lease exemptions has been used, that fact as well as the amount of short-term lease commitments, if the portfolio of short-term leases that gave rise to the current period expense is dissimilar to the portfolio of short-term leases to which the lessee is committed at the end of the reporting period.

Qualitative Disclosure Requirements

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

Refer BDO's Illustrative IFRS Financial Statements here for illustrative disclosures.

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

**These disclosures need not include short-term leases of low value assets included in the disclosure of 'short-term leases expensed'.

BDO comment - Disclosure Initiative

In line with the IASB's focus in other standards requiring disclosure of the most relevant information rather than simply a prescriptive list, IFRS 16 similarly contains an overarching requirement for an entity to provide information to enable users to understand the impact that leasing transactions have on its financial position and performance. The disclosure requirements as prescribed by the standard may not meet this objective by themselves. Determining the appropriate level of disclosure is a matter of judgment and may be complex for entities with significant or unusual leases.

In addition, the disclosure requirements should be viewed in light of the IASB's *Disclosure Initiative* project. The initiative aims to reduce unnecessary disclosure and improve the overall quality of financial statements by highlighting the most relevant information to users and not disclosing information that is immaterial or irrelevant. An entity with very few, straightforward and relatively low value leases may consider certain of the disclosures required by IFRS 16 to be immaterial.

8. LESSOR ACCOUNTING

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

BDO comment

The IASB acknowledges there is asymmetry in lessee and lessor accounting under IFRS 16. For leases that are classified as operating leases by the lessor, the lessee will also recognise an asset for the same underlying asset in its statement of financial position: the lessor the actual asset and the lessee a right-of-use of that asset. However, feedback received during the project indicated that, ultimately, a symmetrical approach to lessee and lessor accounting was not necessary. Lessor accounting under IAS 17 was well understood and most users of financial statements did not adjust the financial statements of lessors for the effects of leases, indicating that the lessor accounting model in IAS 17 provided the information that they required. Consequently, the IASB concluded that the costs associated with making changes to lessor accounting at this point would be difficult to justify, and therefore decided substantially to carry forward the lessor accounting model in IAS 17.

The areas that may affect lessors are those where IFRS 16 expands guidance or provides guidance on issues not previously addressed in IAS 17, such as:

- the new definition of a lease (see section 3);

Section 3

- clarification that variable payments that depend on an index or a rate are factored into the definition of lease payments, and so could impact the assessment as to whether the present value of the lease payments amounts to substantially all of the fair value of the underlying asset for the purposes of classifying a lease as a finance lease or operating lease;
- revised sale-and-leaseback guidance (see section 9);

Section 9

- separation of lease and non-lease components in a contract (see section 8.2);
- sub-lease guidance (see section 8.3);
- guidance on lease modifications (see section 8.6); and
- enhanced disclosure requirements (see section 8.7).

Section 8.2
Section 8.6
Section 8.3
Section 8.7

The COVID-19 pandemic resulted in different types of rent concessions being agreed between lessees and lessors. On 28 May 2020, the IASB issued an amendment to IFRS 16 that provided a practical expedient to lessees whereby a lessee could elect not to assess whether a rent concession is a lease modification, subject to certain conditions. However, the practical expedient was not extended for lessors as the IASB noted that the circumstances differ for lessors and any changes made to lessor accounting could have had unintended consequences because they could have introduced differences between the accounting for lease and non-lease components. Lessors were required to apply the existing requirements of IFRS 16 to rent concessions granted as a result of COVID-19 pandemic.

8.1 Distinction between a Lease and a Sale or Purchase

IFRS 16 does not include specific requirements to distinguish a lease from a sale or purchase of an asset. As noted by the IASB in the Basis for Conclusions to IFRS 16 (BC138), there was little support from stakeholders for including such requirements.

As observed by the IASB in IFRS 16.BC139, accounting for a transaction depends on the substance of that transaction and not its legal form. Consequently, if a contract grants rights that represent the in-substance purchase of an item of property, plant and equipment, those rights meet the definition of property, plant and equipment in IAS 16 and would be accounted for applying that Standard, regardless of whether legal title transfers. If the contract grants rights that do not represent the in-substance purchase of an item of property, plant and equipment but that meet the definition of a lease, the contract would be accounted for applying IFRS 16.

The primary basis for distinction between a lease and a sale or a purchase is the assessment of whether the contract conveys the right to use an underlying asset or whether it transfers control of the underlying asset. IFRS 16 applies to contracts that convey the right to use an underlying asset for a period of time. Transactions that transfer control of the underlying asset to an entity are sales or purchases within the scope of other Standards such as IFRS 15 or IAS 16.

The scoping requirements of IFRS 15 provide as below:

> IFRS 15.5 (emphasis added)
>
> *An entity shall apply this Standard to all contracts with customers, except the following:*
>
> *(a) Lease contracts within the scope of IFRS 16 Leases….*

Thus, as IFRS 15 scopes out lease contracts within the scope of IFRS 16, an entity first determines whether the arrangement meets the definition of a lease in accordance with the requirements of IFRS 16. If the entity determines that the contract meets the definition of a lease, the entity needs to determine whether the lease contains any non-lease components. Lessors are required to apply the principles within IFRS 15 for allocating consideration to components of a contract (refer section 8.2).

8.2 Separation of Lease and non-Lease Components

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

This may result in significantly different outcomes than if the entire contract were within the scope of IFRS 15. For example, IFRS 15 contains specific guidance on variable consideration, where variable consideration should be included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved ('the variable consideration constraint').

Variable payments under a lease classified as an operating lease for a lessor would typically be included in income as the contingency is resolved.

Therefore, determining whether a contract is in the scope of IFRS 15, IFRS 16 or partially within both standards, may significantly alter the pattern of revenue recognition. It should be noted that separation is required even if it only affects presentation and disclosure. Disaggregation of different revenue streams is required by IFRS 15 and 16.

8.3 Sub-Leases

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

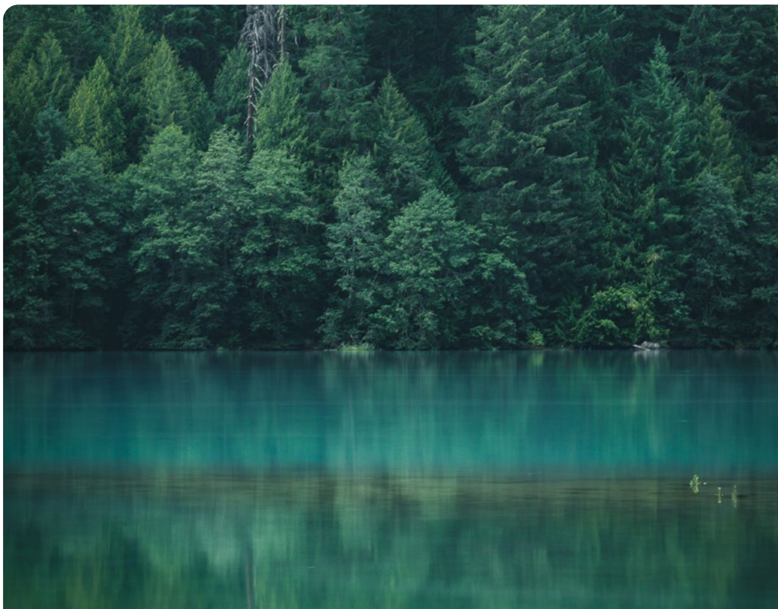
Example 8.3-1 – Sub-Lease Assessment

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

At the beginning of year three, the intermediate lessor subleases the 5,000 square metres of office space for the remaining three years of the head lease to a sub-lessee.

Assessment

From the intermediate lessor's perspective, at the time the sub-lease is entered into, the right-of-use asset has a remaining economic life of three years, and it is being sub-leased for the entirety of that period. As the sub-lease is for all of the remaining useful economic life of the right-of-use asset the sub-lease is classified as a finance lease, even though three years is unlikely to be the full remaining useful economic life of the underlying property.



BDO comment

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

However, because the asset held by the intermediate lessor is a right-of-use asset with a much shorter useful economic life, the classification of the sub-lease by the intermediate lessor may differ from that of the head lessor.

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

When a head lease is short-term and the intermediate lessor takes advantage of the related practical expedient not to recognise short-term leases in its statement of financial position in its capacity as a lessee, the intermediate lessor must classify the sub-lease as an operating lease.

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

Finance leases

- Derecognise the right-of-use asset (1) and recognise instead a lease receivable equal to the net investment in the sub-lease (2) *
- Recognise the difference between (1) and (2) as a gain or loss in the income statement
- Retain the previously recognised lease liability in capacity as lessee and recognise interest expense thereon; and
- Recognise interest income on the lease receivable in capacity as finance lessor.

Operating leases

- Retain the right-of-use asset in capacity as lessee and continue to recognise depreciation thereon
- Retain the lease liability in capacity as lessee and continue to recognise interest expense thereon
- Recognise lease income from the sub-lease in capacity as operating lessor

* A lessor uses the interest rate implicit in the lease to measure the net investment in the sublease. If the interest rate implicit in the sublease cannot be readily determined, the intermediate lessor may use the discount rate used for the head lease, adjusted for any initial direct costs associated with the sublease.

8.4 Impairment of lease receivables

As required by IFRS 9.2.b(i), finance lease receivables (i.e. net investments in finance leases) and operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements of IFRS 9.

Specific to operating type leases, amounts recognised in the statement of financial position relating to leases may include:

Balance arising from operating lease requirements	Assessment (all 'yes' responses means the IRE applies)
Amounts currently receivable (e.g. CU100 of rent due for a period in accordance with the terms of the lease contract).	Within the scope of IFRS 9's ECL requirements, as these are lease receivables. The lessor has an unconditional right to collect these contractual cash flows.
Assets that arise from the 'smoothing' of operating lease income due to variability in the periodic cash payments. For example, if the timing of cash payments in an operating lease is deferred (e.g. an initial 6 months 'rent-free period'), then an asset will be recorded during that period, despite cash not being contractually due until a later period (e.g. DR asset, CR operating lease income during the rent-free period). For example, if a lessor offers a 6 month rent-free period, and as at the reporting date, 2 months have elapsed, the lessor will have recognised an asset due to the recognition of operating lease income over these 2 months, however, the lessor has no unconditional right to collect cash from the lessee at that reporting date.	The term 'operating lease receivables' is not defined in IFRS Accounting Standards. IFRS 16 refers to prepaid or accrued lease payments, however, these terms are not defined in IFRS 16. In October 2022, the IFRS Interpretations Committee (the Committee) issued an agenda decision on lessor forgiveness of lease payments. The agenda decision addressed a request about a lessor's application of IFRS 9 and IFRS 16 in accounting for a particular rent concession. In relation to a question on applying the lease modification requirements in IFRS 16, the Committee observed that lease payments contractually due from the lessee that the lessor has recognised as an operating lease receivable are not accrued lease payments. Therefore, in substance, the Committee has made a distinction between operating lease receivables, which are the amounts contractually due and accrued lease payments, which may be assets recognised due to 'smoothing' of operating lease income. The derecognition and impairment requirements in IFRS 9 are applicable to the operating lease receivables. However, it is not clear whether impairment requirements in IFRS 9 apply to accrued lease payments, as lessors do not have an unconditional right to collect cash flows relating to these assets at the reporting date (subject to any credit terms), which is a fundamental characteristic of a financial asset.
Assets that arise from the 'smoothing' of operating lease income due to up-front payments from lessors to lessees. For example, a lessor may offer a lessee an allowance for signage or leasehold improvements at the commencement of a lease, which is recorded as an asset (DR lease incentive asset, CR cash) and reduces operating lease income over the lease term.	

IFRS 9 permits an accounting policy choice for lessors in how they account for ECL relating to lease receivables. This accounting policy choice may be made separately for operating and finance lease receivables.

A lessor may choose to:

(a) Recognise ECL in accordance with IFRS 9's 'default' ECL requirements, which requires the recognition of either a 12-month or lifetime ECL depending on whether the receivable's credit risk has increased significantly since initial recognition; or

(b) Always recognise lifetime ECL.

Always recognising lifetime ECL means that lessors do not need to track the change in credit risk of lease receivables, which simplifies measurement, and in many cases, 12-month and lifetime ECL may result in the same figure for short-term receivables, such as many operating lease receivables.

In measuring ECL, lessors must estimate the credit losses as the difference between:

(a) All contractual cash flows that are due to the entity in accordance with the contract; and

(b) All the cash flows that the entity expects to receive (i.e. the cash shortfalls), discounted at the original effective interest rate.

In many cases, the effective interest rate of an operating lease receivable will be zero, as most operating lease receivables are short-term in nature and do not accrue interest.

In estimating the cash shortfalls, lessors must consider how they expect both their own actions and actions taken by lessees will affect the cash flows to be received by the lessor. For example, if a lessor expects that it will enter into concessions with lessees (e.g. reductions in rent), then this should be considered in estimating the cash shortfalls. (Refer section 8.6.2 for IFRS Interpretations Committee Agenda Decision *Lessor Forgiveness of Lease Payments*)

Section 8.6.2

This means that, despite a concession not being effective as at the date that a lessor measures ECL, the lessor must consider the actions it expects to take, and the effect of those actions on cash flows. For example, the cash flows a lessor would receive will differ depending on whether a lessor exercises a right that it may have to evict a tenant due to delinquency in payment versus the cash flows a lessor would receive if it entered into a rent concession to increase the chances that a lessee will remain economically viable in the long-term.

ECL is an 'expected value', meaning that it considers multiple potential scenarios, therefore, a lessor might probability-weight the likelihood that it will enter into lease concessions or take other actions that will affect the cash shortfalls.

8.5 Common issues arising when accounting for operating leases

8.5.1 Accounting for operating leases in case of restricted access to underlying assets

- *Basis of recognition of operating lease income:*

Sometimes, lessors restrict access to the underlying assets. For example, during the COVID-19 pandemic, lessors were required to restrict access to the underlying assets (e.g. real estate, offices, retail locations etc.) due to restriction imposed by governments. In such circumstances, a question arises whether the lessors can change the basis over which they recognise operating lease income.

IFRS 16.81 states that:

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

Lessors will have developed an accounting policy for leases prior to the restrictions being imposed, for example due to COVID-19. In practice, most operating lease income is recognised on a straight-line basis, as this generally represents the pattern in which benefit from the use of the underlying asset is diminished. It is rare that another basis of recognition is more representative.

For a lessor to change its accounting policy, it would have to satisfy the requirements of IAS 8.14(b), which requires that a change in accounting policy that is not required by an IFRS must 'results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.'

Rarely would a change in the pattern of recognition of operating lease income due to restrictions such as those during COVID-19 satisfy this requirement. For example, suspending the recognition of operating lease income because the underlying asset's availability to the lessee has been diminished due to government imposed lockdown would generally not better represent the pattern in which the benefit from the use of the underlying asset is diminished. This is because the lessee still has the right to direct use of the asset based on the lease contract during a period of lockdown or restriction; those rights are simply modified by changes in local law or regulation.

- *Basis of depreciation of the underlying asset*

Another issue that arises in case of restriction of access to underlying assets is whether the lessor can suspend or modify the basis for depreciating the underlying asset (e.g. a building when tenants are not permitted to access it due to government lockdown).

Generally, IAS 16.50 requires the depreciable amount of an asset to be allocated on a systematic basis over its useful life. IAS 16.55 requires that (emphasis added):

> *…Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognised. Therefore,* ***depreciation does not cease when the asset becomes idle*** *or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero when there is no production.*

Therefore, the use of an underlying asset, such as a building, being diminished due to restriction of access (e.g. during the COVID-19 pandemic) does not justify or result in the cessation of depreciation.

8.6 Lease Modifications

The accounting for lease modifications depends on whether the lease is classified as a finance lease or an operating lease from the lessor's perspective immediately prior to the modification.

8.6.1 Finance Leases

Modifications - Separate Leases

A finance lessor needs to consider the same criteria as the lessee when the contract is modified. Therefore, a modification to a lease classified as a finance lease is accounted for as a separate lease if both:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

If both criteria are met, a lessor would follow the lessor guidance on recognition and measurement of that separate lease.

Modifications – Not Separate Leases

If a modification to a finance lease does not meet both of the above criteria, the lessor follows the following guidance:

Applying the modified contract from inception, the lease would have been classified as an operating lease	All other lease modifications
• Account for the lease modification as a new lease from the effective date of the modification; and • Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.	• Apply the requirements of IFRS 9 *Financial Instruments*.

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

8.6.2 Operating Leases

Any modification to a lease contract that was classified as an operating lease results in the modified contract being accounted for as a new lease from the date of modification. Any debtor or deferred rental income that is on balance sheet in respect of the original lease at the modification date is considered to be part of the lease payments for the new lease.

Therefore, if the modified lease contract is also classified as an operating lease, no adjustment is made to the carrying value of the leased asset, although the period over which it is depreciated may change. The period over which any previously recognised debtor (relating to accrued rents received) is settled or deferred income (relating to rents received in advance) released to the income statement may also change.

If the modified lease contract is classified as a finance lease, then the asset being leased is derecognised and a receivable recognised instead equal to the net investment in the lease.

Change in consideration which is not a lease modification

In some cases, there may be a change in consideration which is not a lease modification. In such cases, the lessor would account for these payments as if they were part of the original terms and conditions of the lease. IFRS 16 does not contain specific requirements for how a lessor recognises the effect of variable lease payments, however, IFRS 16.90(b) requires disclosure of 'income relating to variable lease payments that do not depend on an index or rate', implying that such payments are included in profit or loss, similar to the requirement for lessees.

Therefore, lessors will generally reflect variable lease payments that do not depend on an index or rate in profit or loss in the period in which the event or condition that triggers those payments occurs.

For example, lessee and lessor enter into a contract for the lease of retail space for a lease term of five years, with lease payments of CU100 per month. The original lease contract contains a clause that if the shopping centre is shut down due to government-imposed intervention, then the lessee will receive a 75% discount on lease payments for as long as the shopping centre remains closed. Subsequently, government restricts access to the shopping centre on account of the COVID-19 pandemic. As a result, the lessee receives a 75% discount on lease payments during the period of closure of the shopping centre. This is not a lease modification because the change in consideration results from the original terms and condition of the lease. The lessor would reflect the reduction in operating lease income in each of the periods where the reduction is triggered by the shopping centre remaining closed. Therefore, if monthly operating income would have otherwise been CU100 per month, the lessor would record CU25 (CU100 – 75% reduction) of operating lease income.

IFRS Interpretations Committee Agenda Decision Lessor Forgiveness of Lease Payments

In October 2022, the IFRS Interpretation Committee (the Committee) issued an Agenda Decision *Lessor Forgiveness of Lease Payments* that addressed questions on accounting for rent concessions granted by a lessor in an operating lease receivable. The request asked how the lessor applies the expected credit loss model in IFRS 9 and whether the lessor applies the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 in accounting for the rent concession.

IFRS Interpretations Committee agenda decision – Lessor Forgiveness of Lease Payments

At its October 2022 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of a question it had received about accounting for a rent concession.

The request described a rent concession granted by the lessor in a lease classified as an operating lease applying IFRS 16.

In the fact pattern, the lessor legally releases the lessee from its obligation to make specifically identified lease payments, some of which are amounts contractually due but not paid, which are recognised as operating lease receivable and some are not yet contractually due. No other changes are made to the lease contract. Before the date the rent concession is granted, the lessor applies the expected credit loss model in IFRS 9 to the operating lease receivable.

The request asked:

a. how the lessor applies the expected credit loss model in IFRS 9 to the operating lease receivable before the rent concession is granted if it expects to forgive payments due from the lessee under the lease contract; and

b. whether the lessor applies the derecognition requirements in IFRS 9 or the lease modification requirements in IFRS 16 in accounting for the rent concession.

Applying the expected credit loss model in IFRS 9 to the operating lease receivable

IFRS 9.2.1(b)(i) states that 'operating lease receivables recognised by a lessor are subject to the derecognition and impairment requirements' in IFRS 9.

IFRS 9 defines credit loss as 'the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls)…'. IFRS 9.5.5.17 states that 'an entity shall measure expected credit losses … in a way that reflects (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes; (b) the time value of money; and (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions'.

Considering these requirements, the Committee noted that in the fact pattern described in the request, the lessor applies the impairment requirements in IFRS 9 to the operating lease receivable. The lessor estimates expected credit losses on the operating lease receivable by measuring any credit loss to reflect 'all cash shortfalls'. These shortfalls are the difference between:

a. all contractual cash flows due to the lessor in accordance with the lease contract (and included in the gross carrying amount of the operating lease receivable); and

b. all the cash flows the lessor expects to receive, determined using 'reasonable and supportable information' about 'past events, current conditions and forecasts of future economic conditions'.

This measurement of expected credit losses includes the lessor considering its expectations of forgiving lease payments recognised as part of that receivable.

Accounting for the rent concession—IFRS 9 and IFRS 16

Applying the derecognition requirements in IFRS 9 to the operating lease receivable

IFRS 9.2.1(b)(i) states that operating lease receivables recognised by a lessor are subject to the derecognition requirements in IFRS 9.

On granting the rent concession, the lessor's contractual rights to the cash flows from the operating lease receivable expire. Therefore, derecognition requirements in IFRS 9.3.2.3(a) are met. Therefore, on the date the rent concession is granted, the lessor remeasures expected credit losses on the operating lease receivable (and recognises any change to the expected credit loss allowance in profit or loss) and derecognises the operating lease receivable (and associated expected credit loss allowance).

Applying the lease modification requirements in IFRS 16 to future lease payments under the lease

The rent concession is 'a change in … the consideration for a lease … that was not part of the original terms and conditions of the lease'. Therefore, applying IFRS 16.87, the lessor accounts for the modified lease as a new lease from the date the rent concession is granted.

IFRS 16.87 requires a lessor to consider any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. The Committee observed that lease payments contractually due from the lessee that the lessor has recognised as an operating lease receivable are not accrued lease payments. Consequently, neither those lease payments nor their forgiveness are considered as part of the lease payments for the new lease.

In accounting for the modified lease as a new lease, a lessor applies IFRS 16.81 and recognises the lease payments (including any prepaid or accrued lease payments relating to the original lease) as income on either a straight-line basis or another systematic basis.

The Committee concluded that the lessor accounts for the rent concession described in the request on the date it is granted by applying:

(a) the derecognition requirements in IFRS 9 to forgiven lease payments that the lessor has recognised as an operating lease receivable; and

(b) the lease modification requirements in IFRS 16 to forgiven lease payments that the lessor has not recognised as an operating lease receivable.

Example 8.6.2-1 – Change in operating lease payments relating to future periods

Lessor entered into a lease with lessee on 1 January 2019 for a lease term of five years. Monthly operating lease payments are CU100 per month (CU100 * 60 months = CU6,000 total consideration).

On 1 May 2020, lessor agrees to reduce May – December 2020 rent to CU50 due to the effects of the pandemic. Therefore, remaining revised consideration is CU4,000 (CU50 * 8 months in 2020 + CU100 * 36 months from 2021 – 2023).

Assessment

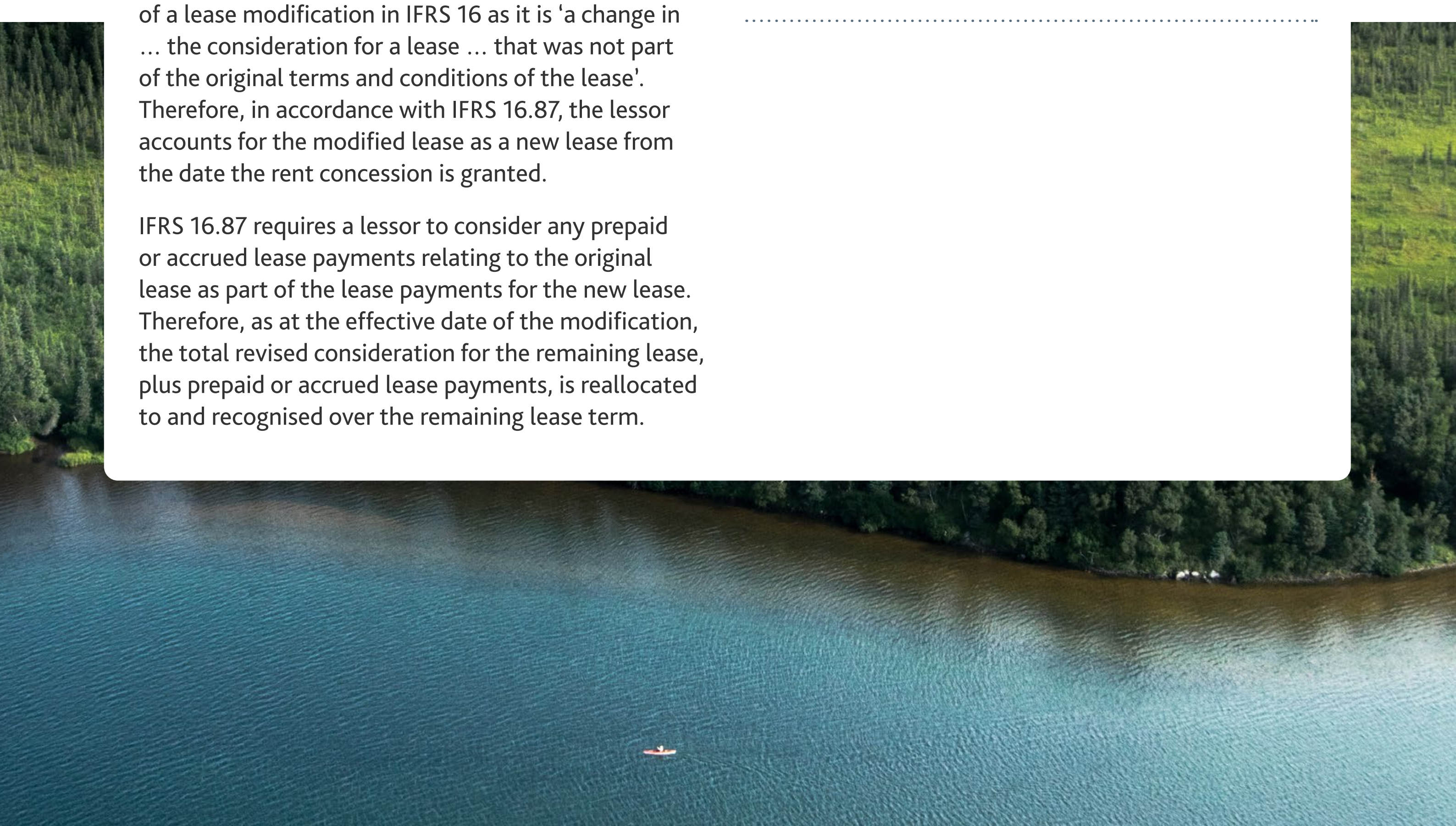
The rent concession in this case meets the definition of a lease modification in IFRS 16 as it is 'a change in … the consideration for a lease … that was not part of the original terms and conditions of the lease'. Therefore, in accordance with IFRS 16.87, the lessor accounts for the modified lease as a new lease from the date the rent concession is granted.

IFRS 16.87 requires a lessor to consider any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. Therefore, as at the effective date of the modification, the total revised consideration for the remaining lease, plus prepaid or accrued lease payments, is reallocated to and recognised over the remaining lease term.

From 1 May 2020 onward, lessor recognises CU4,000 / 44 months = CU90.90 per month as operating lease income.

For example, to accrue May 2020 operating lease income, lessor records (assuming Lessee pays in advance):

DR cash	50 (equal to revised consideration for May – December 2020)
DR lease receivable	40.90 (difference between operating lease income and cash)
CR operating lease income	90.90 (operating lease income, as calculated above)



Accounting for unamortised lease incentives as at the time of the lease modification and on a go forward basis

Lessors may provide lease incentives to lessees, often at the commencement of a new lease. For example, allowances for leasehold improvements, reimbursements of certain costs, etc. Included in the definition of 'lease payments' is that they include fixed payments less any 'lease incentives', therefore, when a lessor recognises operating lease income in accordance with IFRS 16.81, the effect of these lease incentives are typically spread over the lease term.

For example, if a lessor provides a lessee with CU500 in cash to make leasehold improvements at the commencement of a lease, the lessor will account for the payment as an asset (e.g. DR asset, CR cash) and amortise that asset as an adjustment of operating lease income over the lease term. As IFRS 16.87 requires lease modifications to operating leases to be accounted for as 'new leases' as at the effective date of the modification, the question arises as to how these assets recorded as at the commencement of the original lease should be accounted for in the 'new lease'.

In our view, these assets should be included in the calculation of operating lease income in the 'new lease'. That is, the assets should continue to amortise over the lease term of the new lease. This is because IFRS 16.87 states (emphasis added):

> *A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, **considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease**.*

The asset recorded relating to lease incentives may be considered as a 'prepaid lease payment', as a lease incentive is an adjustment in the total consideration for the lease.

Accounting for a change in the timing of lease payments when the nominal cash flows are unchanged

Generally, when a lessor determines how to recognise operating lease income over the lease term, the resulting calculation does not reflect the time value of money.

If a lessor grants a rent concession that affects the timing of payments, but not the nominal cash flows, and the concession is a lease modification, then the change in timing will not result in a change in operating lease income. This is because, as noted above, the allocation of total consideration to the discrete periods in the lease term does not generally consider the time value of money.

Example 8.6.2-2 – Change in timing of lease payments when the nominal cash flows are unchanged

Lessor enters into a lease with lessee on 1 January 20X1 for a lease term of three years. The operating lease payments for the first year are CU1,100 per month and they increase by CU100 every year.

In April 20X2, due to financial difficulties, the lessee requests for a deferral of lease payments. The lessor provides for a deferral of April-June 20X2 lease payments. These will be amortised 1/12th per month from July 20X2-June 20X3.

Assessment

As required by IFRS 16.81, the lessor recognises operating lease income on a straight-line basis over the lease term. The monthly operating lease income to be recognised is calculated as below:

((CU1,100 * 12 months in 20X1) + (CU1,200 * 12 months in 20X2) + (CU1,300 * 12 months in 20X3))/36

= CU1,200

The operating lease income recognised from January 20X1 to March 20X2 is CU18,000 (CU1,200 * 15 months).

The total operating lease payment for this period is as below:

((CU1,100 * 12 months in 20X1) + (CU1,200 * 3 months January-March 20X2)

= CU16,800

Therefore, the accrued lease payment recognised as on 31 March 20X2 is CU1,200 (i.e. CU18,000 less CU16,800).

Deferring April – June 20X2 rent and amortising it 1/12th per month from July 20X2 – June 20X3 would not result in a change in operating lease income recognised on a monthly basis.

The monthly operating lease income from the period April 20X2-December 20X3 is calculated as below:

((CU0 * 3 months April-June 20X2) + (CU1,300 * 6 months July-December 20X2) +

(CU1,400 * 6 months January- June 20X3) + (CU1,300 * 6 months July-December 20X3) +

(Accrued lease payments of CU1,200)) / 21

= CU1,200

Thus, the monthly operating lease income remains the same after rent deferral.

The deferral may affect the ECL recorded by the lessor, as allowing the lessee additional time to pay the total consideration may reduce total credit losses.

8.7 Disclosure Requirements

Disclosure requirements for lessors are summarised as follows:

Quantitative Disclosure Requirements

Finance leases

- Selling profit or loss;
- Finance income on the net investment;
- Income from variable lease payments;
- Qualitative and quantitative explanation of changes in the net investment; and
- Maturity analysis of lease payments receivable, on an undiscounted basis for a minimum of each of the first five years and a total of the amounts for the remaining years, alongwith reconciliation of undiscounted lease payments to the net investment in the lease.

Operating leases

- Lease income, separately disclosing variable lease payments;
- Disclosure requirements of IAS 16 for leased assets, separating leased assets from non-leased assets;
- Other applicable disclosure requirements based on the nature of the underlying asset (eg. IAS 36, 38, 40, 41); and
- Maturity analysis of lease payments, on an undiscounted basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

The standard requires the quantitative disclosures to be presented in a tabular format, unless another format is more appropriate.

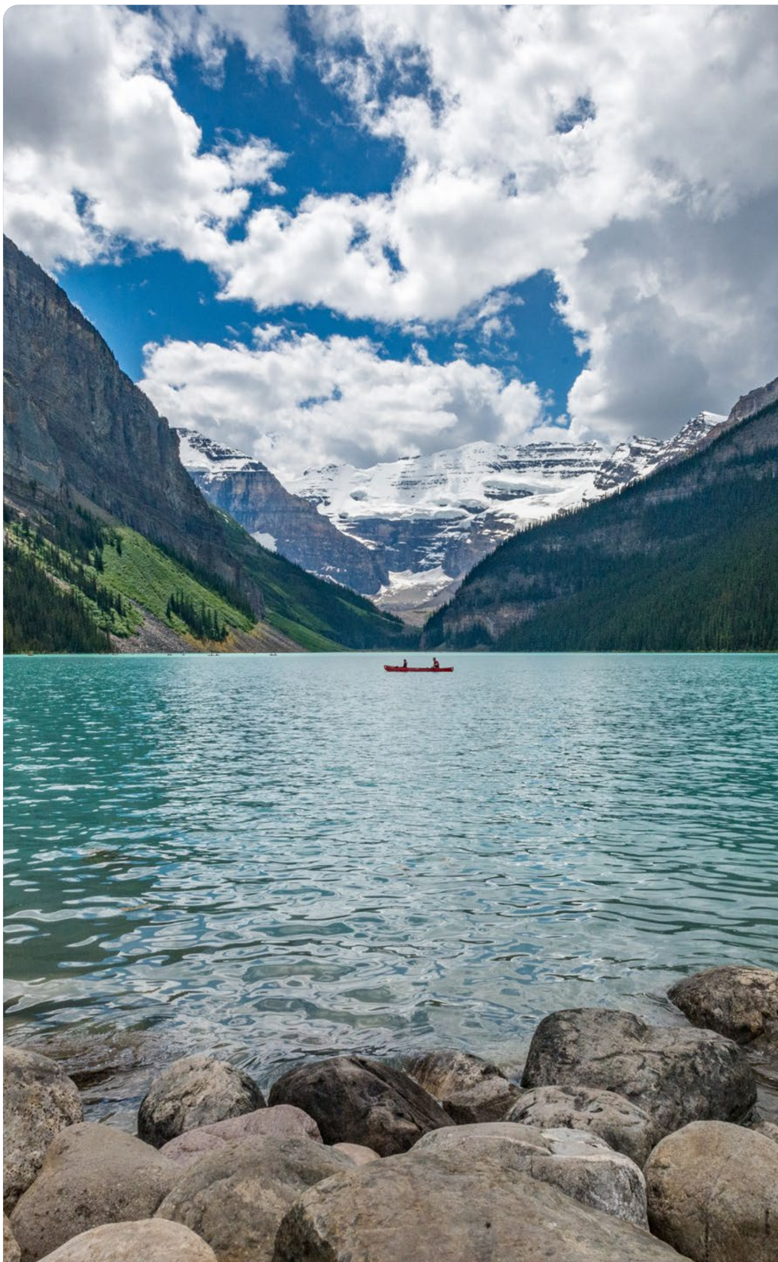
Qualitative Disclosure Requirements

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

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

- buy-back agreements;
- residual value guarantees;
- variable lease payments for excess use; and
- any other risk management strategies.

Refer BDO's Illustrative IFRS Financial Statements here for illustrative disclosures.



9. SALE-AND-LEASEBACK TRANSACTIONS

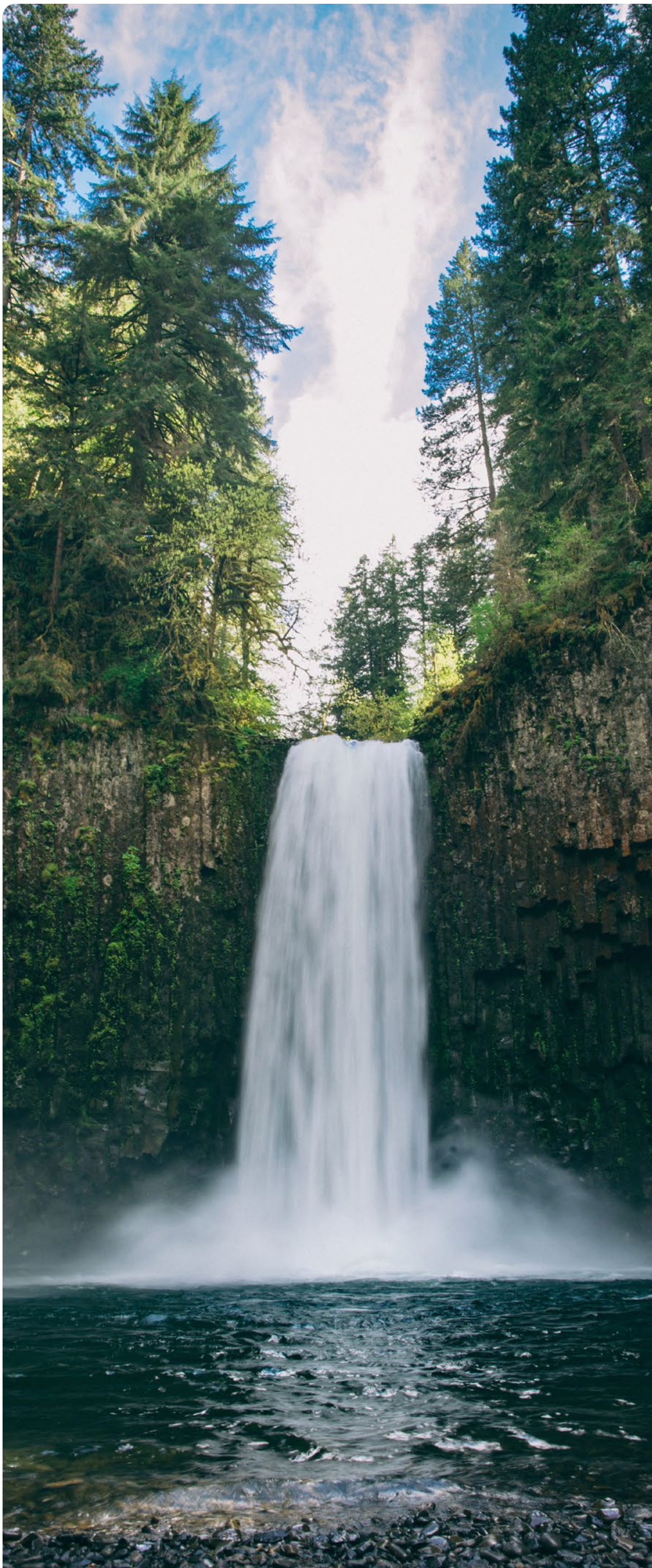
In a sale-and-leaseback transaction ('SALT'), an entity (seller-lessee) sells an asset to another entity (buyer-lessor) who then leases it back to the seller-lessee. The seller-lessee can thereby immediately receive liquid funds from the buyer-lessor and still keep its right to use the asset sold through the leaseback side of the contract. Often the fair value of the asset is greater than its book value, and so entering into a SALT can result in an accounting profit being recognised.

In order to determine the appropriate accounting treatment under IFRS 16, the sale must first be assessed as to whether it qualifies as a sale in accordance with the requirements of IFRS 15 (please refer to BDO's IFRS In Practice publication on IFRS 15).

BDO comment

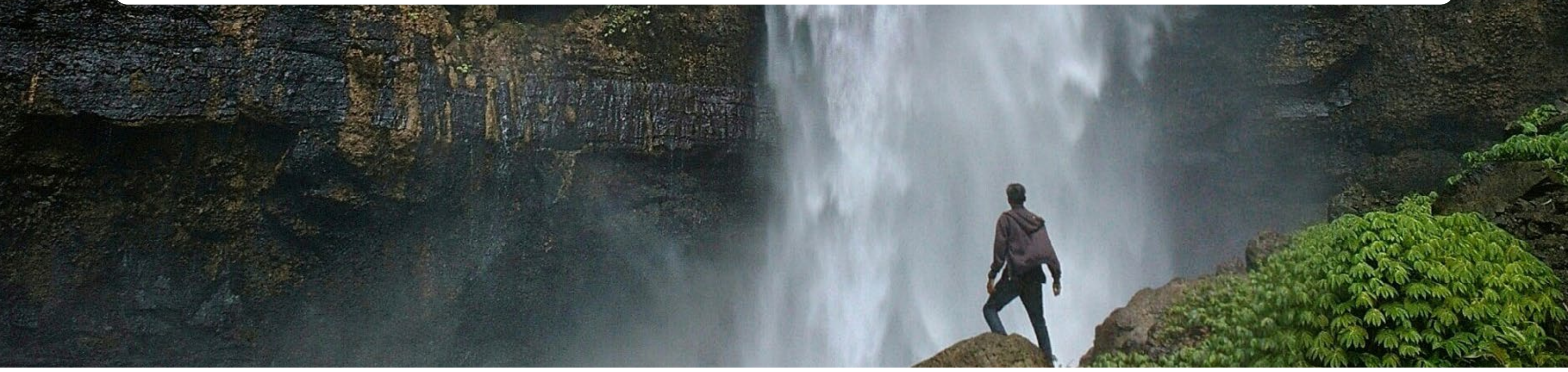
If the underlying lease in a SALT would be classified as a finance lease by the buyer-lessor, it is unlikely that the transaction would satisfy the conditions in IFRS 15 (i.e. it is likely that control would not have passed). However, the indicators used to assess whether a lease is operating or finance focuses on risks and rewards rather than control (which is the criterion in IFRS 15).

Despite this distinction, it would be unusual for a SALT to satisfy the control criteria in IFRS 15 if the resulting lease transferred substantially all of the risks and rewards to the seller-lessee. However, in very limited circumstances a transaction may satisfy the control criteria in IFRS 15, but nonetheless be classified as a finance lease (for example, in a situation where the lease is classified as a finance lease due to the underlying asset being of a highly specialised nature (IFRS 16.63(e))).



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

If the sale side of the transaction does qualify as a sale under IFRS 15, it is necessary to consider whether the sales price as stated in the contract is equal to the asset's fair value. In an arm's length transaction it is highly likely that the totality of the sale and leaseback transaction is on-market. However, this does not prevent the consideration received on the sale side of the contract being off market, with compensating off-market lease payments on the leaseback side of the transaction. Therefore, IFRS 16 requires the profit or loss on the sale side of the transaction from the lessee's perspective (and initial measurement of the asset purchased from the lessor's perspective) to be determined by reference to the fair value of the asset, not the stated contractual sale price. Consequently, lessees need to determine the fair value of the asset in order to ensure they recognise the correct profit or loss on sale (as do lessors for the purposes of accounting for the cost of the asset) rather than assuming the asset's fair value equals the stated contractual sales price.



BDO comment

In determining the fair value of an asset in a SALT, there is uncertainty as to which of the requirements in IFRS a seller/lessee should follow in determining that fair value. While IFRS 13, *Fair Value Measurement* is typically the standard that provides guidance on the determination of fair value, IFRS 13.6(b) scopes out leasing transactions accounted for in accordance with IFRS 16. Fair value is defined in IFRS 16 itself, however, the definition of fair value in IFRS 16 is prefaced with 'for the purpose of applying the lessor accounting requirements in this Standard…'. Therefore, it is unclear which definition of fair value a seller/lessee should apply when applying the SALT guidance in IFRS 16.

In our view, since IFRS 16 refers to IFRS 15, *Revenue from Contracts with Customers* in determining whether the transfer of an asset is accounted for as a sale, and IFRS 15 is included in the scope of IFRS 13 for fair value measurement, a lessee should refer to IFRS 13 in applying the SALT guidance in IFRS 16.

If it is determined that the fair value of the asset is less than or greater than the contractual sales price, then the difference is accounted for by the lessee as additional borrowing or a prepayment, respectively. Similarly, the lessor accounts for the difference as rents receivable or deferred rental income, respectively, (if the leaseback is classified as an operating lease) or an adjustment to the finance lease receivable (if the leaseback is classified as a finance lease).

In some cases, it may be easier to compare the contractual leaseback rentals to market rentals rather than the contractual sales price to the fair value of the leased asset, in which case the standard also permits this approach when determining whether both sides of the SALT transaction are at open market rates.

As a further complication in the calculation of the lessee's profit or loss on disposal, it needs to be remembered that a seller-lessee does not transfer control of the whole asset to the buyer-lessor, because it continues to control the same asset during the leaseback period. It is only losing control of the asset subsequent to the leaseback period. Therefore, the seller-lessee's profit or loss on disposal will not simply be equal to the fair value of the asset less its carrying amount. Instead, it is the amount of consideration attributable to the portion of the asset for which control has passed to the buyer-lessor (i.e. monies received which do not have to be paid back to the lessor over the leaseback period) less the portion of the asset's carrying amount attributable to the period after the end of the leaseback and for which control has passed to the buyer-lessor.

Example 9-1 – Sale-and-leaseback transaction where transfer is a sale (lessee)

A seller-lessee enters into a sale and leaseback transaction whereby it sells a property to a buyer-lessor for CU2,000,000. Simultaneously, the seller-lessee leases the property back from the buyer-lessor for a period of 18 years with annual lease payments at the end of each year of CU120,000. The sale meets the criteria of IFRS 15 to be accounted for as a sale. There are no initial direct costs in the transaction. Before the transaction occurs, the property has a carrying value of CU1,000,000.

The fair value of the property at the time of sale is CU1,800,000. Since the consideration does not equal fair value, adjustments must be made to determine any gain or loss arising by reference to the asset's fair value. The excess consideration of CU200,000 (CU2,000,000 – CU1,800,000) is therefore accounted for as additional financing provided by the buyer-lessor to the seller-lessee, not consideration on the sale side of the transaction.

The discount rate is 4.5% per annum determined by reference to the seller-lessee's incremental borrowing rate as the rate inherent in the lease is not readily determinable. The present value of the annual leaseback payments (18 payments of CU120,000, 4.5% discount per annum) is CU1,459,200.

Assessment

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

DR Cash	2,000,000[1]
DR Right-of-use asset	699,555[2]
CR PPE (the property sold)	1,000,000[3]
CR Lease liability	1,259,200[4]
CR Financial liability	200,000[5]
CR Gain on rights transferred	240,355[6]

1. Total cash received from the buyer-lessor.

2. The retained right-of-use of the asset sold is measured by reference to the previous carrying value of the property. The fair value of the property is 1,800,000, whilst the fair value of the leaseback rental is 1,259,000 (i.e. 200,000 less than the repayments that the lessee is required to make). Therefore, the cost of the property for which control has not passed to the buyer-lessor = 1,000,000 x 1,259,000/1,800,000 = 699,355.

3. The previous carrying value of the property is derecognised.

4. Present value of future lease payments is CU1,459,200 (CU120,000 per year for 18 years, 4.5% annual discount). This includes the difference between the consideration received and the fair value of the property of CU200,000 (CU2,000,000 – CU1,800,000), which is recognised as financial liability. Remaining present value of future lease payments is CU1,259,200. In other words, had proceeds on sale been on-market at CU1,800,000, then the present value of the leaseback payments would only have been CU1,259,000. The proceeds above market on the sale side of the transaction are therefore treated as additional financing.

5. The excess consideration of CU200,000 is recognised as additional financing provided by the buyer-lessor to the seller-lessee.

6. The gain on sale is the balancing entry in the transaction, but can be reconciled as follows:

Gain = Proceeds attributable to the portion of the asset for which control is transferred

LESS

Carrying value of the portion of the asset for which control is transferred

Proceeds attributable to the portion of the asset being disposed for which control is transferred:

= Total proceeds less total amount of financing received

= CU2,000,000 – CU1,459,200

= CU540,800

Carrying value of the portion of the asset being sold for which control is transferred:

= Carrying value less right-of-use asset retained

= CU1,000,000 – CU699,555

= CU300,445

Therefore gain on disposal

= CU540,800 – CU300,445

= CU240,355

BDO comment

SALTs are common for transactions involving real estate. Due to the lessee having to exclude from the calculation of profit on disposal the total consideration attributable to the financing received, the accounting required by IFRS 16 will typically result in smaller gains on disposal when recognising the sale side of the transaction.

It should be noted that the carrying value of the asset being sold and leased back must be at its appropriate carrying amount following the application of other IFRS Accounting Standards prior to the SALT. For example, if land had a carrying value of CU100,000 immediately prior to a SALT, where the sales price (at the fair value of the land) was CU90,000, the seller would have to apply IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations* prior to accounting for SALT. Applying IFRS 5.15, the seller would measure the land at the lower of its carrying amount and fair value less costs to sell. As the SALT is about to take place, the lower of carrying amount (CU100,000) and fair value less costs to sell (CU90,000 from the SALT) is CU90,000, therefore, the land should be written down prior to the SALT accounting.

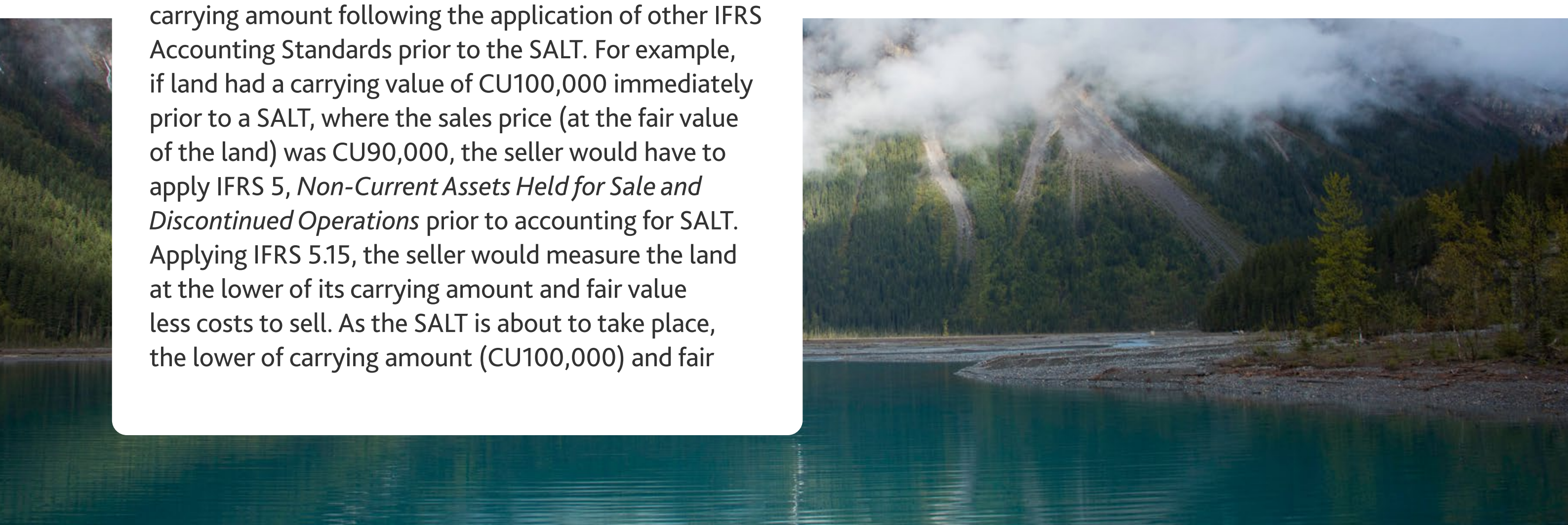
Subsequent measurement of lease liability in a SALT

The initial measurement of the lease liability that arises from a SALT is a consequence of how the seller-lessee measures the right-of-use asset and the gain or loss recognised at the date of the transaction. The seller-lessee is required to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee recognises only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor. However, IFRS 16 does not prescribe a methodology for determining the proportion of the carrying amount of the asset that relates to the right of use retained by the seller-lessee.

IFRS 16 Appendix A defines ‘lease payments’ that are to be included in the measurement of lease liabilities. The lease payments as defined in Appendix A exclude variable lease payments that do not depend on an index or rate (e.g. payments that depend on a percentage of revenue derived from the asset’s use).

Following the definition of ‘lease payments’ in Appendix A, in case of a SALT involving variable payments that do not depend on an index or rate, while measuring the lease liability, the seller-lessee would exclude variable payments that do not depend on an index or rate. This measurement of lease liability may result in recognition of gain on the right-of-use retained by the seller-lessee, as the SALT would generally be economically structured considering the expected lease payments, including the variable lease payments.

This issue was highlighted in an agenda decision by the IFRS Interpretations Committee from June 2020.



IFRS Interpretations Committee agenda decision - Sale and Leaseback with Variable Payments

At its June 2020 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of a question it had received about a sale and leaseback transaction with variable payments.

The request described a sale and leaseback transaction where payments for the lease include variable payments that do not depend on an index or rate. The variable payments were determined to be not in-substance fixed payments as described in IFRS 16.

The request asked how the seller-lessee measures the right-of-use asset arising from the leaseback, and thus determines the amount of any gain or loss recognised at the date of the transaction.

As noted by the Committee in the agenda decision, IFRS 16 does not prescribe a method for determining the proportion of the asset transferred (commonly property, plant equipment – PPE) to the buyer-lessor that relates to the right-of-use retained.

The Committee observed that in the transaction described in the request the seller-lessee could determine the proportion by comparing, for example, (a) the present value of expected payments for the lease (including those that are variable), with (b) the fair value of the PPE at the date of the transaction. The amount of the gain or loss recognised relates only to the rights transferred to the buyer-lessor. The Committee further clarified that the seller-lessee also recognises a liability at the date of the transaction, even if all the payments for the lease are variable and do not depend on an index or rate.

The Committee concluded that IFRS 16 provides an adequate basis for a seller-lessee to determine the accounting for the sale and leaseback transaction at the date of the transaction.

At the Tentative Agenda Decision stage for the above agenda decision, the Committee recommended that the IASB amend IFRS 16 to specify how the seller-lessee applies IFRS 16's subsequent measurement requirements to the lease liability that arises in the sale and leaseback transaction. This is because IFRS 16's subsequent measurement requirements would result in variable lease payments being recognised in profit or loss in the period in which the event or condition that triggers those payments occur, which would be inconsistent with the fact that the Agenda Decision would require all lease payments to be included in the initial measurement of the lease liability arising from a sale and leaseback transaction.

In September 2022, the IASB amended IFRS 16. The amendments insert paragraph 102A in IFRS 16 which states:

> *After the commencement date, the seller-lessee shall apply paragraphs 29–35 to the right-of-use asset arising from the leaseback and paragraphs 36–46 to the lease liability arising from the leaseback. In applying paragraphs 36–46, the seller-lessee shall determine 'lease payments' or 'revised lease payments' in a way that the seller-lessee would not recognise any amount of the gain or loss that relates to the right of use retained by the seller-lessee. Applying the requirements in this paragraph does not prevent the seller-lessee from recognising in profit or loss any gain or loss relating to the partial or full termination of a lease as required by paragraph 46(a).*

These amendments create an exception to the definition of 'lease payments' applicable for other than SALT, by requiring the seller-lessee to determine 'lease payments' or 'revised lease payments' in a way that the seller-lessee would not recognise any amount of the gain or loss that relates to the right of use retained by the seller-lessee.

It should be noted that the amendments do not prescribe specific measurement requirements for lease liabilities arising from a sale and leaseback.

Refer to the illustrations below, which illustrate approaches that may be followed by the seller-lessee. The seller-lessee may apply other methodologies to determined lease payments subject to the requirements of the Amendments i.e. the seller-lessee would not recognise any amount of the gain or loss that relates to the right of use retained by the seller-lessee.

Example 9-2 – Sale-and-leaseback transaction with variable payments

Fact pattern:

On 1 January 20X1, Entity A (seller-lessee) sells a piece of machinery to Entity B (buyer-lessor) for consideration of CU2,500,000, which is the fair value of the machinery at the date of sale.

The carrying value of the machinery immediately before the sale is CU2,000,000.

At the same time as the sale transaction, the seller-lessee enters into a lease contract with the buyer-lessor for use of the machinery, for a period of five years. Lease payments consist of fixed payments of CU50,000 per annum and variable payments at 3% of the revenue generated from the use of the machinery. The variable payments are determined to be not in-substance fixed payments.

The transfer of the machinery satisfies the requirements of IFRS 15 *Revenue from Contracts with Customers* to be accounted for as a sale.

Accordingly, seller-lessee accounts for the transaction as a sale and leaseback.

The interest rate implicit in the lease cannot be readily determined. Seller-lessee's

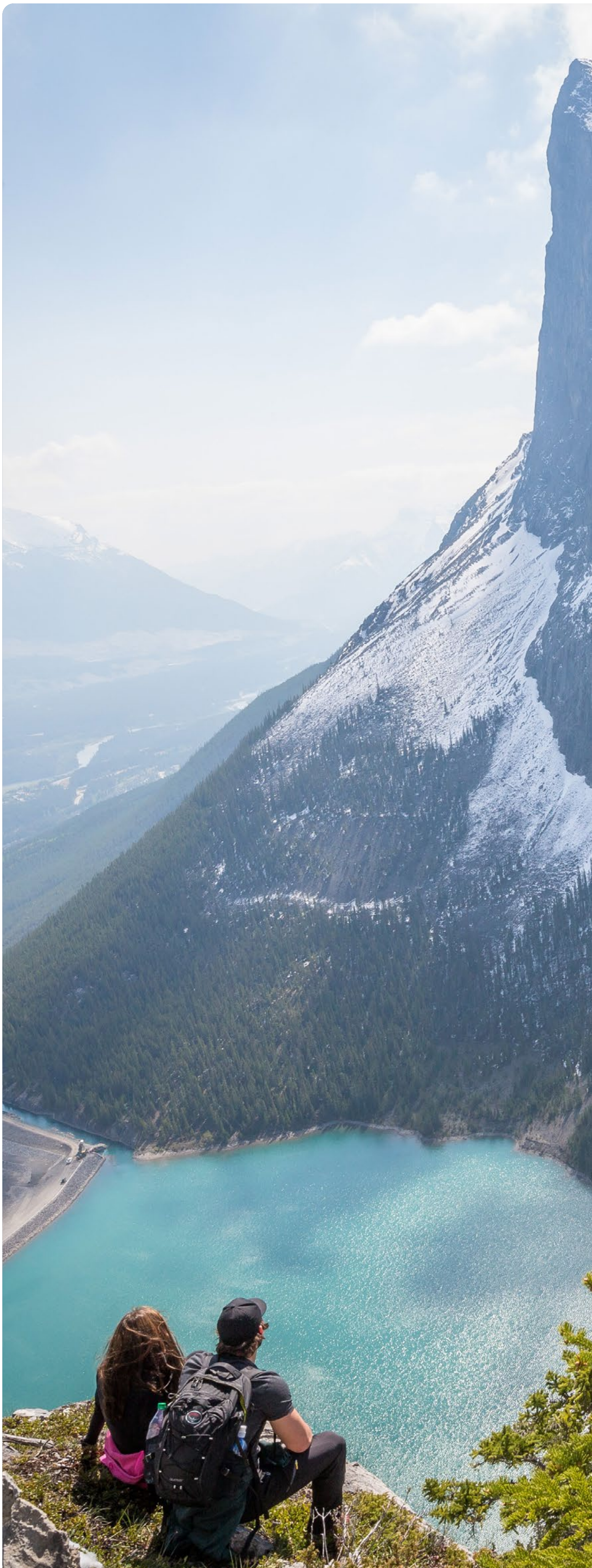
incremental borrowing rate is 4%.

The seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term.

Scenario 1:

At the commencement of the leaseback, the seller-lessee is able to estimate the revenue for the period of the lease. The estimated revenue at lease commencement is as below:

Year	Revenue (CU)
20X1	1,500,000
20X2	1,600,000
20X3	1,650,000
20X4	1,700,000
20X5	1,800,000



Assessment:

A. Determination of proportion of right-of-use retained

IFRS 16.100(a) requires the seller-lessee to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

IFRS 16, as amended, does not prescribe a method for determining this proportion.

One possible method is to compare the present value of expected lease payments (including those that are variable) with the fair value of the asset at the date of the transaction.

Following this method, seller-lessee measures the present value of expected lease payments as below:

(Amounts in CU)

Year	Fixed lease payment	Estimated revenue	Variable lease payments (3% of estimated revenue)	Total lease payment	Present value (discounted at incremental borrowing rate of 4%)
20X1	50,000	1,500,000	45,000	95,000	91,346
20X2	50,000	1,600,000	48,000	98,000	90,607
20X3	50,000	1,650,000	49,500	99,500	88,455
20X4	50,000	1,700,000	51,000	101,000	86,335
20X5	50,000	1,800,000	54,000	104,000	85,480
				Total	**442,223**

The seller-lessee arrives at the proportion of the carrying amount of the machinery related to the right-of-use retained to be 17.7%, calculated as [CU442,223 (present value of expected lease payments)/ CU2,500,000 (fair value of the machinery)].

B. Measurement of right-of-use asset and lease liability at commencement

The lease liability at commencement of the leaseback transaction is measured at CU442,223, which is the present value of expected lease payments.

The right-of-use asset at commencement is measured at CU353,778, calculated as CU2,000,000 (previous carrying amount of the machinery) * 17.7% (proportion of the machinery that relates to the right-of-use retained).

C. Determination of gain on rights transferred

The proportion of rights transferred is 82.3% (1 – 17.7%). The gain on rights transferred is measured at CU411,555, calculated as CU500,000 (total gain on sale of the machinery (CU2,500,000 – CU2,000,000) * 82.3%.

D. Accounting entry on the date of the transaction

At the date of the transaction, the seller-lessee accounts for the transaction as below:

DR Cash	CU2,500,000	
DR Right-of-use asset	CU353,778	
CR Machinery		CU2,000,000
CR Lease liability		CU442,223
CR Gain on rights transferred		CU411,555

E. Subsequent measurement of the right-of-use asset

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

F. Subsequent measurement of the lease liability

Approach - Expected lease payments at the commencement date

Applying IFRS 16.102A, the seller-lessee determines 'lease payments' to reflect the expected lease payments at the commencement date that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at that date of CU442,223.

Under this approach, the lease liability arising from the leaseback is:

(Amounts in CU)

Year	Opening lease liability	Interest @ incremental borrowing rate of 4%	Lease payments	Closing lease liability
20X1	442,223	17,689	95,000	364,912
20X2	364,912	14,596	98,000	281,509
20X3	281,509	11,260	99,500	193,269
20X4	193,269	7,731	101,000	100,000
20X5	100,000	4,000	104,000	-

In accordance with the requirements of IFRS 16.102A and IFRS 16.38(b), any difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability is recognised in profit or loss. For example, if the seller-lessee pays CU103,000 in year 20X2 for the use of the machinery, it recognises CU5,000 (CU103,000 – CU98,000) in profit or loss.

Scenario 2:

At the commencement of the leaseback, the seller-lessee is not able to estimate the revenue for the period of the lease.

The estimated remaining useful life of the machinery is 20 years.

Assessment:

A. Determination of proportion of right-of-use retained

IFRS 16.100(a) requires the seller-lessee to measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee.

IFRS 16, as amended, does not prescribe a method for determining this proportion.

Since the seller-lessee is not able to estimate the revenue for the period of the lease, the method followed in Scenario 1 of estimating expected lease payments cannot be followed.

Considering the facts and circumstances, a possible approach is to compare the lease period (five years to the remaining useful life of the asset (20 years). Based on this, the proportion of the previous carrying amount of the asset that related to the right-of-use retained by the seller-lessee is 25%.

B. Measurement of right-of-use asset and lease liability at commencement

The right-of-use asset at commencement is measured at CU500,000, calculated as CU2,000,000 (previous carrying amount of the machinery) * 25% (proportion of the machinery that relates to the right-of-use retained).

The lease liability at commencement of the leaseback transaction is measured at CU625,000, calculated as CU2,500,000 (fair value of the machinery on the date of the transaction) * 25% (proportion of the machinery that relates to the right-of-use retained).

C. Determination of gain on rights transferred

The proportion of rights transferred is 75% (1 – 25%). The gain on rights transferred is measured at CU375,000, calculated as CU500,000 (total gain on sale of the machinery (CU2,500,000 – CU2,000,000) * 75%.

D. Accounting entry on the date of the transaction

At the date of the transaction, the seller-lessee accounts for the transaction as below:

DR Cash	CU2,500,000	
DR Right-of-use asset	CU500,000	
CR Machinery		CU2,000,000
CR Lease liability		CU625,000
CR Gain on rights transferred		CU375,000

E. Subsequent measurement of the right-of-use asset

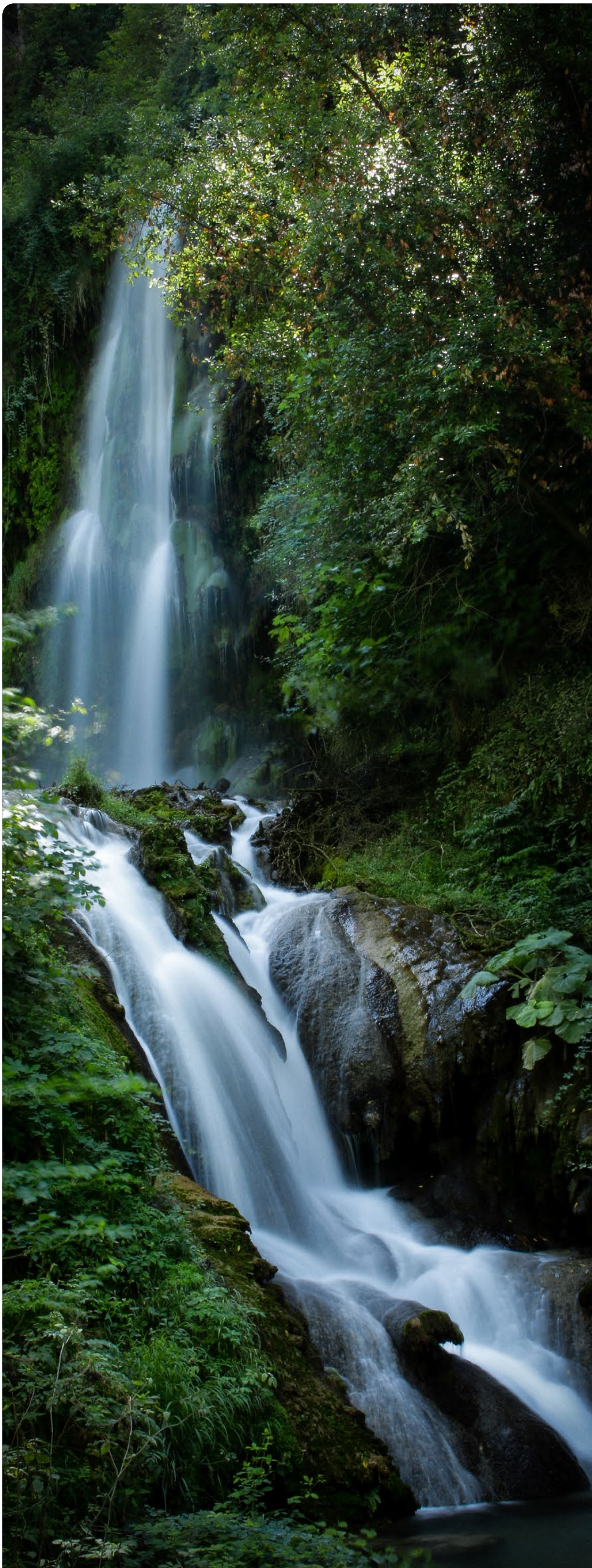
The seller-lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

F. Subsequent measurement of the lease liability

Approach – Equal lease payments over the lease term

As the seller-lessee is unable to estimate revenue for the period of the lease and the lease liability at initial recognition is not measured as the present value of expected lease payments, the seller-lessee will be unable to follow the approach or subsequent measurement of lease liability used in scenario 1.

An alternate approach that the seller-lessee can use is imputing equal lease payments over the lease term.



Under this approach, applying IFRS 16.102A, the seller-lessee determines 'lease payments' to reflect equal periodic payments over the lease term that, when discounted using its incremental borrowing rate, result in the carrying amount of the lease liability at the commencement date of CU625,000.

Under this approach, the lease liability arising from the leaseback is:

Year	Opening lease liability	Interest @ incremental borrowing rate of 4%	Lease payments	Closing lease liability
20X1	625,000	25,000	140,392	509,608
20X2	509,608	20,384	140,392	389,600
20X3	389,600	15,584	140,392	264,792
20X4	264,792	10,592	140,392	134,992
20X5	134,992	5,400	140,392	-

In accordance with the requirements of IFRS 16.102A and IFRS 16.38(b), any difference between the payments made for the lease and the lease payments that reduce the carrying amount of the lease liability is recognised in profit or loss. For example, if the seller-lessee pays CU150,000 in year 20X2 for the use of the machinery, it recognises CU9,608 (CU150,000 – CU140,392) in profit or loss.

As can be seen from the above illustration, the measurement of right-of-use asset and lease liability recognised in a SALT will differ based on facts and circumstances of each case, even though the contractual terms of the lease agreement are the same. As noted by the IASB in Basis for Conclusions to the amendments (IFRS 16.BC294A(c)), the amendments do not require the seller-lessee to estimate the expected lease payments. Therefore, in case of a leaseback that includes variable lease payments that do not depend on an index or rate, the seller-lessee will need to develop its accounting policy for determining lease payments as required by IFRS 16.102A.

These amendments are effective for annual reporting periods beginning on or after 1 January 2024, with earlier application permitted. If a seller-lessee applies these amendments for an earlier period, it shall disclose that fact.

A seller-lessee is required to apply the amendments retrospectively in accordance with IAS 8 to sale and leaseback transactions **entered into after the date of initial application of IFRS 16**. Thus, if the date of initial application of IFRS 16 for a seller-lessee was 1 January 2019, these amendments would apply to the sale and leaseback transactions entered into after 1 January 2019. This is because specific transitional requirements applied to sale and leaseback transactions that occurred prior to the date of initial application of IFRS 16, and those transactions are unaffected by these amendments.

10. INTERACTION WITH IFRS 3

Classification of leases

IFRS 3.15 requires:

> *At the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other IFRSs subsequently. The acquirer shall make those classifications or designations on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.*

Therefore, an acquirer classifies the assets acquired based on the facts and circumstances as at the acquisition date. For example, an acquirer classified financial assets acquired based on the requirements of IFRS 9 as at the acquisition date (e.g. the contractual cash flows test and an assessment of the business model).

IFRS 3.17(a) contains an exception to this principle relating to leases acquired in a business combination:

> *This IFRS provides an exception to the principle in paragraph 15:*
>
> *(a) classification of a lease contract in which the acquiree is the lessor as either an operating lease or a finance lease in accordance with IFRS 16 Leases*

Therefore, an acquirer is not required to reclassify leases acquired in a business combination, assuming that the acquiree classified them appropriately and no modifications were made to the lease as a consequence of the business combination. For example, if the acquirer acquired the acquiree, and the acquiree is a lessor with all leases classified as operating type in accordance with IFRS 16, applying IFRS 3.17(a), the acquirer does not reassess whether those leases would be classified as operating or finance type as at the acquisition date of the acquiree.

10.1 Acquiree is a lessee

Measurement of leases acquired in a business combination

IFRS 3 requires that most assets and liabilities acquired in a business combination be measured at their acquisition date fair values. An exception to this requirement is for leases, where IFRS 3.28A-28B states:

> *The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with IFRS 16 in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:*
>
> *(a) leases for which the lease term (as defined in IFRS 16) ends within 12 months of the acquisition date; or*
>
> *(b) leases for which the underlying asset is of low value (as described in paragraphs B3–B8 of IFRS 16).*
>
> *The acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) as if the acquired lease were a new lease at the acquisition date. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.*

The following example illustrates the application of these requirements.

Refer section 5.2 for discussion of the discount rate applicable for leases acquired in a business combination.

Section 5.2

Example 10.1-1 – Business combination where acquiree is a lessee

Entity A enters into a property lease for a period of eight years on 1 January 20X1, with annual lease payments of CU250,000, payable annually in advance. Entity A has an option to extend the lease by two years with annual lease payment of CU275,000 during the extension period. At lease commencement, Entity A assesses that it is not reasonably certain to exercise the extension option. The rate implicit in the lease is not readily determinable. Entity A's incremental borrowing rate at the time of lease commencement is 6.5%.

On 1 January 20X4, Entity A is acquired by Entity B. Entity B determines that it is reasonably certain to exercise the extension option. Entity B's incremental borrowing rate at the time of the business combination is 4%. Entity A's incremental borrowing rate at the time of the business combination is 7%. At the time of the business combination, the market rental for the property was CU315,000 per annum for a period of seven years.

Assessment

Entity B will measure the lease liability and right-of-use asset at the time of business combination as follows:

A. Measurement of lease liability

Entity B is required to measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) as if the acquired lease were a new lease at the acquisition date.

Since Entity B determines that it is reasonably certain to exercise the extension option, the lease term is determined to be seven years (five years in the non-cancellable period plus the two year extension option). The lease liability is the present value of lease payments (CU250,000 for first five years and CU275,000 for the next two years, payable annually in advance), discounted at Entity A's incremental borrowing rate which is 7%. (Refer to section 5.2 for guidance on determination of discount rate). The lease liability is therefore CU1,476,118.

Section 5.2

B. Measurement of right-of-use asset

Entity B is required to measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms. The market rental for the property at the time of the acquisition is CU315,000 per annum. Entity B has acquired the lease on favourable terms as the contractual lease payments are below-market.

Therefore, the right-of-use asset is measured by discounting CU315,000 for a period of seven years at a discount rate of 7%, which amounts to CU1,816,460.

Alternatively, the right-of-use asset can be measured by adding the present value of rent differential between the market rent and contractual rent to the lease liability.

The difference between the lease liability and the right-of-use asset affects the measurement of goodwill or a bargain purchase gain in the purchase price allocation of the business combination.

The lease liability and the right-of-use asset are subsequently measured by Entity B in accordance with the subsequent measurement requirements of IFRS 16.

A practical consequence of applying the requirements of IFRS 3 is that Entity B and Entity A will measure the same lease at different amounts, assuming that Entity A continues to prepare separate financial statements. This will require adjustments on consolidation of Entity A by Entity B on an ongoing basis.

10.2 Acquiree is a lessor

IFRS 3 requires the acquirer to classify lease contracts in which the acquiree is a lessor on the basis of the contractual terms and other factors at the inception of the contract or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date.

Acquiree is a lessor in an operating lease

If the acquiree is a lessor in an operating lease, the acquirer is not required to recognise a separate asset or liability if the terms of the operating lease are either favourable or unfavourable when compared with market terms. Instead, the acquirer takes into account the terms of the operating lease in measuring the acquisition date fair value of the asset classified as an operating lease such as a building.

In the basis for conclusions of IFRS 3, the IASB noted that IAS 40 *Investment Property* requires the fair value of investment to take into account rental income from current leases. Therefore, the IASB decided to require the acquirer in a business combination to follow the guidance in IAS 40 for assets subject to operating leases in which the acquiree is the lessor. However, this requirement in IFRS 3 is not restricted to assets accounted for under fair value model in IAS 40, but applies to all assets where the acquiree is a lessor in an operating lease. The IASB further noted in the basis for conclusions of IFRS 3 that the entity would be required to adjust the depreciation or amortisation method for the leased asset to reflect the timing of cash flows attributable to the underlying leases, in line with the requirements of IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

Acquiree is a lessor in a finance lease

IFRS 3 does not contain specific requirements for accounting for net investment in a lease. In accordance with the general requirements of IFRS 3, the acquirer will measure the net investment in the lease and the underlying asset at fair value.

11. INTERACTION BETWEEN IFRS 16 AND OTHER IFRS ACCOUNTING STANDARDS

IFRS 16 has resulted in several consequential amendments to other IFRS Accounting Standards. A summary of the more significant amendments are:

Standard	Effect of Amendments
IFRS 1 *First-time Adoption of IFRS*	• The option to use fair value as deemed cost in an entity's opening statement of financial position upon adopting IFRS has been extended to right-of-use assets. • If an entity elects not to apply IFRS 3 retrospectively to past business combinations upon adopting IFRS, it still must recognise the acquiree's lease contracts based on the requirements of IFRS 16. • An entity may elect to follow several simplifications for initial measurement: – Measure the lease liability as the present value of remaining lease payments discounted using the lessee's incremental borrowing rate at the date of transition; – Measure the right-of-use asset at either: – (1) the amount that would have been recognised had IFRS 16 applied on commencement of the lease except that it is discounted using the lessee's incremental borrowing rate at the date of transition; or – (2) an amount equal to the lease liability. • A right-of-use asset for a lease that meets the definition of investment property and is measured using the fair value model would be measured at fair value on adoption of IFRS. • A lessee may also use several other simplifications on a lease-by-lease basis: – Use a single discount rate for a reasonably similar portfolio of leases; – Elect not to measure leases that terminate within 12 months of the date of transition to IFRS; – Elect not to measure leases where the underlying asset is of low-value; – Exclude initial direct costs from the measurement of right-of-use assets; – Elect to use hindsight (e.g. in determining the lease term if options exist).
IFRS 3 *Business Combinations*	• Clarifies that an acquirer recognises and measures an acquiree’s lease liabilities and right-of-use assets using the principles in IFRS 16, and not at fair value, i.e. leases acquired are accounted for as if they were new leases as at the acquisition date. • As IFRS 16 recognises leases 'on balance sheet', separate intangible assets relating to off-market operating leases acquired in a business combination prior to the adoption of IFRS 16 will no longer be recognised. Instead, the acquirer adjusts the initial measurement of the right-of-use asset to reflect favourable or unfavourable terms when compared to market terms.
IFRS 7 *Financial Instruments: Disclosures*	• Requires disclosure of maturity analysis of lease liabilities by lessees and maturity analysis of lease payments receivable by lessors. • Extends the exemption from disclosure of fair values of financial instruments to lease liabilities.

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

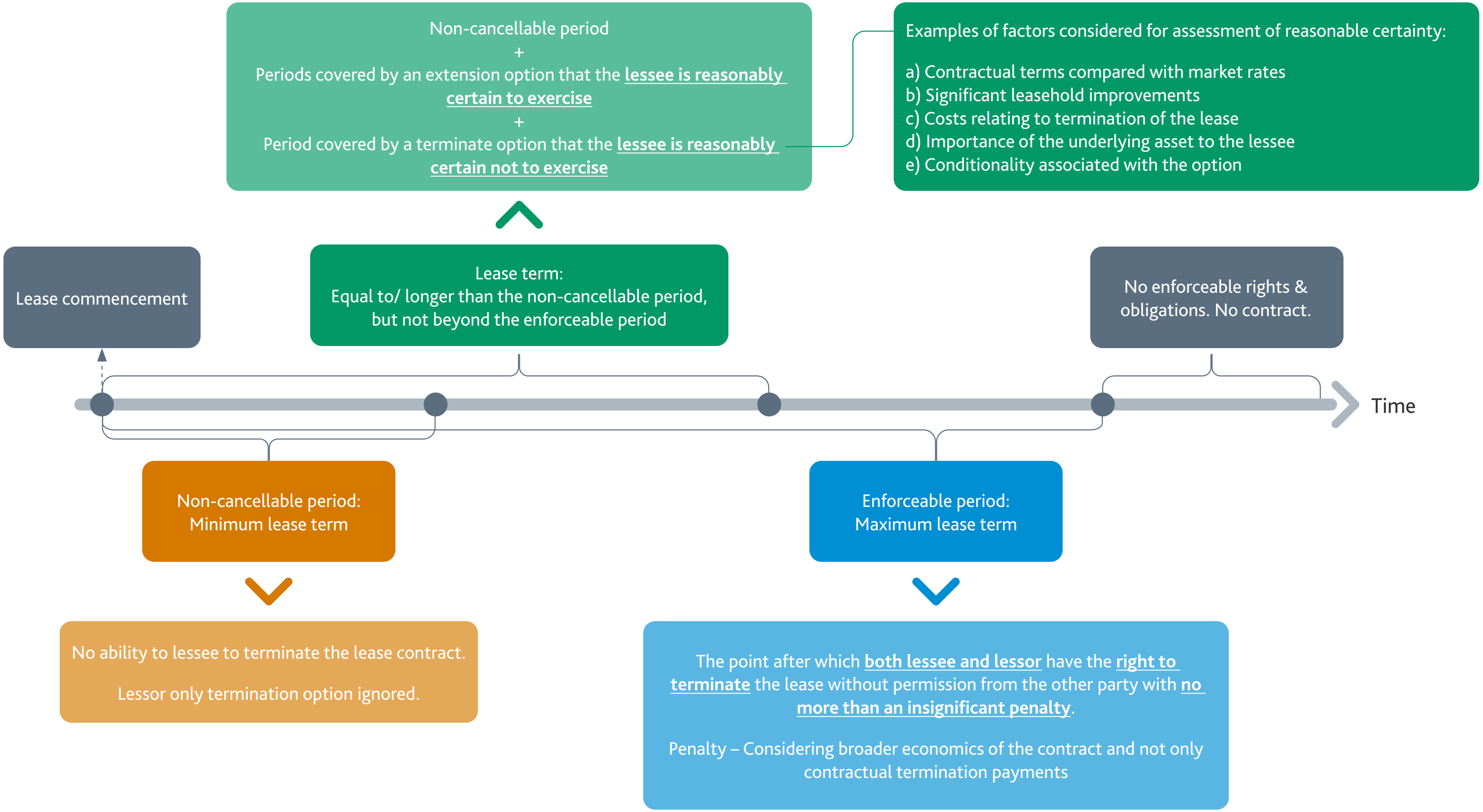
APPENDIX A – DEFINITIONS

commencement date of the lease (commencement date)	The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.
contract	An agreement between two or more parties that creates enforceable rights and obligations.
economic life	Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.
effective date of the modification	The date when both parties agree to a **lease modification**.
fair value	For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
finance lease	A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.
fixed payments	Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.
gross investment in the lease	The sum of: (a) the **lease payments** receivable by a **lessor** under a **finance lease**; and (b) any **unguaranteed residual value** accruing to the lessor.
inception date of the lease (inception date)	The earlier of the date of a **lease** agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
initial direct costs	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.
interest rate implicit in the lease	The rate of interest that causes the present value of (a) the **lease payments** and (b) the **unguaranteed residual value** to equal the sum of (i) the **fair value** of the **underlying asset** and (ii) any **initial direct costs** of the lessor.
lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.
lease incentives	Payments made by a **lessor** to a **lessee** associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee.
lease modification	A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).
lease payments	Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, comprising the following: (a) fixed payments (including in-substance fixed payments), less any lease incentives; (b) variable lease payments that depend on an index or a rate; (c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

lease payments (continued)	(d) payments of penalties for terminating the **lease**, if the lease term reflects the lessee exercising an option to terminate the lease. For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component. For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.
lease term	The non-cancellable period for which a **lessee** has the right to use an **underlying asset**, together with both: (a) periods covered by an option to extend the **lease** if the lessee is reasonably certain to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.
lessee's incremental borrowing rate	The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.
lessor	An entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.
net investment in the lease	The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.
operating lease	A **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.
optional lease payments	Payments to be made by a **lessee** to a **lessor** for the right to use an **underlying asset** during periods covered by an option to extend or terminate a **lease** that are not included in the **lease term**.
period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
residual value guarantee	A guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.
right-of-use asset	An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.
short-term lease	A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.
sublease	A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.
underlying asset	An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

unearned finance income	The difference between: (a) the **gross investment in the lease**; and (b) the **net investment in the lease**.
unguaranteed residual value	That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.
useful life	The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.
variable lease payments	The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

APPENDIX B – LEASE TERM ASSESSMENT FLOW CHART



Non-cancellable period
+
Periods covered by an extension option that the **lessee is reasonably certain to exercise**
+
Period covered by a terminate option that the **lessee is reasonably certain not to exercise**

Examples of factors considered for assessment of reasonable certainty:

a) Contractual terms compared with market rates
b) Significant leasehold improvements
c) Costs relating to termination of the lease
d) Importance of the underlying asset to the lessee
e) Conditionality associated with the option

Lease commencement

Lease term:
Equal to/ longer than the non-cancellable period, but not beyond the enforceable period

No enforceable rights & obligations. No contract.

Non-cancellable period:
Minimum lease term

Enforceable period:
Maximum lease term

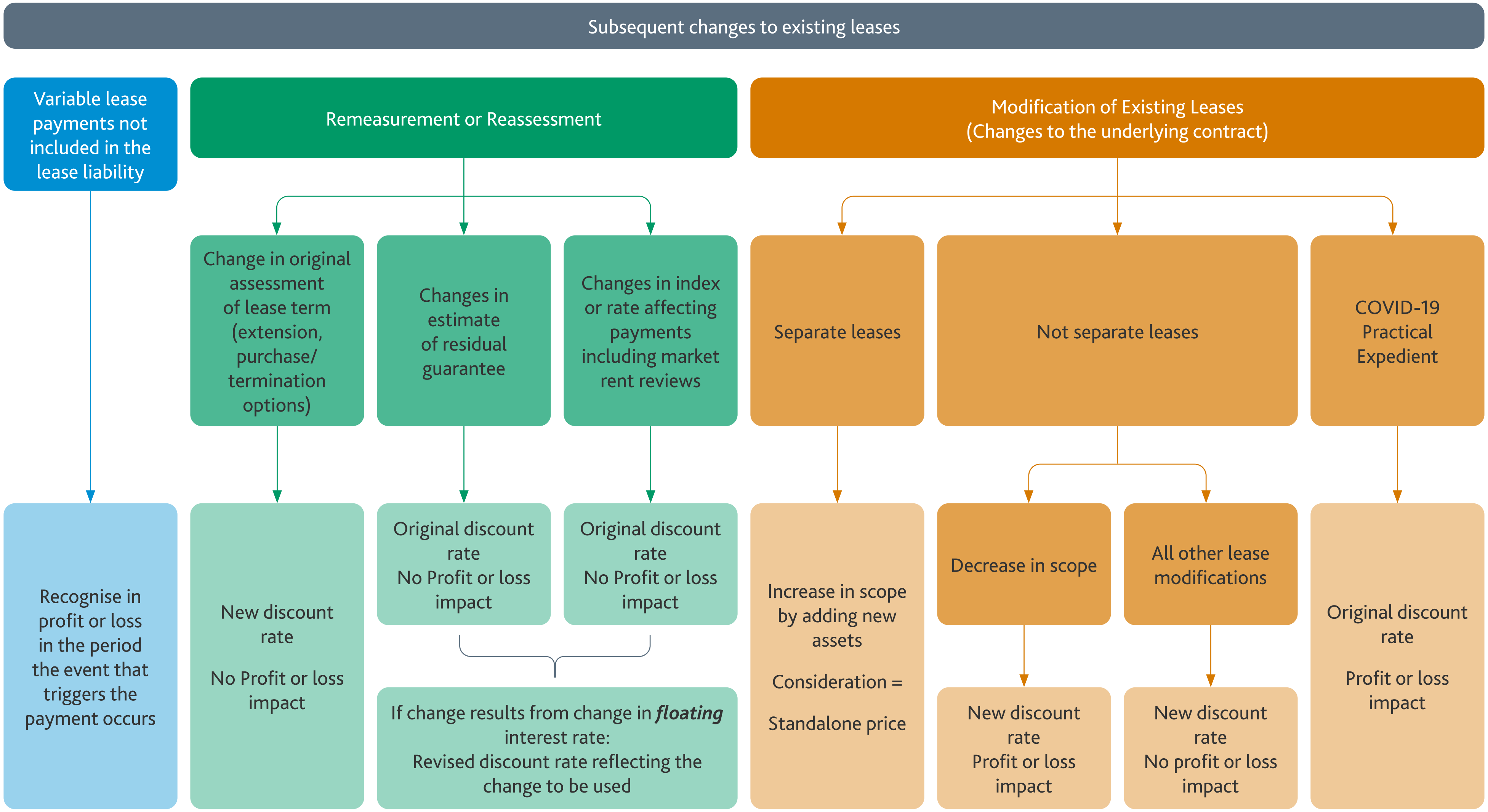
No ability to lessee to terminate the lease contract.

Lessor only termination option ignored.

The point after which **both lessee and lessor** have the **right to terminate** the lease without permission from the other party with **no more than an insignificant penalty**.

Penalty – Considering broader economics of the contract and not only contractual termination payments

APPENDIX C – SUBSEQUENT CHANGES TO EXISTING LEASES (ACCOUNTING BY LESSEE)



Subsequent changes to existing leases

Variable lease payments not included in the lease liability

Recognise in profit or loss in the period the event that triggers the payment occurs

Remeasurement or Reassessment

Change in original assessment of lease term (extension, purchase/ termination options)

New discount rate

No Profit or loss impact

Changes in estimate of residual guarantee

Original discount rate
No Profit or loss impact

Changes in index or rate affecting payments including market rent reviews

Original discount rate
No Profit or loss impact

If change results from change in ***floating*** interest rate:
Revised discount rate reflecting the change to be used

Modification of Existing Leases
(Changes to the underlying contract)

Separate leases

Increase in scope by adding new assets

Consideration =

Standalone price

Not separate leases

Decrease in scope

New discount rate
Profit or loss impact

All other lease modifications

New discount rate
No profit or loss impact

COVID-19 Practical Expedient

Original discount rate

Profit or loss impact

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