IFRS News Special Edition on Lease Accounting

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Major reforms to global lease accounting

IFRS News Special Edition
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The IASB has published IFRS 16 'Leases' completing its long-running project on lease accounting.

This special edition of IFRS News explains the key features of the new Standard and provides practical insights into its application and impact.

Introduction

The IASB has published IFRS 16 'Leases', completing its long-running project to overhaul lease accounting.

IFRS 16 will require lessees to account for leases 'on-balance sheet' by recognising a 'right-of-use' asset and a lease liability. For many businesses, however, exemptions for short-term leases and leases of low value assets will greatly reduce the impact.

IFRS 16 also:

- changes the definition of a lease
- sets requirements on how to account for the asset and liability, including complexities such as non-lease elements, variable lease payments and option periods
- changes the accounting for sale and leaseback arrangements
- largely retains IAS 17's approach to lessor accounting
- introduces new disclosure requirements.

IFRS 16 represents the first major overhaul of lease accounting for over 30 years. The IASB has long believed that IAS 17's split between operating and finance leases is flawed, and has resulted in too much structuring and off-balance sheet financing. The IASB's solution has remained the same throughout the project: to do away with the operating versus finance lease distinction and account for all leases 'on-balance sheet'.

While many agree that reforms to lease accounting are long overdue, bringing all leases on-balance sheet is controversial. The IASB hopes to reduce controversy through various compromises – in particular by exempting short-term and low value asset leases. As a result businesses that lease only assets such as printers and laptops will face only a limited impact. For businesses that lease 'big-ticket' assets, such as property and high value equipment, this will however be a major change.

Whatever your views on the new Standard, businesses would be well-advised to start an impact analysis sooner rather than later.

Andrew Watchman, Global Head – IFRS

Background

IFRS 16 represents the first major overhaul of lease accounting for over 30 years. The new Standard replaces IAS 17 'Leases' along with three Interpretations (IFRIC 4 'Determining whether an Arrangement contains a Lease', SIC 15 'Operating Leases-Incentives' and SIC 27 'Evaluating the Substance of Transactions Involving the Legal Form of a Lease').

IFRS 16 will affect most companies that report under IFRS and are involved in leasing, and will have a substantial impact on the financial statements of lessees of property and high value equipment.

The table summarises the main changes at a glance:

Issue	Effect
Who's affected?	• entities that lease assets as a lessee or a lessor
What's the impact on lessees?	• all leases will be accounted for 'on-balance sheet', other than short-term and low value asset leases • lease expense will typically be 'front-loaded' • lease liability will exclude: – option periods unless exercise is reasonably certain – contingent payments that are linked to sales/usage and future changes in an index/rate
What's the impact on lessors?	• only minor changes from the current Standard – IAS 17
Are there other changes?	• a new definition of a lease will result in some arrangements previously classified as leases ceasing to be so, and vice versa • new guidance on sale and leaseback accounting • new and different disclosures
When are the changes effective?	• annual periods beginning on or after 1 January 2019 • various transition reliefs • early application is permitted provided IFRS 15 'Revenue from Contracts with Customers' is applied.

History

IFRS 16 is the end-product of a leases project added to the IASB's agenda ten years ago. The initial discussion paper was published in 2009, followed by two exposure drafts.

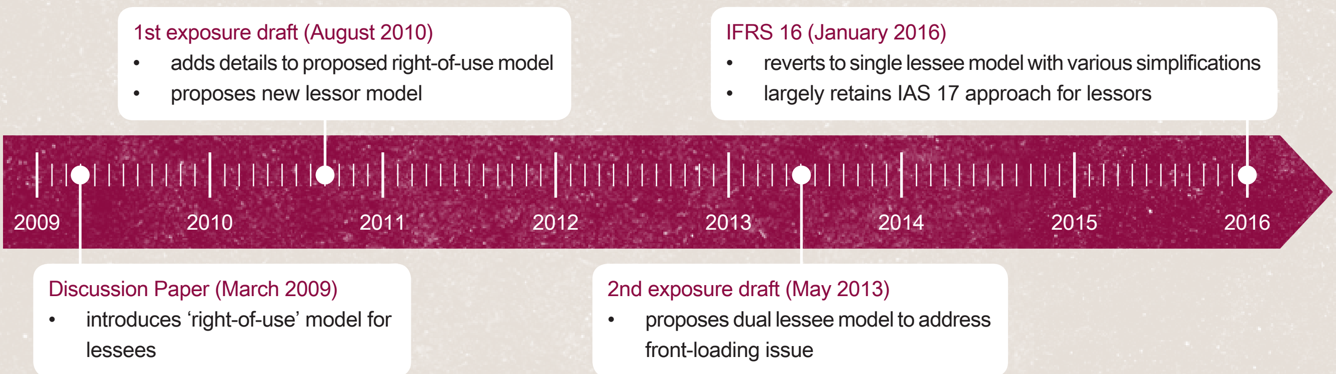
Throughout this time the IASB has maintained its view that all leases should be 'on-balance sheet' – a view that has inevitably been controversial. However, as the project has progressed the IASB has looked for ways to simplify the requirements and reduce the controversy. The diagramme summarises the key stages in IFRS 16's development:

Practical insight – US convergence

The new leases standard started out as a joint project between the IASB and its US counterpart, the FASB. However, as the project progressed the two Boards have made different decisions in some areas. The outcome is that IFRS 16 and the new US standard are not fully 'converged'. Two of the more significant differences are that the US standard:

- will divide leases into two types for lessees (financing and operating), similar to the proposals in the Boards' May 2013 exposure draft. Both lease types will be 'on-balance sheet' but the expense profile for operating leases will generally be 'straight-line'
- will not provide an exemption for low-value asset leases.

Development of IFRS 16



Scope

IFRS 16 applies to all leases for both the lessee and lessor, except for a few scope exclusions. These exclusions, some of which are similar to IAS 17's, are summarised in the table:

Scope exclusion	Standard to apply
Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources	None specified. Depending on the circumstances IFRS 6 'Exploration for and Evaluation of Mineral Resources' or IAS 38 'Intangible Assets' might apply
Leases of biological assets in scope of IAS 41 held by a lessee	IAS 41 'Agriculture'
Service concession arrangements in scope of IFRIC 12	IFRIC 12 'Service Concession Arrangements'
Licences of intellectual property granted by a lessor in scope of IFRS 15	IFRS 15 'Revenue from Contracts with Customers'
Rights held under licensing agreements in scope of IAS 38 for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights*	IAS 38 'Intangible Assets'

* for leases of other types of intangible asset a lessee is permitted to apply IFRS 16 but not required to do so

In addition, IFRS 16 provides optional accounting simplifications for short-term and low-value asset leases. These are discussed in the lessee accounting section below.

Practical insight – impact on investment property

Under IAS 17 and IAS 40 'Investment Property', a lessee of property classified as investment property applies:

- IAS 40 to its interest in the property if the lease is a finance lease (and can choose either the cost model or the fair value model)
- IAS 17 if the lease is an operating lease. However, an investor-lessee can alternatively elect to treat the lease as a finance lease and apply IAS 40's fair value model to its interest in the property.

IFRS 16 makes extensive consequential amendments to IAS 40, including expanding its scope to include all investment property held under leases (including leases that would be classified as operating under IAS 17). IFRS 16 also applies to these leases. As a result, an investor-lessee recognises a lease liability and a right-of-use asset. The 'right-of-use' asset is accounted for:

- at fair value in accordance with IAS 40 if the investor-lessee uses the fair value model for owned investment property; or
- otherwise at cost less depreciation and impairment in accordance with IFRS 16.

The main change is therefore the accounting for investment property held under an operating lease (as defined by IAS 17). Under IFRS 16 these leases can no longer be accounted for 'off-balance sheet' (unless the lease is short-term).

IFRS 16 applies to all leases for both the lessee and lessor except for a few scope exclusions.

Definition of a lease

Because the new lease accounting results in many more leases being 'on-balance sheet', the evaluation of whether a contract is (or contains) a lease becomes even more important than today. IFRS 16 changes the definition of a lease and provides new guidance on applying the definition.

In practice, the main impact will be on contracts that are not in the legal form of a lease but involve the use of a specific asset and therefore might contain a lease – such as outsourcing, contract manufacturing, transportation and power supply agreements. Currently, this evaluation is based on IFRIC 4. IFRS 16 replaces IFRIC 4 with new guidance that differs in some important respects.

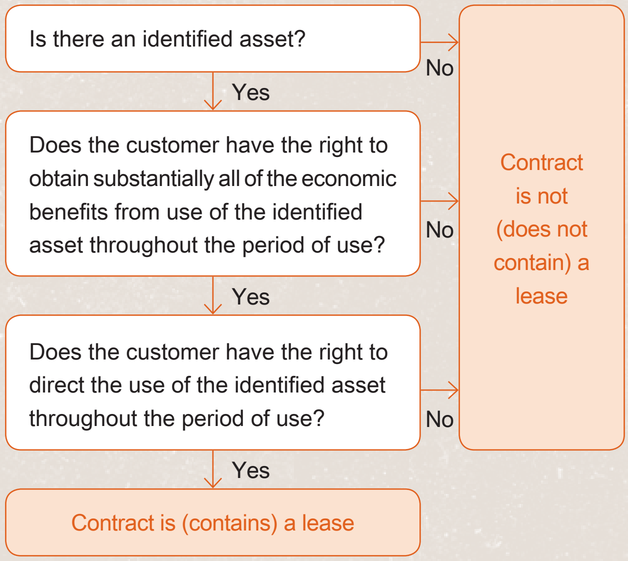
Practical insight – Key changes from IFRIC 4

One of the main changes from IFRIC 4 is the relevance of pricing when evaluating whether a contract to supply goods or services contains a lease. Under IFRIC 4, such contracts do not contain leases if the unit price paid by the customer is either fixed or at fair value at the time of delivery. IFRS 16 does not include this 'pricing exemption'.

As a result, some contracts that do not contain a lease today will do so under IFRS 16, and vice versa. If a contract contains a lease, the lease component is accounted for on-balance sheet in the same way as a standalone lease (unless it is a short-term or low-value asset lease).

Applying the new definition (see below) involves three key evaluations. These are summarised in the flowchart:

Flowchart: the three key evaluations



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

A contract can be (or contain) a lease only if the underlying asset is 'identified'. Having the right to control the use of the identified asset requires having the right to:

- obtain all of the economic benefits from use of the identified asset; and
- direct the use of the identified asset.

The new Standard provides extensive guidance and illustrative examples to help apply this definition. The following table and simplified examples summarise the key points.

Applying the lease definition

Component of definition	Guidance
Is there an identified asset?	• an asset is 'identified' if it is explicitly specified in the contract, or implicitly specified when made available to the customer • as asset is not identified if the supplier has a substantive right to substitute another asset • a physically distinct portion of an asset can be an identified asset but a portion of an asset's capacity cannot
Does the customer have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use?	• considers direct and indirect benefits such as using, holding, or sub-leasing the asset • considers only the economic benefits within the defined scope of a customer's rights to use an asset
Does the customer have the right to direct the use of the identified asset throughout the period of use?	• normally present if the customer has the right to decide how and for what purpose the asset is used • if relevant decisions about use of the asset are predetermined, the customer has control if it (i) has the right to operate the asset; or (ii) designed the asset (or aspects of it) in a way that predetermines its use

Example 1 – Executive jet

A multi-national business (the customer) enters into a five-year contract with an aviation company for the exclusive use of a particular executive jet. The contract details the interior and exterior specifications for the jet. The aviation company is permitted to use an alternative aircraft but this would be uneconomic due to various factors such as the cost of customising the aircraft to meet the contractual specifications.

Subject to certain restrictions, the customer decides where the executive jet will fly and which passengers will use it. The aviation company operates the aircraft using its own crew.

Analysis – The contract contains a lease. The contract specifies an executive jet. The aviation company's right to substitute another aircraft is not substantive because it would be uneconomic to exercise this right. The customer decides how and for what purpose the jet is used which provides it with the right to control the use of the jet.

Example 2 – Ship

A car manufacturer enters into a contract with a shipping company to transport cars from Hamburg to Singapore. The contract specifies a particular ship and the cars to be transported, which will require the full capacity of the ship. The shipping company operates and maintains the ship and is responsible for the safe passage of the cars to Singapore. The car manufacturer is not able to make changes (eg to the destination or nature of the cargo) once the contract has been signed.

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

Example 3 – Contract manufacturing

A retailer enters into a contract manufacturing arrangement with a manufacturer to supply an own-brand food product for a three-year period. The recipe, packaging and quantity of the food product are specified in the contract.

The contract does not specify which factory (or factories) will be used, but the manufacturer has only one suitable factory. Constructing another factory would not be viable. Fulfilling this contract will not require all of the factory's capacity.

The manufacturer makes all decisions about the operations of the factory, including how to utilise the available capacity and what output to produce with that capacity.

Analysis – The contract does not contain a lease. Although the contract implicitly specifies an asset (the one suitable factory), the retailer does not have the right to decide how this factory is used after the contract has been signed. The recipe, packaging and quantity of the food product are pre-specified in the contract. Also, the retailer does not have the right to obtain substantially all the benefits from use of the factory because the manufacturer decides how to use the available capacity.

Example 4 – Power supply

A utility company contracts with a windfarm operator to purchase all of the electricity produced by a new windfarm for 30 years. The operator owns the windfarm. The utility company designed the windfarm before it was constructed and hired experts to assist in determining the location, obtaining permits and specifying the turbines to be used. The operator constructs the windfarm to the contractual specifications and then operates it. The operator will receive tax amortisation deductions on the windfarm, while the utility company receives green certificates.

Analysis – The contract contains a lease. The utility company has the right to obtain substantially all of the economic benefits from use of the windfarm over the 30-year contract period. The contract pre-determines how and for what purpose the windfarm is used, so neither party is able to take these decisions after the contract is signed. In this circumstance, the utility company's role in designing the windfarm means that it has control for IFRS 16 purposes.

The new lessee accounting approach

Subject to the optional accounting simplifications for short-term and low-value asset leases (see below), a lessee will be required to recognise its leases on the balance sheet. This involves recognising:

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

Lessees have the option to apply the model to a portfolio of similar leases if the effect is reasonably expected to be materially the same as a lease-by-lease approach.

Optional accounting simplifications

IFRS 16 provides important reliefs or exemptions for:

- low-value asset leases
- short-term leases.

If these exemptions are used, the accounting is similar to operating lease accounting under IAS 17. Lease payments are recognised as an expense on a straight-line basis over the lease term or another systematic basis (if more representative of the pattern of the lessee's benefit). The two exemptions are discussed further below.

Low-value asset leases

IFRS 16 provides an optional exemption for leases of 'low-value' assets. The assessment of value is based on the value of the underlying asset when new, regardless of its actual age. The exemption is available whether or not these leases are (individually or collectively) material to the reporting entity.

The Basis for Conclusions accompanying IFRS 16 explains that, when deciding on this exemption, the IASB had in mind leases of assets with a value when new of around US$5,000 or less. Accordingly, leases of assets such as low value IT equipment, office equipment and furniture would typically qualify, but vehicle leases would not. It should be noted that the reference to a US$5,000 threshold is not in the main body of the new Standard and does not establish a 'bright-line' rule. Factors such as price inflation and changes in foreign exchange rates (for entities whose functional currency is not the US Dollar) may reduce the relevance of this guideline over time.

The use of this exemption is an accounting policy choice that is available on a lease-by-lease basis.

Example – Low-value asset leases

A financial services company enters into a single lease contract for ten office printers/copiers. The lease has a three year, non-cancellable term. One of the assets is a high-end production printer with a purchase price when new of US$20,000. The other nine assets are more basic models with prices when new of $3,000 each.

Although the ten assets are under the same lease, the company concludes that each asset is a separate 'lease component' because:

- the company benefits from each asset on its own
- the assets are not highly interrelated.

Analysis

Because each asset is a distinct lease component, IFRS 16 treats this contract as containing ten separate leases in principle. The total lease payments are then allocated to each of the ten components on a relative stand-alone selling price basis.

The company can then elect to apply the low-value asset exemption to some or all of the nine basic model lease components. If it does so, these are accounted for similarly to operating leases under IAS 17.

The lease of the high-end production printer must be accounted for 'on-balance sheet'.

Short-term leases

IFRS 16 provides another optional exemption for short-term leases. A lease is short-term if it has a lease term of 12 months or less at the commencement date. However, a lease cannot qualify if it contains a purchase option.

Importantly, the lease term excludes any optional extension periods unless the lessee is reasonably certain to exercise its option (or reasonably certain not to exercise an option to terminate the lease.

The use of this exemption is an accounting policy choice that must be made consistently for each class of underlying asset.

Example – Short-term lease

A mining company has entered into several leases of transport vehicles. Each lease has a stated term of 36 months, but with break clauses allowing the company to terminate each lease after 12 months and 24 months without penalty.

At the commencement date of each lease the company assesses the likelihood that it will exercise its 12-month termination option. This assessment considers all relevant facts and circumstances that create an economic incentive not to terminate the lease early. Management concludes that it is not 'reasonably certain' that the termination option will not be exercised (said differently, there is a realistic possibility that the 12-month termination option will be exercised).

In reaching this conclusion, management takes into account that:

- there is no significant termination penalty
- the rentals in years 2 and 3 are not below market
- the business's transport needs tend to change with sufficient speed that the existing vehicle fleet may no longer be optimal in 12 months' time and alternative vehicles could be sourced and introduced into the operations without significant cost or disruption.

Analysis

The leases of transport vehicles qualify for the short-term election. The mining company has an accounting policy choice to either apply the general IFRS 16 lessee model or account similarly to operating leases under IAS 17 (ie recognise the lease payments on a straight-line basis over the lease term or another systematic basis if more representative of the pattern of benefit). This accounting policy must be applied consistently to all short-term leases of underlying assets of the same class (eg all short-term leases of transport vehicles).

Applying the new lessee accounting approach

Initial accounting

At the commencement date the lessee recognises a lease liability and a right-of-use asset. The liability is initially measured at the present value of future lease payments. For this purpose, lease payments include fixed, non-cancellable payments for lease elements, amounts due under residual value guarantees, certain types of contingent payments and amounts due during optional periods that are 'reasonably certain'. Termination penalties are included if the lease term reflects the exercise of a termination option.

The lease liability does not include:

- payments for non-lease elements (unless the practical expedient permitting non-separation of non-lease elements is applied – see below)
- payments in optional extension periods unless extension is 'reasonably certain'
- future changes in variable payments that depend on an index or rate
- variable payments linked to the lessee's future sales or usage of the underlying asset.

The discount rate is the rate implicit in the lease, if readily determinable. If not, the lessee's incremental borrowing rate is used.

The diagramme summarises the initial measurement of the lease liability:

Initial measurement of the lease liability

Fixed (and in-substance fixed) future payments for lease elements, less any lease incentives receivable over the lease term (including payments in optional extension periods if extension 'reasonably certain')

+

Variable payments linked to an index/rate based on level of index/rate at commencement

+

Amounts expected to be payable under residual value guarantees

+

Exercise price of a purchase option if the lessee is reasonably certain to exercise that option

+

Termination penalties if lease term reflects exercise of a termination option

Discounted at rate implicit in the lease (or lessee's incremental borrowing rate)

The initial measurement of the right-of-use asset is based on the lease liability. Adjustments are made for any:

- prepaid lease payments
- lease incentives received
- initial direct costs incurred
- an estimate of costs the lessee is obliged to incur to dismantle, remove or restore the underlying asset and/or site.

The diagramme summarises how the initial right-of-use asset is measured starting with the lease liability:

Initial measurement of the right-of-use asset

Initial amount of lease liability

+

Lease payments made to lessor at or before commencement date

–

Lease incentives received

+

Initial direct costs

+

Estimated cost of removing and/or restoring leased asset

Right-of-use asset

Subsequent accounting for right-of-use asset and lease liability

In subsequent periods, the right-of-use asset is accounted for similarly to a purchased asset. The lease liability is accounted for similarly to a financial liability. Accordingly:

- the right-of-use asset is depreciated
- the lease liability is accounted for under the effective interest method. Lease payments are apportioned between interest expense and a reduction of the lease obligation.

Said differently, the accounting is similar to today's accounting for finance leases.

The initial and subsequent accounting for a simple 3-year lease are illustrated in the following example.

Example – Lessee accounting for a simple three-year lease

On 1.1.20X1 a company enters into a three-year lease of office premises. The rentals are CU10,000 payable at the end of each year. There are no services or other non-lease elements. No initial direct costs are incurred or incentives received. The applicable discount rate (see below) is 5%.

Analysis

The initial measurement of the right-of-use asset and lease liability is CU27,232 (10,000/1.05 + 10,000/1.05^2 + 10,000/1.05^3). The table below summarises the cash flows and balance sheet and profit and loss account treatment (assuming straight-line depreciation over three years):

Cash flow and P&L	1.1.20X1 CU	20X1 CU	20X2 CU	20X3 CU
Lease payments	–	10,000	10,000	10,000
Depreciation expense	–	9,077	9,077	9,078
Interest expense	–	1,362	930	476
Total expense	–	10,439	10,007	9,554
Balance sheet (CU)				
Right-of-use asset	27,232	18,155	9,078	–
Lease liability	27,232	18,594	9,524	–

The accounting entries on initial recognition are:

	Debit (CU)	Credit (CU)
Right-of-use asset	27,232	
Lease liability		27,232

The subsequent accounting entries in Year 1 are:

	Debit (CU)	Credit (CU)
Depreciation expense	9,077	
Interest expense	1,362	
Lease liability	8,638	
Cash		10,000
Right-of-use asset		9,077

The accounting entries in Years 2 and 3 continue in the same pattern.

The lessee initially recognises a lease liability (which is the present value of future lease payments) and a right-of-use asset (which is based on lease liability).

Practical insight – Front-loading of lease expense

In this example rentals over the three years are CU30,000 in total. Under IAS 17, assuming this is an operating lease (which is likely for a three-year property lease), the annual expense will be CU10,000. Under IFRS 16 the total expense over the three years is also CU30,000 but this is 'front-loaded' – in other words the expense is higher in the early years. This results from recognising interest at a constant rate of return on the outstanding liability.

The lease liability is re-measured (with a corresponding adjustment to the right-of-use asset) when:

- the lease term is revised (see below under 'Renewal and termination options')
- future lease payments based on an index or rate are revised (see below under 'Variable lease payments')
- the lease is modified (see below under 'Lease modifications')
- there is a change in the amounts expected to be paid under residual value guarantees.

Renewal and termination options

As noted above, the initial lease liability takes into account lease payments during option periods only if exercise of an option to extend is considered reasonably certain (or non-exercise of an option to terminate the lease is reasonably certain). This is consistent with IFRS 16's definition of the 'lease term'.

Definition of lease term:

IFRS 16 defines the lease term as the non-cancellable period of the lease, together with both of the following:

(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.

The lessee must reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, if there is a significant event or change in circumstances that:

- is within the lessee's control; and
- affects whether exercise (or non-exercise) is reasonably certain.

A change in this assessment triggers a re-measurement of the lease liability. Similarly, re-measurement is required if the lessee actually exercises an extension option that was not considered reasonably certain, or does not exercise a termination option that was considered reasonably certain. To account for these events the lessee:

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

The accounting for a reassessment of an extension option is illustrated in the following example:

Under IFRS 16, the expense is 'front loaded' – in other words the expense is higher in earlier years.

Example – Reassessment of an extension option

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

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

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

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

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

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

Analysis

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

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

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

Variable lease payments

The accounting for variable lease payments depends on the nature of the variability. Payments that vary based on an index or rate are included in lease payments for classification and measurement purposes based on the prevailing index or rate at the measurement date. The lease liability is re-measured when the index or rate changes and the lease payments are revised. This differs from current practice; future changes in inflation are often not included in minimum lease payments under IAS 17.

Payments that vary based on future usage of the leased asset are not included in lease payments for classification and measurement purposes. However, variable payments that are in-substance fixed payments are included in the lease payments.

Practical insight – In-substance fixed lease payments

IFRS 16 provides the following examples of lease payments that are variable in legal form but should be treated as fixed in-substance:

- payments that must be made only if an asset is proven to be capable of operating during the lease
- payments that must be made only if an event occurs that has no genuine possibility of not occurring
- payments that are initially variable but for which the variability will be resolved in future (which become 'in-substance fixed' when resolved)
- arrangements in which there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case the lease payments are the realistic set of payments.

The diagramme summarises the initial and subsequent accounting requirements for variable lease payments:

Accounting for variable lease payments

Type of variable payment	Initial accounting	Subsequent accounting
Variable lease payments that depend on an index or a rate	Include in lease liability and asset based on level of index/rate at the commencement date	Adjust lease liability and asset when revised index/rate changes the lease payments (using original discount rate)
Other variable lease payments (eg payments linked to sale or usage)	Exclude from lease liability and asset	Recognise an expense in the period that the event or condition that triggers the payments occurs
In-substance fixed lease payments	Treat as fixed lease payments	Treat as fixed lease payments

Non-lease elements

Non-lease elements

Many contracts contain both lease and non-lease elements. Examples of non-lease elements include: maintenance, security and other onsite services in a property lease, the supply of goods in a contract manufacturing agreement, operational services in a transport or outsourcing contract and the lessor paying insurance costs or property taxes that relate to the underlying asset. The lessee needs to account for non-lease elements separately from the lease element(s). This requires an allocation of the total contractual payments to lease and non-lease elements based on relative stand-alone selling prices. Non-lease elements are then accounted for under the applicable IFRS guidance.

IFRS 16 includes a practical expedient allowing lessees to make an accounting policy election (by class of underlying asset) to treat non-lease elements as part of the lease.

Practical insight – Including non-lease elements in the lease accounting

Taking advantage of the practical expedient to not separate non-lease components from lease components will certainly simplify the accounting for a contract that contains a lease. However, this will also increase the amount of assets and liabilities recognised and could have implications for impairment.

Lease modifications

Accounting for a modification to a lease depends on the nature of the modification. The possible outcomes are to account for the change as:

- a separate lease
- a re-measurement of the lease liability using a discount rate determined at that date, and corresponding adjustment to the right-of-use asset
- a re-measurement of the lease liability using a discount rate determined at that date and partial termination of the lease. The asset is adjusted to reflect its reduced scope, and the impact of revised pricing and the change in discount rate on the remaining scope. A termination gain or loss is recognised (calculated as the difference between pre-modification carrying values of the asset and liability multiplied by the proportionate reduction in scope). Example 17 accompanying IFRS 16 illustrates this accounting.

IFRS 16's requirements on accounting for a lease modification are summarised in the diagramme:

Types of lease modification

Does modification (i) increase the scope of the lease by adding a right to use one or more underlying assets; and (ii) increase consideration by an amount commensurate with stand-alone price for increased scope (and any appropriate price adjustments to reflect circumstances)?

Yes → Account for new terms as a separate lease

No → Does modification decrease scope of lease (ie is it a full or partial termination)?

- No → Adjust liability to reflect revised consideration, with corresponding adjustment to asset
- Yes → Adjust lease liability to reflect revised consideration; adjust asset to reflect change in scope plus effect of revised pricing and discount rate (with termination gain/loss in P&L)

IFRS 16 includes a practical expedient allowing lessees to make an accounting policy election (by class of underlying asset) to treat non-lease elements as part of the lease.

Lessor accounting

IFRS 16's requirements for lessor accounting are similar to IAS 17's. In particular:

- the distinction between finance and operating leases is retained
- the definitions of each type of lease, and the supporting indicators of a finance lease, are substantially the same as IAS 17's (see below)
- the basic accounting mechanics are also similar, but with some different or more explicit guidance in a few areas such as variable payments.

Definitions of finance and operating leases

Finance lease
A lease that transfers substantially all the risks and rewards incidental to ownership of an underlying asset.

Operating lease
A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

Summarised indicators of a finance lease

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease →

- the lease transfers ownership of the underlying asset to the lessee
- lessee has a bargain purchase option
- lease term is major part of the economic life of the underlying asset
- present value of the lease payments amounts to substantially all of the fair value of the underlying asset
- underlying asset is of a highly specialised nature

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease →

- if lessee can cancel lease it bears resulting losses for lessor
- gains or losses from changes in fair value of the residual accrue to the lessee
- lessee has the ability to continue the lease for a secondary period at a bargain rent.

Finance leases

For a finance lease, the lessor initially recognises a receivable at an amount equal to the net investment in the lease. The net investment in the lease is the present value of:

- the lease payments, which are determined consistently with IFRS 16's guidance for lessees (for example, variable payments that depend on an index or a rate are included, initially measured using the index or rate as at the commencement date); and
- any unguaranteed residual value accruing to the lessor.

The net investment is discounted using the interest rate implicit in the lease. This rate is defined in such a way that the initial net investment equals the sum of the fair value of the underlying asset and the lessor's initial direct costs.

Subsequently a finance lessor recognises finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the net investment in the lease.

Practical insight – Impairment of lease receivables

Under IFRS 9 'Financial Instruments' lessors will be required to account for impairment of lease receivables using a new 'expected loss' model. IFRS 9 is effective from 1 January 2018. Our 'Get Ready for IFRS 9' series of publications provides more detail.

Operating leases

For an operating lease, the lessor:

- uses a depreciation policy for underlying assets subject to operating leases that is consistent with the normal depreciation policy for similar assets
- adds initial direct costs of obtaining the lease to the underlying asset and recognises them as an expense over the lease term on the same basis as the lease income
- recognises lease payments as income on either a straight-line basis or another systematic basis if more representative of the pattern in which benefit from use of the underlying asset is diminished.

Subleases

A sublease involves the re-leasing by a lessee of the underlying asset to a third party, while the 'head lease' between the original lessor and lessee remains in effect. Under IFRS 16 subleases are accounted for by the sub-lessor in the in the same way as other leases. The sublease is classified as 'operating' or 'finance' by reference to the right-of-use asset.

As an exception, if the head lease is short-term and accounted for using the optional simplification described above, the sublease is classified as an operating lease.

Practical insight – Lease modifications for lessors

IFRS 16 has new guidance on lease modifications for the two lease types:

Modification to a finance lease

A modification to a finance lease 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 increases by an amount commensurate with the stand-alone price for the increased scope and any appropriate adjustments to reflect the circumstances.

If these conditions are not met, the accounting depends on whether the lease would have been an operating lease if the new terms were in effect at inception. If so, the lessor accounts for the modified lease as a new operating lease from the modification date (measuring the underlying asset equal to the net investment in the original lease immediately before the modification). If not, the guidance in IFRS 9 on modified financial assets applies.

Modification to an operating lease

A modification to an operating lease is accounted for as a new lease from the modification date. Prepaid or accrued lease payments relating to the original lease are treated as payments for the new lease.

Manufacturer-lessors

IFRS 16's requirements on accounting for a finance lease by a manufacturer- or dealer-lessor are similar to IAS 17's. The manufacturer- or dealer-lessor recognises a selling profit at the commencement date made up of:

- revenue for the fair value of the underlying asset (or the present value of the lease payments if lower)
- cost of sales for the cost (or carrying amount if different) of the underlying asset less the present value of the unguaranteed residual value
- costs incurred in connection with obtaining the finance lease as an expense.

If a manufacturer- or dealer-lessor charges an artificially low interest rate, selling profit must be restricted to the amount that would apply based on a market interest rate.

A manufacturer-lessor does not recognise selling profit on entering into an operating lease.

Practical insight – Impact of IFRS 16 on lessors

IFRS 16's changes to lessor accounting are limited to some detailed matters and are mainly a consequence of changes to lessee accounting. The main changes from IAS 17 relate to:

- subleases – under IFRS 16 the head lease and a sublease are two separate contracts that are accounted for under the lessee and lessor models. The sublease is classified by reference to the right-of-use asset. IAS 17 has limited guidance but in practice subleases are often classified by the intermediate lessor by reference to the underlying asset
- new definition of a lease – see above
- lease modifications – see above
- initial direct costs – which are defined slightly differently than in IAS 17. IFRS 16's definition clarifies that these are incremental costs that would not have been incurred if a lease had not been obtained
- variable payments – under IAS 17 contingent rents are not part of 'minimum lease payments' and generally excluded from finance lease liabilities and assets
- lessor disclosures – see below.

Sale and leaseback accounting

IFRS 16 makes significant changes to sale and leaseback accounting.

If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor determine whether the transfer qualifies as a sale. This determination is based on the requirements for satisfying a performance obligation in IFRS 15.

The different accounting treatments for whether or not the transfer qualifies as a sale are described below.

Transfer of the asset is a sale

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

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

The seller-lessee recognises a portion of the total gain or loss on the sale. The amount recognised is calculated by splitting the total gain or loss into (i) an unrecognised amount that relates to the retained rights; and (ii) a recognised amount that relates to the rights retained in the underlying asset by the buyer-lessor at the end of the leaseback. The leaseback itself is then accounted for under the lessee accounting model.

The buyer-lessor accounts for the purchase in accordance with the applicable standards (eg IAS 16 'Property, Plant and Equipment' if the asset is property, plant or equipment). The lease is accounted for under IFRS 16's lessor accounting requirements.

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

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

Example – Sale and leaseback

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

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

Analysis

(a) SellCo

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

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

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

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

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

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

(b) BuyCo

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

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

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

Transfer of the asset is not a sale

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

- the seller-lessee continues to recognise the asset and accounts for the amounts received as a financial liability
- the buyer-lessor does not recognise the transferred asset and accounts for the amounts paid as a financial asset.

Presentation and disclosure

IFRS 16 requires a lessee and a lessor to provide information about leasing activities within their financial statements.

The Standard explains how this information should be presented and what disclosures are required. An overview of these requirements is summarised below.

Presentation

For a lessee, a lease that is accounted for under the general model gives rise to:

- an asset and liability in the balance sheet. The asset and liability must be presented or disclosed separately from other, non-lease assets and liabilities (except for investment property right-of-use assets which are presented as investment property)
- interest expense on the liability (part of finance costs) and depreciation expense on the right-of-use asset.

In the statement of cash flows payments are classified:

- as financing for the amounts relating to the principal portion of the lease liability
- in the same classification as interest paid for amounts relating to the interest portion of the lease liability
- as operating for amounts relating to short-term and low-value asset leases that are accounted for off-balance sheet and for variable payments not included in the lease liability.

For a lessor, the requirements are largely the same as IAS 17's. In summary:

- for finance leases the net investment is presented as a receivable in the balance sheet
- assets subject to operating leases are presented according to the nature of the underlying asset.

Disclosures

IFRS 16 requires different and more extensive disclosures about leasing activities than IAS 17.

The objective of the disclosures is to provide users of financial statements with a basis to assess the effect of leases on the entity's financial position, performance and cash flows. To achieve that objective, lessees and lessors disclose both qualitative and quantitative information.

Lessee disclosures

Disclosure area	Summary of requirements
Quantitative information about leases (generally in a tabular format)	• depreciation charge for right-of-use assets by class of underlying asset • interest expense on lease liabilities • expense relating to low-value and short-term leases (other than leases of 1 month or less) if exemption(s) elected • commitments for short-term leases if expense disclosed reflects a dissimilar lease portfolio to the period-end commitment • expense relating to variable lease payments not included in lease liabilities • income from subleasing • total cash outflow for leases • additions to right-of-use assets • gains or losses from sale and leaseback transactions • the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset • maturity analysis of lease liabilities • additional information about right-of-use assets that are investment property or are revalued under IAS 16
Additional qualitative and quantitative information as necessary to meet the disclosure objective	• nature of leasing activities • future cash outflows to which the lessee is potentially exposed that are not reflected in the lease liabilities, including exposure arising from: – variable lease payments – extension and termination options – residual value guarantees – leases not yet commenced • restrictions or covenants imposed by leases • sale and leaseback transactions

Lessor disclosures

Disclosure area	Summary of requirements
Finance leases	• selling profit or loss • finance income on the net investment in the lease • income relating to variable lease payments not included in the measurement of the net investment in the lease • qualitative and quantitative explanation of significant changes in net investment in the lease • maturity analysis of lease receivable
Operating leases	• lease income, separately disclosing income for variable lease payments that do not depend on an index or rate • as applicable for underlying asset, relevant disclosures in – IAS 16 for leases of property, plant and equipment, disaggregated by class – IAS 36 'Impairment', IAS 38, IAS 40 and IAS 41 • maturity analysis of lease payments
Other	• additional qualitative and quantitative information about leasing activities as necessary to meet disclosure objectives, including but not limited to: – nature of leasing activities – how the risk associated with any rights retained in the underlying asset is managed

Effective date and transition

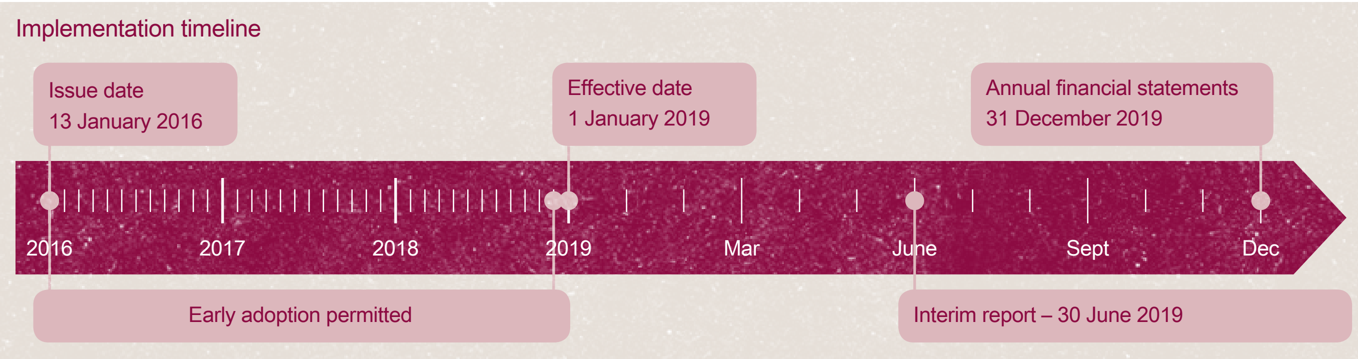
IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted for entities that apply IFRS 15 at or before the date of initial application of this Standard.

IFRS 16 includes two possible transition methods as follows:

- full retrospective application
- partial retrospective application

These are explained in more detail below.

The transition timeline (for an entity that produces interim financial statements half-yearly) is summarised in the diagramme:



IFRS 16 provides lessees with a choice between two transition methods:

- full retrospective application – with restatement of comparative information in accordance with IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'
- partial retrospective application – without restating comparatives. Under this approach the cumulative effect of initially applying IFRS 16 is recognised as an adjustment to equity at the date of initial application (DOIA) (eg 1 January 2019 for a lessee that adopts IFRS 16 on the effective date and has a 31 December year-end).

If a lessee chooses partial retrospective application, a number of more specific transition requirements and optional reliefs also apply. These are summarised in the table below.

Lessors are not required to make any adjustments in respect of leases in place at the date of transition, except for intermediate lessors (ie lessors with sub-leases). Instead, the Standard is applied prospectively from the date of transition.

IFRS 16 also provides both lessees and lessors with optional transition relief from reassessing whether contracts in place at the DOIA are, or contain, a lease.

Finally, the Standard sets out transition requirements in relation to:

- sale and leaseback transactions before the DOIA
- leases assumed in previous business combinations.

Transition provisions for lessees when using partial retrospective application

Area	Requirement or optional relief
Leases previously classified as operating leases	• lease liability at the DOIA is measured at the present value of the remaining lease payments, discounted at the lessee's incremental borrowing rate at the DOIA • choice to measure right-of-use asset at either: – carrying amount as if IFRS 16 had been applied since commencement, but discounted at the incremental borrowing rate at the DOIA; or – amount of lease liability, adjusted for prepaid or accrued rentals • the right-of-use asset is measured at fair value at the DOIA for leases of investment property that were accounted for as operating leases under IAS 17 but to which the IAS 40 fair value model will apply in future • optional reliefs are available in relation to: – low-value asset leases and leases for which the lease term ends within 12 months of DOIA – leases of investment property to which the IAS 40 fair value model has been applied – use of a single discount rate for a portfolio of leases with reasonably similar characteristics – relying on the IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' 'onerous' assessment instead of an impairment review on transition (in which case the right-of-use asset is reduced by the amount of any onerous lease provision) – excluding initial direct costs from the right-of-use asset – use of hindsight in determining the lease term if lease contains extension or termination options
Leases previously classified as finance leases	• right-of-use asset and lease liability are measured at the same amounts as under IAS 17 at the DOIA
Disclosures	• relief from disclosing the current period impact in accordance with IAS 8 if entity elects the partial retrospective application approach • some additional disclosures required in year of transition

Practical insight – next steps

Although the new standard is not mandatorily effective until 2019, there are several actions that entities should take to prepare for implementing the requirements:

- evaluate both the recognition and disclosure requirements to determine how the information will be accumulated
- consider whether to adopt any of the practical expedients and policy choices that will impact the type of information that must be accumulated to prepare for transition
- compile information about existing leases to gauge the impact of the new leasing model
- design and prepare to implement new controls over the recording of right-of-use lease assets and liabilities, including transition, initial measurement, modifications, and impairment testing
- review loan covenants and other agreements that incorporate financial ratios and metrics, such as compensation arrangements, that could be affected by the new leasing model.

We hope you find the information in this Special Edition of IFRS News helpful in giving you an overview of IFRS 16. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.global/locations to find your local member firm.

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