Lease components

The unit of account for lease accounting

IFRS®16

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Contents

Separation challenges

Lease agreements frequently bundle multiple components – from complex outsourcing arrangements, to simple real estate leases in which the landlord provides building maintenance. If your business has leases, you will probably face component questions when implementing IFRS 16 *Leases.*

The lease component is the unit of account for lease accounting. Lessors and lessees need to identify, and generally separate, lease and non-lease components to apply the new standard. To do this, they need to allocate the consideration in the contract between the components that they account for separately.

For a lessor, this process is necessary to correctly distinguish lease income from other revenue. Lessors generally apply IFRS 15 *Revenue from Contracts with Customers* to do this.

For a lessee, this process has a more fundamental accounting impact – it determines what proportion of a contract will be recognised on-balance sheet. The new standard has specific guidance on how to determine this.

This publication contains practical guidance and examples showing how to identify lease and non-lease components in a contract and how to allocate the consideration. We hope you will find it useful as you apply the new standard.

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1 At a glance

1.1 Key facts

The lease component is the unit of account for lease accounting.

Lessors and lessees separate lease components from other lease components and, generally, from non-lease components such as services. They then allocate – and, if necessary, reallocate – the consideration in the contract between the components that they account for separately.

The key steps in accounting for the components of a contract are as follows.

Identify separate lease components (see Chapter 2)

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Identify non-lease components (see Chapter 3)

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Allocate consideration (see Chapter 4)

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Reallocate consideration on lease modification or reassessment (see Chapter 5)

A lessor applies IFRS 15 to separate components. A lessee applies specific guidance in the new standard that is similar to, but less detailed than, IFRS 15.

For lessees only, a practical expedient allows a lease and associated non-lease components to be accounted for as a single lease component rather than separately (see Section 3.2). Otherwise, lease components and non-lease components are always separated, with non-lease components accounted for under other standards.

Once the lease and non-lease components have been identified and separated, the lessee allocates the contract consideration to each lease component on the basis of its stand-alone price and the aggregate stand-alone prices of the non-lease components.

All of this is done at the beginning of a contract, so that each lease component can be accounted for from its commencement date. In addition, if a contract is modified, or the new standard requires the lease payments to be reassessed, then subsequent reallocations may be necessary (see Chapter 5).

1.2 Key impacts

Distinguishing lease income from other revenue. For lessors, identifying components and allocating consideration will determine the split of lease income vs revenue from contracts with customers. These amounts are often presented, and must be disclosed, separately. For example, a real estate company will need to distinguish lease income from revenue for other building-related services – e.g. common area maintenance (CAM).

Determining what proportion of a contract will be on-balance sheet. For lessees, distinguishing between lease components (generally on-balance sheet) and non-lease components (generally off-balance sheet) will be a key driver of the impact of the new standard. This will also require careful allocation of consideration between components.

Deciding whether to apply the practical expedient. Lessees will need to decide whether, and if so when, to apply the practical expedient to combine a lease component with associated non-lease components. This decision must be made separately for each class of underlying asset. Applying the practical expedient will generally simplify application of the new standard – but when payments are fixed, this will increase reported assets and liabilities, and impact many financial ratios.

Identifying components and gathering information. This may require a substantial effort to identify all components, gather information on the stand-alone prices and allocate the consideration on commencement, reassessment and modification of the lease.

New estimates and judgements. The new standard introduces new estimates and judgements that affect the measurement of lease liabilities. A lessee determines the liability at commencement and may be required to remeasure it – e.g. remeasurement of the lease components on a reassessment or modification. This will require ongoing monitoring and increase financial statement volatility.

Balance sheet volatility. The new standard introduces financial statement volatility to assets and liabilities for lessees and lessors, due to the requirements to account for reassessment and lease modifications. This may impact a company's ability to accurately predict and forecast results and will require ongoing monitoring.

Changes in contract terms and business practices. The impact of the new standard is not limited only to financial reporting. It may prompt changes to certain contract terms and business practices – e.g. changes in the structuring or pricing of a lease agreement, including the type of variability of lease payments and the inclusion of options in the contract. The new standard is likely to affect departments beyond financial reporting – including treasury, tax, legal, procurement, real estate, budgeting, sales, internal audit and IT.

New systems and processes. Companies should ensure that they have systems and processes that enable them to identify separate lease and non-lease components and gather information for allocating consideration to comply with the requirements.

Careful communication with stakeholders. Investors and other stakeholders will want to understand the new standard's impact on the business. Areas of interest may include the effect on financial position and financial results, the costs of implementation and any proposed changes to business practices.

Sufficient documentation. The judgements, assumptions and estimates applied in determining how to measure the lease liability at the commencement date, as well as remeasurement when a reassessment or modification occurs, will need to be documented.

2 Identifying separate lease components

Each separate lease component is a unit of account to be accounted for under the new standard.

IFRS 16.12, B2, B32, BC130

When a company concludes that a contract is or contains a lease, it identifies each separate lease component, which is the unit of account under the new standard. However, before setting out to identify and separate lease components, it is important to establish whether the new standard requires you to assess a single contract or a combination of contracts. Separate accounting for multiple contracts may not always deliver a faithful representation of the transaction.

2.1 Combining contracts

IFRS 16.B2

It is usually appropriate to account for each contract individually. However, when two or more contracts are entered into 'at or near the same time' with the same counterparty (or related parties of the counterparty), the contracts are combined as a single contract if one or more of the following criteria are met:

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

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

– the rights to use underlying assets conveyed in the contracts form a single lease component (see Section 2.2).

Example 1 – Combining contracts

IFRS 16.B2

Lessee S leases a specifically identified space in a building and a printing press from Lessor L for three years. S enters into two separate contracts, executed within a few days of each other.

The contractual payments for the building space are fixed at 250,000 per year and payments for the printing press are based entirely on the level of use – i.e. 75 for each hour operated.

The estimated stand-alone prices of the building space and printing press are 300,000 per year and 50 for each hour operated, respectively.

S and L each predict that the printing press will be operated for 2,000 hours per year over the three-year lease term.

S and L conclude that the contracts are combined and considered as a single contract under the new standard. This is because the two contracts are executed near the same time with the same counterparty, and together they fulfil a single commercial objective. L agrees to a lower fixed payment for the building space contract to incentivise S, with the expectation of making up the difference with above-market variable payments in the printing press contract.

Example 2 – Contracts combined in a group

IFRS 16.B2

Company P has two divisions – S and T.

S enters into an arrangement with Supplier E for a right to store its gas in a specified storage tank that has no separate compartments. At inception of the contract, S has rights to use 50% of the storage tank's capacity throughout the term of the contract.

On the same date, T enters into a separate arrangement with E to use 50% of the capacity of the same storage tank.

Storage tank

Storage rights of Division S 50%	Storage rights of Division T 50%

In this scenario, P concludes that the two contracts are combined and considered as a single contract, even if the contracts are executed by different divisions.

Therefore, assuming that the other elements of the lease definition are met, the arrangement is a lease from P's perspective. When the two arrangements are combined, P has rights to use substantially all of the storage tank's capacity.

How does a company determine whether the contracts were entered into 'at or near the same time'?

IFRS 16.BC130

The new standard does not provide any guidance on the meaning of 'at or near the same time'. A company considers its customary business practices and other reasonable expectations – e.g. changes to contracting practices – when evaluating whether two or more contracts have been entered into at or near the same time. Additionally, companies evaluate why the arrangements were written as separate contracts and how the contracts were negotiated – e.g. both contracts negotiated with the same parties vs different divisions within a company negotiating separately.

A company considers specific facts and circumstances that may be unusual. For example, a company could combine two or more large contracts that were entered into at different times if they were clearly negotiated and discussed over the same period of time and appear to be significantly inter-related.

How does combining contracts affect lease accounting?

IFRS 16.BC130–BC132

The objective of the requirement to combine contracts is to faithfully represent the transaction. For example, if two parties enter into a contract for the lease of an asset for one year starting today and then sign another contract to lease the same asset starting one year later, it is not appropriate to apply the short-term lease exemption to these two contracts. For more detail on the application of short-term lease exemption, see 6.2.2 in our Lease Definition publication.

The requirement's intention is to limit structuring opportunities to avoid lease accounting by separating contracts. These would particularly affect the company's accounting for sale-and-leaseback transactions, short-term leases and leases of low-value assets.

If the combined contracts include multiple lease and non-lease components, then the allocation to the components may differ from those amounts allocated based on the original, separate contracts.

2.2 Separate lease components

IFRS 16.12, BC133

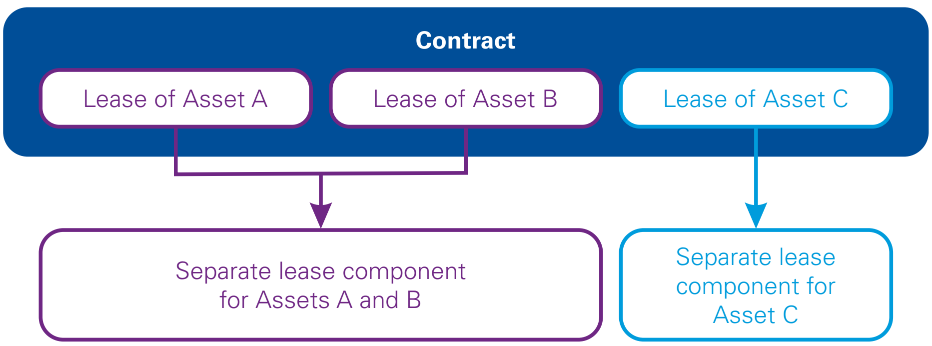
After identifying that a contract, or a combination of contracts, is or contains a lease, a company identifies each separate lease component. The guidance on what constitutes a separate lease component is the same for lessees and lessors.

IFRS 16.B32–B33

A lease contract may allow the lessee the right to use multiple assets – e.g. a building and equipment. If a lease contract involves the use of multiple assets, then a company assesses whether the right to use each of these underlying assets meets the criteria to be identified as a separate lease component. The right to use an underlying asset is a *separate* lease component if both of the following criteria are met:

- the lessee can benefit from using the underlying asset either on its own or together with other resources that are readily available; and
- the asset is neither highly dependent on, nor highly inter-related with, the other assets in the contract.

A contract with multiple leases may contain one or many separate lease components.



IFRS 16.B32

Example 3 – Multiple lease components: Separation criteria met

Lessee X enters into a 15-year lease for five floors of a building. The floors are accessed via common lifts and stairs, but each floor has separate access controls. Each floor is equipped with the necessary facilities (e.g. wash rooms) to allow it to be used separately. X can sub-lease each floor without significant work.

X concludes that the right to use each individual floor is a separate lease component because:

- X can benefit from the use of an individual floor on its own; and
- the use of an individual floor is neither dependent on nor highly inter-related with the use of other floors in the building. X can control access to each individual floor separately. In addition, each floor can be sub-leased without significant work.

Example 4 – Multiple lease components in a master lease agreement: Separation criteria met

Lessee C enters into a master lease agreement (MLA) with Lessor E to lease 30 vehicles for a fixed monthly payment of 5,000 per vehicle for a total term of five years from delivery of the first vehicle.

C takes delivery of the 30 vehicles immediately. C concludes that the contract contains 30 separate lease components, because:

- C can benefit from using each vehicle on its own; and
- each vehicle is independent of the other vehicles in the contract.

IFRS 16.B32

Example 5 – Multiple lease components: Land and building: Separation criteria not met

Lessee T leases a single-storey industrial building from Lessor Q for five years.

T has exclusive use of the property, which includes a driveway. In addition to the explicit lease of the building, there is an implied lease of the underlying land.

T concludes that there is a single lease component in the contract because:

- it cannot derive any benefit from using the land without the building; and
- the assets (i.e. building, driveway and land under the building) are highly dependent on each other.

In this scenario, T recognises a single lease liability with a corresponding right-of-use asset.

However, if the contract included the right to use an adjacent piece of land that T could use for a number of different purposes (e.g. to redevelop into a garden or a car park), then there might be multiple separate lease components – one for the building, driveway and underlying land and another for the adjacent land.

Additional considerations may apply to Q's assessment of whether to account for the land and building elements separately – see Section 2.3.

Example 6 – Single lease component: Turbine plant: Separation criteria not met

IFRS 16.B32

Lessor G leases a gas-fired turbine plant to Lessee P for 10 years to produce electricity. The plant consists of the turbine housed within a building together with the land on which the building sits. The building was designed specifically to house the turbine, has a similar economic life to the turbine of approximately 15 years and has no alternative use.

G and P assess whether the lease of the turbine includes separate lease components. The rights to use the turbine, the building and the land are highly inter-related because each is an input into a combined item contracted for by P – i.e. the right to use a gas-fired turbine plant that can produce electricity.

Therefore, G and P conclude that the contract contains only one lease component.

Is identifying lease components under the new standard consistent with identifying a performance obligation under IFRS 15?

IFRS 16.BC134

Yes, in broad terms. Identifying separate lease components in a lease contract under IFRS 16 is similar to identifying performance obligations in a revenue contract under IFRS 15.

Under both standards, a company determines whether a customer or a lessee is contracting for a number of separate deliverables or for one deliverable. Therefore, IFRS 16's requirements on separating lease components are similar to those in IFRS 15 on the identification of performance obligations.

However, IFRS 16 does not simply cross-refer to IFRS 15. Instead, it contains guidance that is similar to, but less extensive than, that in IFRS 15. In addition, IFRS 16 contains additional guidance for lessors on separation of the land and building elements of a lease of real estate (see Section 2.3). In theory, different conclusions could be reached under IFRS 15 and IFRS 16.

How can we interpret 'readily available' when applying the first criterion?

IFRS 15.27(a), 28

The first criterion for considering whether a right to use an asset is a separate lease component is based on the 'capable of being distinct' test in IFRS 15. This test is based on the characteristics of the underlying asset itself.

IFRS 16.B32

Resources are considered 'readily available' when they are sold or leased separately by the lessor or other suppliers, or when the lessee has already obtained them from the lessor or from other transactions or events.

The fact that the lessor or other companies regularly lease an asset separately indicates that a customer can benefit from the lease of that asset on its own or with other readily available resources.

For a discussion of identifying a performance obligation in a revenue contract, see Section 2.1 of our IFRS 15 handbook – Revenue.

How can we interpret 'highly dependent or highly inter-related' when applying the second criterion?

IFRS 15.27(b), 29(c)

The second criterion is based on part of the 'distinct in the context of the contract' test in IFRS 15.

IFRS 16.B32

An asset might be highly dependent on, or highly inter-related with, the other assets if the lessee could not lease the asset without significantly affecting its rights to use other assets in the contract.

IFRS 15 provides an example of when two or more goods or services are 'significantly affected by each other'. It states that this would be the case when the company would not be able to fulfil its promise to the customer by transferring each of the goods or services independently – i.e. the fulfilment of each promise depends on the other.

For a discussion of identifying a performance obligation in IFRS 15, see Section 2.1 of our IFRS 15 handbook – Revenue.

Does the identification of separate lease components always affect the accounting outcome?

IFRS 16.12

No. In some circumstances, identifying a separate lease component will not affect the lease accounting. In Example 3, the right to use each individual floor in the building is identified as a separate lease component. However, accounting for the right to use each of the five floors separately may be the same as accounting for the five floors together. That is, the aggregate lease liability and right-of-use asset, and the income statement effects would be the same.

IFRS 16.B58

However, there may be circumstances in which this would not be the case. For example, if Lessee X were to sub-lease one of the floors under a finance lease, then it would derecognise the right-of-use asset relating to that floor. This would require it to allocate the total consideration in the lease to each separate lease component as described in Chapter 4.

Does pricing affect separating components?

No. Pricing is not considered when assessing whether the right to use an underlying asset is identified as a separate lease component in a contract involving multiple leases.

IFRS 16.B32

The separation criteria relate to the benefits from the right to use the asset either on its own or together with other resources that are readily available, and the relationship between the asset and the other assets for which the lessee has a right of use in the contract – i.e. the asset is neither highly dependent on, nor highly inter-related with, the other assets in the contract.

IFRS 16.B2

This is different from the contract combination test. When determining whether two or more contracts are combined, the price interdependency is one criterion to consider – if the amount of consideration to be paid in one contract depends on the price or performance of the other contract, then the contracts are combined as a single contract.

2.3 Lessors – Additional considerations for land and buildings

IFRS 16.12, B53

The general guidance on identifying separate lease components is the same for lessees and lessors. A lessor then classifies each lease component as a finance or an operating lease, based on the extent to which the lease transfers the risks and rewards incidental to ownership of the underlying assets (this guidance is not relevant to lessees).

IFRS 16.B55, B57

When a lease includes both land and building elements, the lessor assesses the classification of each element separately, unless the value of the land at inception of the lease is deemed immaterial. In this case, the lessor may treat the land and building as a single unit to classify it as either a finance or an operating lease, applying the criteria in the new standard.

If separating the land element would have no effect on the lease classification, then the lessor does not need to separate it because the accounting impact would be insignificant. However, if the land and building elements are classified differently – e.g. operating lease for the land and finance lease for the building – then the lessor accounts for the two elements separately.

IFRS 16.B56

When accounting for the land and building separately, the lessor allocates lease payments between the two elements in proportion to the relative fair values of the leasehold interests in the land and building elements at the date of lease inception. This is different from the general allocation requirements – see Section 4.3.

IFRS 16.B56–B57

If the lease payments cannot be allocated reliably between the two elements, then the entire lease is classified as a finance lease, unless both elements are clearly operating leases.

IFRS 16.B32, B55–B57

When a lease contract contains both land and building elements, a lessor considers the specific guidance described above, notwithstanding the fact that the land and building might be highly interdependent and highly inter-related.

Example 7A – Classification of land and building: No separation

IFRS 16.61–63, B32, B55

Lessor Q leases a single-storey industrial building to Lessee T for five years.

T has exclusive use of the property, which includes a driveway. In addition to the explicit lease of the building, there is an implied lease of the underlying land.

T and Q conclude that there is only one separate lease component in the contract because:

- T cannot derive any benefit from using the land without the building; and
- the assets (i.e. building, driveway and land under the building) are highly dependent on each other.

However, as the lessor, Q is required to assess the classification of the land and building elements separately. Q concludes that both land and building elements are clearly operating leases. This is because Q does not transfer substantially all of the risks and rewards incidental to ownership of either the land or building. Therefore, separating the land and building elements would have no effect on lease classification and would be insignificant from an accounting perspective.

Q classifies the entire lease as an operating lease.

Example 7B – Classification of land and building: Separation required

IFRS 16.61–63, B55–B56

Modifying Example 7A, Lessor Q leases the building to Lessee T for 30 years. The remaining economic life of the building on lease commencement is expected to be 30 years.

T and Q conclude that there is only one separate lease component in the contract.

Q assesses the classification of the land and building elements separately. Q concludes that:

- the land element is classified as an operating lease; but
- the building element is classified as a finance lease, because the lease term is for the major part of the economic life of the building.

Therefore, Q accounts for the land and building elements separately. To do this, Q allocates the lease payments between the land and building elements in proportion to the relative fair values of their respective leasehold interests.

Why does the standard include additional guidance on separating land and building leases for lessors?

IFRS 16.B55, BC58

This guidance is brought forward from IAS®17 *Leases* to minimise changes to lessor accounting. However, it is inconsistent with the general guidance on separating components in a number of respects. For example, it requires separate classification of land and building elements even when they would be a single lease component. In addition, it requires lease payments to be allocated based on relative fair values of the leasehold interests, rather than using the principles in IFRS 15 that lessors are required to apply in other cases.

How small does the relative value of the land element need to be in relation to the total value of the lease to avoid separation?

IFRS 16.BCZ250

The test here is whether the value of the land element at inception of the lease is deemed immaterial. There is no bright line test – e.g. no specific percentage threshold.

Generally, materiality as a concept is applied at the level of the financial statements. However, this test – which is brought forward from IAS 17 – typically considers the significance of the land element in relation to the lease, not the financial statements as a whole.

Why does the lessor allocate the lease payments between the land and building components based on the relative fair values of the respective leasehold interests?

IFRS 16.B56, BCZ245–BCZ247

An allocation based on the relative fair values of the land and building elements – rather than based on the relative fair values of the respective leasehold interests in the land and building elements – is not generally appropriate because the land often has an indefinite economic life and is likely to maintain its value beyond the lease term. Therefore, the lessor would not normally need compensation for 'using up' the land. In contrast, the future economic benefits of a building are likely to be 'used up' to some extent over the lease term (which is reflected via depreciation).

Therefore, when allocating the lease payments between the land and the building elements, it is reasonable to assume that the lease payments relating to the:

- *building element (depreciable asset)* are set at a level that enables the lessor not only to make a return on its initial investment, but also to recover the part of the value of the building 'used up' over the lease term; and
- *land element (non-depreciable asset)* (assuming a residual value that equals its value at inception of the lease) are set at a level that enables the lessor to make only a return on the initial investment.

Does an intermediate lessor that leases and sub-leases land and a building classify the land element separately?

IFRS 16.B55, B57

As mentioned above, when a lease includes both land and building elements, the lessor assesses the classification of each element separately, unless the value of the land element at inception of the lease is deemed immaterial. When determining whether the land element is an operating or a finance lease, an important factor is that the land normally has an indefinite economic life.

IFRS 16.B58

An issue arises when a company leases land and buildings under a head lease and sub-leases them as an intermediate lessor. In this case, the company classifies the sub-lease with reference to the right-of-use asset arising from the head lease. Therefore, the underlying asset for the land element of the sub-lease does not have an indefinite economic life.

For example, if the head lease is for 20 years, which is similar to the estimated useful life of the building, then the intermediate lessor does not separate the land element from the building element to classify the sub-lease. However, if the head lease for the land is for 999 years, then the intermediate lessor would separate the land element when assessing classification.

2.3.1 Multi-tenant building

As mentioned in Section 2.3 above, if a lease of a building (or space in a multi-tenant property) includes a land lease element, then that element is accounted for separately by the lessor unless it is deemed to be immaterial or separation would have no effect on the lease classification. Consequently, in such a lease the lessor determines:

- whether the lessee obtains a right to use the land on which the building is located; and if so
- whether the accounting for that right of use is immaterial or the classification for both components would differ.

Determining whether a lease of a building (or space in a multi-tenant property) includes a right to use the underlying land includes determining:

- whether the land represents an identified asset; and if so
- whether the lessee has the right to control its use.

The evaluation will depend on property law in the relevant jurisdiction. However, it will often differ for leases of single-tenant properties and leases of space in multi-tenant properties. Although leases of single-tenant properties will generally include a lease of the underlying land, leases of a space in multi-tenant properties often will not.

Does a lessor of a multi-tenant building separate land and building lease elements?

IFRS 16.B55

Generally, no. When a lessor owns a high-rise apartment building and leases apartments to individual tenants, the lessor first needs to determine whether there is a lease of the underlying land. If there is not, then the lessor does not need to evaluate the separation criteria.

In this case, the entire underlying land is an identified asset. Each tenant has only shared use of the land – i.e. no tenant has a right of use over a physically distinct portion of the underlying land.

This is similar to the conclusion under IFRS 15 that in a sale of an apartment in a multi-tenant building, the promise to transfer the apartment and the related land can be a single performance obligation.

In contrast, a lease component may exist for the land if the lessee is leasing substantially all of the building. In this case, the entire underlying land is likely to be a single, identified asset and the lessee may have the right to control its use. If that is the case, then the lessor is required to account for it as a separate lease component unless it is immaterial or both components (i.e. the land and the building leases) would have the same classification.

2.4 Portfolio approach

IFRS 16.B1

The new standard applies to individual lease components. However, as a practical expedient a company may account for a portfolio of leases with similar characteristics together if it reasonably expects that the effects of doing so would not differ materially from accounting for each lease component individually.

Under the portfolio approach, the estimates and assumptions used to account for leases reflect the size and composition of the portfolio – e.g. the discount rate or lease term would be determined at the portfolio level, instead of at the individual asset level.

Example 8 – Applying the portfolio approach to leases of vehicles

IFRS 16.B1, Ex11

Lessee P enters into 50 individual lease contracts for similar cars during the first quarter of the year. The leases have terms of two years and commence on different dates within the same quarter. The annual lease payments are between 5,000 and 6,000 for each car.

A separate lease exists for each car and is accounted for separately under the new standard. Because the terms and conditions are similar for the lease contracts, including similar start and end dates, and there is a narrow range of fair values for the cars, P reasonably expects that the effect of applying the new standard to these 50 leases as a portfolio will not differ materially from applying it individually to each lease. Therefore, P applies the portfolio approach to determine a single discount rate for these 50 leases.

P uses its incremental borrowing rate because it is unable to determine the rate implicit in the leases. It determines this using the interest rate that it would pay for a secured loan in the amount of the lease payments for a representative lease in the portfolio (i.e. an amount between 5,000 and 6,000) for a representative lease term.

How does the portfolio approach affect lease accounting?

IFRS 16.B1, BC82–BC83

Applying the portfolio approach to a group of lease contracts does not change the company's financial statements materially. However, this approach can reduce the complexity and cost of accounting, especially for companies with large groups of leases for similar assets. For example, establishing a single discount rate for 50 leases in a portfolio will reduce the costs of lease accounting compared with determining discount rates for each of 50 lease contracts.

How does a company determine 'similar characteristics' when applying the portfolio approach?

IFRS 16.BC82–BC83, Ex11, 15.BC69–BC70

The portfolio approach under the new standard is intended to be similar to that under IFRS 15. Under IFRS 15, a company is not expected to evaluate each outcome quantitatively, but applies judgement when selecting the size and composition of the portfolio.

To apply the portfolio approach to a group of lease contracts, a company takes a reasonable approach to determine the portfolio. The characteristics of the leases to consider will include, for example, type or value of underlying assets, terms and conditions of the contract, commencement date and lease term.

3 Identifying non-lease components

The new standard does not apply to non-lease components – other standards apply.

3.1 Non-lease components

IFRS 16.12, 15

A lease contract often includes non-lease components. For example, a car lease may include a maintenance or servicing component. A lessor always accounts for non-lease components separately from the lease components. A lessee also accounts for lease and non-lease components separately, unless it elects, as a practical expedient, to account for a separate lease component and associated non-lease components together as a single lease component – see Section 3.2.

IFRS 16.B33

Only activities or costs that transfer a good or service to the lessee are identified as non-lease components. Amounts payable for activities and costs that do not transfer a good or service are part of the total consideration and are allocated to the lease and non-lease components identified in the contract. Common examples of activities (or costs of the lessor) that do not transfer a good or service to the lessee include the lessee's payments for administrative tasks, insurance costs and property taxes.

Right to use an office building

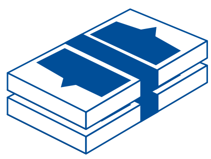
Lease component

Accounted for separately

Cleaning and maintenance services

Non-lease components

Accounted for separately



Property taxes and insurance

Not a component

Not accounted for separately

Example 9 – Non-lease component: Common area maintenance

Lessee L enters into a three-year lease of an apartment. The apartment is in a multi-tenant building that includes shared facilities – e.g. a swimming pool and garden.

In addition to the monthly lease payments, the contract includes an additional fee of 2,000 per quarter for the upkeep of the communal areas, maintenance and security – i.e. common area maintenance (CAM). This fee does not cover costs for non-routine and 'major' maintenance, which are billed to tenants separately.

At commencement, the timing and extent of the landlord's performance of CAM is unknown (i.e. because it's difficult to predict how many repairs will be needed). However, the landlord has committed to keep the building and common areas well maintained.

L determines that the CAM is a non-lease component because it transfers a good or service to L other than the right to use the apartment – i.e. L receives a service that it would otherwise pay for separately (e.g. for plumbing repairs). L has not elected to apply the practical expedient to combine lease and non-lease components. Therefore, L allocates the contract consideration to the lease component and the non-lease component (CAM services). L accounts for the lease component under the new standard; it expenses the amount allocated to CAM as it is incurred.

Are CAM services a non-lease component?

IFRS 16.Ex12

Yes. It is common in a real estate lease for the lessor to provide CAM – e.g. cleaning services, common area repairs or maintenance of a central heating plant.

It appears that CAM services are generally a separate non-lease component(s) because they transfer a service to a lessee that is separate from the right to use the underlying asset. Therefore, they are accounted for separately from the lease components, under other applicable standards. This applies to the lessor and, unless it elects the non-separation practical expedient, to the lessee.

Are property taxes part of the lease payments?

It depends. Real estate is often subject to property taxes, calculated as an assessed value of the property multiplied by a tax rate. Depending on the jurisdiction, the legal obligation to pay the property tax is either levied on the property owner or on the occupier.

Lessee accounting for property taxes

This distinction is important for tenants to determine how to account for taxes levied on the leased properties.

It appears that the lessee's accounting for property tax is driven by the identity of the statutory obligor. The identity of the party that makes the cash payment to the tax authority is less relevant.

Who has the statutory obligation to pay property tax?	
Lessor	Lessee
If the lessor has the statutory obligation to pay the property taxes, but the lease agreement requires them to be reimbursed, or paid, by the lessee, then we believe that the lessee should account for the property taxes as part of the total consideration that is allocated to the separately identified lease and non-lease components of the contract. If the property taxes are determined as a percentage of an assessed value of the property, then reimbursements thereof are typically variable payments that do not depend on an index or rate.	*If the lessee has the statutory obligation to pay the property taxes*, then we believe that the lessee should account for the property taxes as levies under IFRIC®21 *Levies*.

In some jurisdictions, the lessor and the lessee may be jointly liable for the property taxes – i.e. both parties are equally liable to pay the full amount.

This may be the case if:

– joint liability is specified by law; or

– liability is placed initially on the lessor but, in the event of non-payment, there are legal mechanisms in place that allow the tax authority to demand payment from the lessee.

In this case, we believe that the lessee should account for the property taxes in the same way as it would if it were solely liable for them – i.e. under IFRIC 21. This is because they are considered to be a tax that is levied on the lessee and are not a lease payment.

Lessor accounting for property taxes

When the lessor has a statutory obligation to pay the property taxes, the lessor accounts for the property taxes as levies under IFRIC 21. The lessor accounts for the reimbursement from the lessee as a part of the total consideration.

If a lessee reimburses a lessor's general insurance costs, then is this a non-lease component?

Generally, no. In practice, a lessor may obtain an insurance policy to cover the damages to the underlying asset and a lessee reimburses the lessor's insurance costs during the lease term. The payment could be identified separately and determined based on the lessor's actual costs, or included in a fixed, gross payment to the lessor.

In both cases, the insurance does not represent a service provided by the lessor to the lessee and therefore it is not a separate component. The payment is included in the consideration of the contract, which is allocated to the components.

Is payment for value-added taxes included in the lease payments?

Generally, no. In many jurisdictions, a value-added tax (VAT), also referred to as a 'goods and services tax' (GST), is charged on goods and services at the point of sale. This may include leases. The specific rules for calculating and collecting VAT may vary in different jurisdictions; however, the general principles are typically as follows.

- A seller charges VAT to the buyer, collects the VAT and then pays it to the government.
- If the buyer is not the end user and the good or service is purchased as a cost to its business, then it can generally recover the VAT paid by deducting it from the amounts that it remits to the government.
- In some circumstances, the buyer cannot recover the VAT paid, either because the goods or services do not qualify or because of the buyer's status. For example, in some countries banks and insurers are not eligible for VAT refunds. In this case, the VAT is (partially or fully) irrecoverable.

It appears that if VAT is a tax that is levied on the lessee and collected by the lessor, which is acting as an agent for the tax authority, then the VAT is not a lease payment or a non-lease component regardless of whether it is recoverable or non-recoverable. This is because the payment is not made in exchange for the right to use an underlying asset or a good or a service provided to the lessee.

Instead, we believe that a lessee should account for this VAT as a levy under IFRIC 21, even if it elects not to separate lease and non-lease components. This means that a lessee should identify the obligating event for the VAT payment under applicable laws and regulations. For example, if the obligating event is the issue of each periodic invoice by the lessor, then the lessee should recognise a liability for each VAT payment on each invoice date, not at lease commencement. The obligating event for VAT should be assessed according to the requirements of applicable legislation in each case.

3.2 Practical expedient for lessees – Combining lease and non-lease components

IFRS 16.15

As a practical expedient, a lessee may elect, by class of underlying asset, to combine each separate lease component and any associated non-lease components and account for them as a single lease component. This does not apply to embedded derivatives that are separated from the host contract in accordance with IFRS 9 *Financial Instruments*.

Example 10 – Applying the practical expedient to combine lease and non-lease components

IFRS 16.15, 38(b)

Lessee B enters into a five-year lease of an office building. The lease payments are 10,000 per year and the contract includes an additional water charge calculated as 0.005 per litre consumed. Payments are due at the end of the year.

B concludes that the water charge gives rise to a non-lease component in the contract and elects to apply the practical expedient to combine lease and non-lease components.

At the commencement date, B measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of 10,000). Although B has elected to apply the practical expedient to combine non-lease components (i.e. water use) with the lease component, B excludes the water charges from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because B has elected not to separate them from the fixed lease payments. B recognises the payments for water – *as a variable lease payment* – in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the consideration allocated to the water use – *as an operating expense* – in profit or loss as it is incurred.

What are the consequences of applying the practical expedient?

Applying the practical expedient for lessees not to separate non-lease components from lease components has the potential to reduce cost and complexity in some cases. However, lessees will also need to consider the accounting consequences of applying it.

Some lessees may find the balance sheet consequences unattractive. Using this practical expedient may result in recognising a liability for the service component of the contract, which would otherwise remain off-balance sheet until the landlord performs.

At the same time, using the practical expedient will impact the presentation in the statement of profit or loss, with consequential impacts on key ratios.

For example, in a real estate lease the lessor may provide CAM to the tenants. If the CAM is accounted for as a non-lease component, then the tenant will typically recognise the consideration allocated to the CAM as an operating expense as it is incurred. However, if the CAM is fixed or varies depending on an index or rate and the tenant includes it in the lease payments, then it will not be an operating expense. Instead, the company will effectively recognise additional depreciation on the right-of-use asset and interest expense. In this example, applying the practical expedient increases reported earnings before interest, tax, depreciation and amortisation (EBITDA).

Can a lessee combine a lease component with significant non-lease components?

IFRS 16.17, BC135(b)

Yes. The new standard does not prohibit a lessee from combining a small lease component with significant associated non-lease components. However, it is not acceptable for a lessee to combine a tiny lease with a large, unrelated contract and artificially inflate EBITDA.

This practical expedient was provided to reduce cost and complexity for some lessees, without creating significant issues of comparability. The International Accounting Standards Board (the Board) expected that a lessee may not want to adopt this practical expedient for contracts with significant service components, because this would increase the lease liabilities for those contracts.

However, a lessee may want to apply this practical expedient for leases with significant non-lease components for other reasons – e.g. to increase EBITDA.

Can a lessor apply this practical expedient?

IFRS 16.17, BC135–BC136

No – there is no equivalent practical expedient for lessors. The Board considers that a lessor, unlike a lessee, should have information about the value, or a reasonable estimate, of each lease and non-lease component. This is because it needs the information when pricing the contract. In addition, the requirement to allocate the consideration in the contract by applying IFRS 15 ensures consistency for companies that are both a lessor and a seller of goods or services in the same contract.

Can a lessee choose to apply this exemption on an asset-by-asset basis?

IFRS 16.15

No. The practical expedient of combining lease and associated non-lease components can only be elected by class of underlying asset. Therefore, a lessee is not allowed to apply it on an asset-by-asset basis.

For example, if a lessee elects to apply this practical expedient to an office building lease, then the lessee applies the same accounting to all of the associated non-lease components for other office building leases.

Can a lessee choose to combine only one non-lease component when there are more than one?

IFRS 16.15

No. The lessee can elect, by class of underlying asset, not to separate non-lease components from lease components, and to account for them as a single lease component. Therefore, a lessee that elects to apply the practical expedient for a class of underlying asset combines all non-lease components in the contract that are associated with the lease.

For example, a lessee that elects to apply the practical expedient to office building leases accounts for the lease component and all associated non-lease components – e.g. CAM and security services provided under the same contract – as a single lease.

IFRS 16.15

Can a lessee combine a non-lease component that is not associated with the lease component?

No. A lessee can only combine those non-lease components that are associated with the lease.

For example, a lessee enters into a contract to lease IT equipment, along with maintenance for that leased IT equipment and for other IT equipment that it owns.

If the lessee elects to apply the practical expedient, then it can combine the maintenance service for the leased IT equipment with the lease of IT equipment to account for it as a single lease. However, the maintenance of its own equipment cannot be combined and is accounted for separately.

4 Allocating the consideration

Consideration is allocated based on relative prices.

4.1 Contract consideration

IFRS 16.A, 13, 17

The new standard requires both the lessee and lessor to allocate consideration to the lease and non-lease components. The consideration includes all payments in the contract – i.e. those that relate to lease and non-lease component(s), and other payments that relate to items such as taxes, which are not separate components.

4.1.1 Timing of measurement of contract consideration

If different components of a contract commence at different dates, then a question arises over the date(s) at which the contract consideration is measured. The new standard requires the lessee and the lessor to measure the lease liability on commencement of a lease. However, when the components are recognised at different times, it is not clear how the lessee and lessor measure any related amounts.

In the absence of guidance in the new standard, it appears that the lessee and lessor should make a preliminary estimate of the consideration in the contract when the first component commences and allocate it to the lease and non-lease components using relative stand-alone prices. This will generally include, among other things:

- measuring variable payments that depend on an index or a rate based on the index or rate at that point in time;
- assessing whether a renewal option is reasonably certain to be exercised; and
- estimating any expected amounts to be paid under a residual value guarantee.

However, because the new standard requires measurement of lease payments as at the commencement of the lease, it appears that the lessee and the lessor true up the initial measurements and allocation of the consideration at the commencement date.

Example 11 – Master lease agreement: Minimum commitment and different commencement dates; each additional right-of-use asset priced at stand-alone price

Lessee C enters into an MLA with Lessor E to lease up to 50 vehicles for a fixed monthly payment of 5,000 per vehicle for a total term of five years from delivery of the first vehicle. The monthly payment per vehicle is the stand-alone price and does not change depending on how many vehicles are delivered to C.

C is required to take delivery of 20 vehicles immediately and then a minimum of 10 additional vehicles from E by the end of Year 2. The MLA creates enforceable rights and obligations and is itself a contract, because it includes committed delivery of a minimum of 30 vehicles.

When C takes delivery of any of the 10 mandated additional vehicles, there is no lease modification (for details, see our publication Lease modifications). That is, for draw-downs up to the minimum required quantity of 30 there is no lease modification. For these vehicles, C applies the guidance in the new standard on identifying separate lease components and allocating the consideration in the contract to those components. C accounts for each vehicle lease from its commencement date.

Therefore, although there is no lease modification resulting from drawing down 10 additional vehicles after taking delivery of the first 20, some measurement and allocation complexities could arise if there were, for example, residual value guarantees or if the monthly lease payments escalated during the lease term based on an index or rate – e.g. the consumer price index (CPI).

Additional complications arise if the lease contains a number of lease components but with different commencement dates and there is a price inter-dependency (e.g. a volume discount) or other non-lease components (e.g. maintenance services) exist in the contract.

As mentioned above, in the absence of guidance it appears that the lessee and lessor should make a preliminary estimate of the consideration in the contract when the first component commences and allocate it to the lease and non-lease components using relative stand-alone prices.

However, if C takes delivery of more than 30 vehicles in total (the minimum required), then as each additional vehicle is delivered this is a lease modification. In this case, the scope of the lease is increased because C receives the right to use another underlying asset and the consideration for the lease increases by an amount that is commensurate with the stand-alone price for the increase in scope. Therefore, C accounts for the right to use each additional vehicle as a new lease.

Example 12 – Non-lease component provided before commencement date

Lessor R agrees to lease a piece of new IT equipment to Lessee L and provide maintenance services for L's existing IT equipment. At the inception date, the leased IT equipment is on backorder and is expected to be available two months later. However, R agrees to start providing maintenance services on the existing equipment immediately.

The lease of IT equipment is for five years. The annual payment for the lease and maintenance services is fixed, payable from the commencement date of the lease. L also guarantees the residual value of the equipment.

L and R identify two components in the contract:

– a lease of IT equipment; and

– maintenance services (a non-lease component).

L begins recognising expense, and income, for the maintenance services that have been provided before the commencement date. It appears that at the inception date, R and L should make a preliminary estimate of the consideration in the contract – i.e. estimate the amount payable under the residual value guarantee.

However, the new standard requires measurement of the consideration at the lease commencement date. At that date, we believe that R and L should also make adjustments to the initial estimate of the consideration – i.e. estimate the amount payable under the residual value guarantee.

4.2 Allocation of consideration

IFRS 16.13, 17

The consideration in the contract is allocated to each lease and non-lease component.

The allocation of the consideration is a two-step process.

1. Determine the stand-alone price for each component.
2. Allocate the consideration.

The new standard is clear that payments for activities and costs that do not transfer a good or service to the lessee do not give rise to a component (see Section 3.1). The payments are included in the consideration that is allocated to the separate lease and non-lease components in the contract.

Contract

Lease components	Non-lease components	NOT a component
Allocate contract consideration		Activities that do not transfer a good or service – amounts payable for these items are part of the total consideration that is allocated to the lease and non-lease components

The new standard requires different approaches for the lessor and the lessee.

IFRS 16.13–14, 17

	Lessor	Lessee
When there is an observable stand-alone price for each component	Allocate the consideration following the IFRS 15 approach – i.e. on a relative stand-alone selling price basis (see Section 4.3).	Allocate the consideration based on the relative stand-alone price of components (see Section 4.4)
When there is no observable stand-alone price for some or all components		Allocate the consideration based on the stand-alone selling price, estimated using observable information (see 4.4.1)

4.3 Lessor allocation

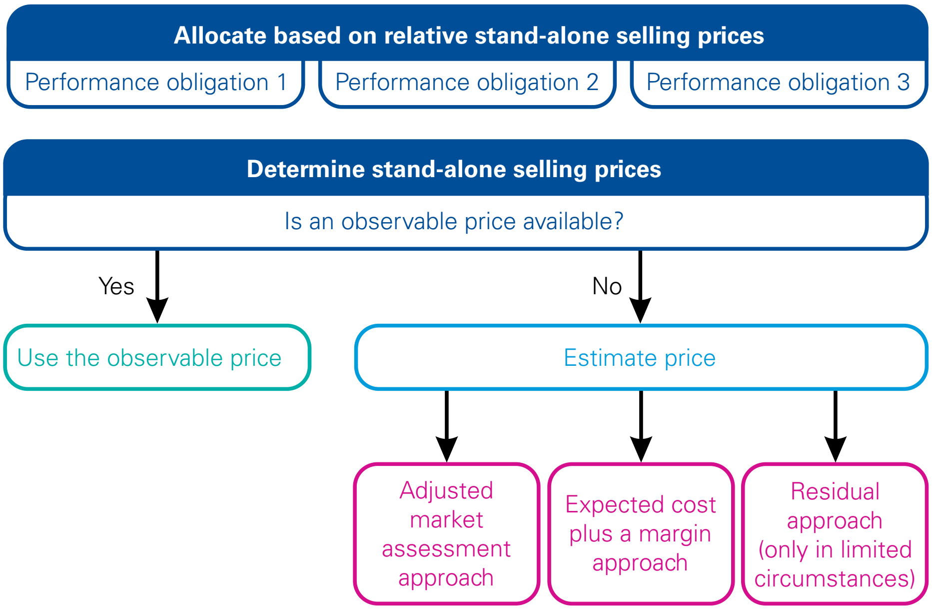
IFRS 16.17, 15.74–77

A lessor allocates consideration in a contract to the separate lease and non-lease components by applying IFRS 15. Under IFRS 15, consideration is allocated on a relative stand-alone selling price basis. Stand-alone selling price is determined at inception of the contract and is the price at which a company would sell a promised good or service separately to a customer. It is best evidenced by the observable price of the same good or service when the company (lessor) sells (or leases) that good or service separately.

IFRS 15.81–86

IFRS 15 also has detailed guidance on the allocation of variable consideration or discounts to one or more components in the contract. See Section 4.2 of our IFRS 15 handbook – Revenue.

IFRS 15.79



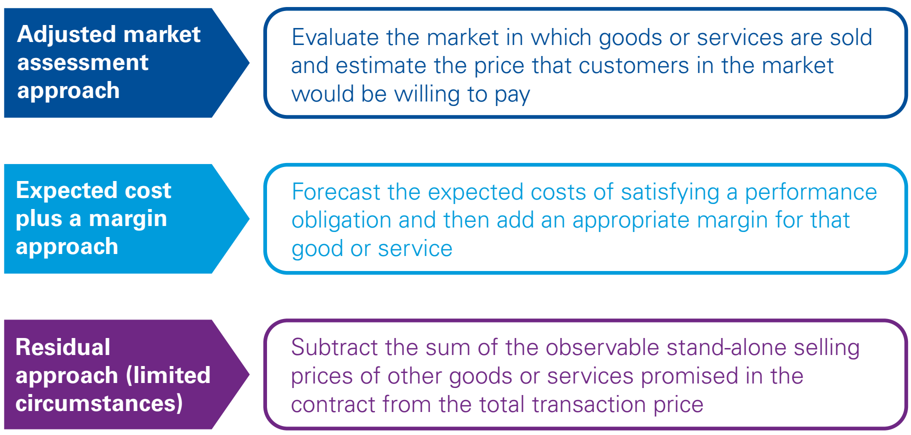
4.3.1 Estimating the stand-alone selling price

IFRS 15.78

A lessor considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, entity-specific factors and information about the customer or class of customer. It also maximises the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of other goods or services with similar characteristics.

IFRS 15.79

IFRS 15 does not preclude or prescribe any particular method for estimating the stand-alone selling price for a good or service when observable prices are not available, but describes the following estimation methods as possible approaches.



IFRS 15.88

After contract inception, a lessor does not reallocate the transaction price to reflect subsequent changes in stand-alone selling prices.

Using the residual approach to estimate stand-alone selling prices

IFRS 15.79(c)

The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain and observable stand-alone selling prices can be established for the other goods or services promised in the contract.

Selling price is…	If…
Highly variable	The lessor sells the same good or service to different customers at or near the same time for a broad range of prices
Uncertain	The lessor has not yet established the price for a good or service and the good or service has not previously been sold on a stand-alone basis

Under the residual approach, a lessor estimates the stand-alone selling price of a good or service on the basis of the difference between the total transaction price and the observable stand-alone selling prices of other goods or services in the contract.

It appears that the total transaction price used in applying the residual approach should include the estimated amount of any variable consideration before applying the constraint (see Section 3.1 of our IFRS 15 handbook – Revenue). This approach is consistent with the allocation objective because the estimated variable consideration is the amount of consideration to which the company expects to be entitled.

IFRS 15.80

If two or more goods or services in a contract have highly variable or uncertain stand-alone selling prices, then a lessor may need to use a combination of methods to estimate the stand-alone selling prices of the performance obligations in the contract. For example, a lessor may use:

- the residual approach to estimate the aggregate stand-alone selling prices for all of the promised goods or services with highly variable or uncertain stand-alone selling prices; and then
- another technique to estimate the stand-alone selling prices of the individual goods or services relative to the estimated aggregate stand-alone selling price that was determined by the residual approach.

4.3.2 Allocate the consideration

IFRS 15.76, 81–86

At contract inception, the transaction price is generally allocated to each performance obligation on the basis of relative stand-alone selling prices (see Example 13). However, when specified criteria are met a discount or variable consideration is allocated to one or more, but not all, of the performance obligations in the contract (see Section 4.5).

IFRS 15.88–89

After initial allocation, changes in the transaction price are allocated to satisfied and unsatisfied performance obligations on the same basis as at contract inception, subject to certain limited exceptions. For a discussion of changes in a transaction price as a result of a contract modification, see Section 8.2 of our IFRS 15 handbook – Revenue.

When a contract contains lease and non-lease components, the lessor allocates consideration to the lease and non-lease components in accordance with IFRS 15. However, if the contract contains a renewal option covering the lease and non-lease components, then the lessor may determine that the contract period under IFRS 15 differs from the lease term under IFRS 16. The lease term as determined under IFRS 16 includes optional renewal periods over which the lessee is reasonably certain to extend, whereas the contract term under IFRS 15 includes periods during which the parties have presently enforceable rights and obligations. In these cases, it appears that a company should allocate the consideration to each component based on the lease term as determined under IFRS 16 (see Example 14).

Example 13 – Lessor allocation of consideration: Observable and estimated stand-alone selling prices

Lessor R leases a specialised machine for two years to Lessee L and provides consulting services to help L use the machine effectively in its production processes. The machine is not sold or leased separately by R and there are no similar machines for sale or lease from other suppliers.

The consideration is 100,000 for the first year and 80,000 for the second year. R priced the contract in this way assuming that it will provide more consulting services in the first year.

R allocates the consideration using estimated stand-alone selling prices, because it does not provide the machine or consulting services separately.

R estimates the stand-alone selling prices as follows.

- There are no similar machines for lease by other suppliers to assess. Consequently, R uses expected cost plus a margin to arrive at a stand-alone selling price of 160,000 for the machine lease.
- R uses a market-based assessment approach to arrive at a stand-alone price of 40,000 for the consulting services based on similar services offered in the marketplace.

On this basis, R allocates the consideration as follows.

	Stand-alone price	Calculation	Allocation
Machine lease	160,000	80% x 180,000	144,000
Consulting service	40,000	20% x 180,000	36,000
	200,000		**180,000**

Example 14 – Lessor allocation to lease and non-lease components based on the lease term

Lessor R leases a bulldozer to Lessee T. Under the arrangement, R also provides maintenance services for the bulldozer for the entire lease term.

The original contract term is five years, with a renewal option for another two years. Annual payments, including maintenance, are determined at 160 for the initial five years. For the extension period, annual payments including maintenance are reduced to 150. Therefore, if the contract runs for five years then the total consideration will be 800, whereas if the contract runs for seven years then the total consideration will be 1,100.

The stand-alone price of the lease without maintenance is estimated at 120 per year, and the stand-alone price for the maintenance is 50 per year.

At the commencement date, R and T conclude that the lease term is seven years, because it is reasonably certain that T will exercise the renewal option.

If the contract were wholly accounted for under IFRS 15, then the contract term would be five years because this is the period for which the two parties are contractually committed. The lease is classified as an operating lease.

We believe that R should allocate the consideration to the lease component and maintenance services based on the lease term as determined under IFRS 16 – i.e. seven years. Therefore, R allocates the total consideration based on seven years (1,100) to the lease and non-lease components as set out below.

	Stand-alone price	%	Allocation
Bulldozer lease	120 x 7 = 840	70.59%	776
Maintenance	50 x 7 = 350	29.41%	324
	1,190		**1,100**

Does the lessor need to allocate consideration when the allocation does not have an impact on the income?

IFRS 16.90, 15.114, B87–B89

Yes, the lessor allocates the consideration to each of the lease and non-lease components, even if there is no impact on the profile of income recognised. This is necessary for presentation and disclosure purposes – i.e. the new standard requires a lessor to disclose lease income. IFRS 15 also requires a company to present and disclose revenue from contracts with customers separately.

For example, when the lease is classified as an operating lease and the non-lease component is a service satisfied over time using a time-based measure, the income from both the lease and non-lease components is recognised over the period: the allocation does not impact the income recognised during the period.

4.4 Lessee allocation

IFRS 16.13–14

If a contract contains a lease component and one or more additional lease or non-lease components, then the lessee allocates the consideration in the contract to each component on the basis of:

– the relative stand-alone price of each lease component; and

– the aggregate stand-alone price of the non-lease components.

A lessee can elect not to separate lease components from any associated non-lease components and account for them as a single lease component. If the lessee applies this practical expedient, then the nature of the payments – e.g. whether they are fixed or variable depending on a rate or index – does not change.

4.4.1 Estimating the stand-alone price

IFRS 16.14

The lessee determines the stand-alone prices of lease and non-lease components based on the price that a lessor or a similar supplier would charge for a similar component separately. A contractually stated price is not presumed to be a stand-alone price.

If an observable stand-alone price is not readily available, then the lessee estimates the stand-alone price of the components by maximising the use of observable information.

How is an observable stand-alone price for a lessee different from an observable stand-alone selling price for a lessor?

IFRS 16.14, 15.77–78

For the *lessee*, observable stand-alone prices include those charged not only by the lessor but also by other suppliers for the same or a similar component – e.g. the price charged for the lease of a similar piece of equipment or for similar services.

For the *lessor*, the definition of observable stand-alone selling price is more specific. Taken from IFRS 15, an observable stand-alone selling price is the price for which the *company* sells *that* good or service separately in similar circumstances and to similar customers.

However, applying a market assessment approach under IFRS 15 might include referring to prices from the lessor's competitors for similar goods or services (and adjusting those prices as necessary to reflect the lessor's costs and margins) as an acceptable technique for estimating the stand-alone selling price. Therefore, although the lessor might use similar information to the lessee, its stand-alone selling price of a component may be considered 'estimated', whereas the lessee's stand-alone price may be considered 'observable'.

How does a lessee estimate the stand-alone prices of lease and non-lease components?

IFRS 16.14

The stand-alone price is a price that the lessor would charge a company for that component or a similar component. The estimation of a stand-alone price would reflect the economic return that a lessor would require for each stand-alone component.

For example, a stand-alone price for a lease component would reflect compensation for the cost of the leased asset but also for the cost of administrative tasks, taxes and insurance that lessees would reasonably incur. For non-lease components – e.g. cleaning services – the price would include compensation for the actual costs, an appropriate profit margin and compensation for certain administrative tasks.

How might the techniques used to estimate stand-alone (selling) prices differ for lessees and lessors?

IFRS 16.BC137, 15.79

Lessees may rely on estimation techniques that differ from those used by lessors because lessors will often have greater access to observable information – e.g. their own incurred cost data or non-public industry information on the pricing of lease or related non-lease components.

Also, IFRS 15 describes suitable estimation approaches, including when a residual approach can be used, whereas IFRS 16 does not have any detailed guidance. Even so, it will generally not be appropriate for a lessee to default to the residual approach when another approach would give a more representative result (see below).

Estimation techniques used should be reasonable, be applied consistently in similar circumstances, maximise the use of observable information and not be developed with a bias to reducing amounts allocated to lease components.

Using the residual approach to estimate stand-alone prices

IFRS 15.79

When allocating the consideration to lease and non-lease components, lessors are explicitly allowed to use the residual approach to estimate stand-alone selling prices, if the criteria specified in IFRS 15 are met. IFRS 16 does not discuss whether lessees may use a residual approach when estimating stand-alone prices.

Example 15 – Lessee estimates the stand-alone price using the residual approach

Lessor R leases a specialised machine for two years to Lessee L and provides consulting services to help L use the machine effectively in its production processes. The machine is specialised and uses new technology. It is not sold or leased separately by R and there are no similar machines for sale or lease from other suppliers.

The consideration is 100,000 for the first year and 80,000 for the second year. R priced the contract in this way assuming that it will provide more consulting services in the first year.

Because R does not sell or lease the specialised machine or provide substantially equivalent consulting services separately, L allocates the consideration in the contract based on observable and estimated relative stand-alone prices.

L determines the stand-alone prices for the lease and the consulting services as follows.

- L obtains an observable stand-alone price for the consulting services based on similar services offered in the marketplace (40,000).
- The machine is specialised and is a new model that uses new technology. Therefore, there is no established selling price in the market. Because L has an observable stand-alone price for the consulting services, L concludes that a residual approach is reasonable and appropriate in the circumstances.

On this basis, L allocates the consideration as follows.

	Stand-alone price	Allocation
Machine lease	140,000 (180,000 – 40,000)	140,000
Consulting	40,000	40,000
	180,000	**180,000**

IFRS 16.14, 15.79

Can a lessee use a residual approach to estimate the stand-alone selling price?

Paragraph 79(c) of IFRS 15 states that an entity may estimate the stand-alone selling price with reference to the total transaction price less the sum of the observable stand-alone selling price of other goods or services (residual approach), but *only if* one of the following criteria is met:

- the entity sells the same good or service to different customers (at or near the same date) for a broad range of amounts (i.e. the selling price is highly variable because a representative stand-alone selling price is not discernible from past transactions or other observable evidence); or
- the entity has not yet established a price for that good or service and the good or service has not previously been sold on a stand-alone basis (i.e. the selling price is uncertain).

The residual approach is appropriate if observable stand-alone selling prices can be established for the other goods or services promised in the contract.

Whereas IFRS 16 does not have similar guidance, it uses a similar approach to IFRS 15 for the lessee allocation – e.g. when separating components and allocating consideration to those components based on relative stand-alone prices. If similar criteria to those in IFRS 15 are met, then it appears that a lessee can use the residual approach to estimate the stand-alone price of the lease component.

This means that one of the following criteria needs to be met:

- the price at which the lessee could purchase the same or substantially similar good or service in the same timeframe varies widely (the price is highly variable); or
- the price at which the lessee could purchase the good or service has not yet been established because that good or service has not previously been sold on a stand-alone basis (the price is uncertain).

Conversely, a lessee will not use the residual approach if:

- another reasonable estimation approach that maximises the use of observable inputs, such as observable cost and/or margin information, is available to the lessee; or
- the residual approach produces a zero or de minimis stand-alone price, which would be inconsistent with the fact that the component transfers a good or service.

Finally, the residual approach requires that there are observable stand-alone prices for the other components.

For a fuller discussion of when the residual approach to estimate stand-alone selling prices is appropriate under IFRS 15, see 4.1.2 of our [IFRS 15 handbook – Revenue].

4.4.2 Allocating the consideration

IFRS 16.13

On commencement of a lease, the contract consideration is allocated to the separate lease and non-lease components on the basis of:

- the relative stand-alone price of each separate lease component; and
- the aggregate stand-alone price of the non-lease components.

Example 16 – Lessee allocation of consideration

IFRS 16.13

Lessee L enters into a five-year lease contract with Lessor M to use a ship, including crew. The contract includes maintenance services provided by M. M obtains its own insurance for the ship. Annual payments are 20,000, including 3,000 for maintenance services and 500 for insurance costs.

L is able to determine that similar maintenance services are offered by third parties for 2,000 a year. L is also able to determine that similar leases for ships without crew or maintenance are offered by third parties for 15,000 a year and, using a cost-plus calculation, L estimates the annual cost of crew hire to be 5,000.

L concludes that this contract includes three components:

- the right to use a ship (lease component);
- maintenance services (non-lease component); and
- services rendered by the crew (non-lease component).

The insurance cost does not transfer a good or service to the lessee and therefore is not a separate component. Consequently, there is no need for L to determine the stand-alone price of the insurance. However, the insurance cost is included as part of the contract consideration and allocated to the lease and non-lease components.

L allocates the consideration to the contract as follows.

	Stand-alone price	%	Allocation
Lease of a ship	75,000	68.18%	68,182
Other services	35,000	31.82%	31,818
	110,000		**100,000**

How does the allocation of the consideration to each component differ between lessees and lessors?

IFRS 16.13, 15.76

Lessees allocate the consideration in the contract on the basis of the relative stand-alone price of each separate lease component and the aggregate stand-alone price of the non-lease components.

Lessors allocate the consideration in the contract to each separate lease and non-lease component, based on the relative stand-alone price of each component, in accordance with IFRS 15.

One of the differences is that the non-lease components are aggregated by the lessee to determine the initial allocation of amounts allocated to the lease components.

The lessee then accounts for the non-lease components within a lease contract in accordance with other applicable standards, which may have different measurement or allocation requirements.

4.5 Allocation of variable consideration

If the contract contains more than one component and includes both variable and fixed payments, then a question arises about how to allocate the variable payments – e.g. whether the variable payments can be allocated to one or more, but not all, of the components. This could be more relevant when the payment is dependent on the performance of, or changes in, one of the components.

IFRS 15.84–86

Under IFRS 15, variable consideration is allocated entirely to one or more, but not all, performance obligations in the contract if the following criteria are met:

- the terms of a variable payment relate specifically to the company's efforts to satisfy the performance obligation; and
- allocating the variable amount of consideration entirely to the performance obligation is consistent with the allocation objective when considering all of the performance obligations and payment terms in the contract.

IFRS 16.14, Ex12

This guidance applies directly to lessors. In addition, in the absence of specific guidance in IFRS 16, it appears that it is acceptable for a lessee to apply this approach when allocating variable payments in a contract that contains a lease component, as follows.

- If variable payments represent the stand-alone price of a specific component and other payments represent the stand-alone prices of other components, then the variable payments should be allocated to that specific component and the other payments to the other components.
- If variable payments do not represent the stand-alone price of a specific component or other payments do not represent the stand-alone prices of other components, then the total consideration, including fixed and variable amounts, should be allocated to all of the components in the contract.

Example 17 – Lessee's allocation: Variable payments allocated in full to a non-lease component

Lessee L enters into a property lease for five years, including cleaning services. L's payments for five years include the following:

- total fixed payments of 500 over five years (i.e. 100 per year); and
- variable payments based on a fixed amount per cleaning hour by the lessor: estimated to be 200 over five years (i.e. 40 per year).

L concludes that the contract includes two components – the lease of a property and the cleaning services (non-lease component). There are observable stand-alone prices for the two components:

- lease of property: fixed payments of 500; and
- cleaning services: determined based on cleaning hours, estimated at 40 per year.

Ignoring discounting, the total contract consideration of 700 (fixed payments of 500 and variable payments of 200) is allocated to the components as follows.

Component	Fixed payments	Variable payments
Lease of property	500	-
Cleaning services	-	Payments based on cleaning hours (estimated at 200)

Variable payments are allocated only to the cleaning services, because the variable payments represent the stand-alone price of the cleaning services and the fixed payments represent the stand-alone price of the lease component.

However, if the payments for both components were not at their stand-alone selling prices, then the total payments would be allocated to both components. This would result in the consideration allocated to each component being a mix of fixed and variable payments.

Example 18 – Lessee's allocation: Variable payments allocated between all components

Lessee L enters into a property lease for five years that includes maintenance services. L's payments for five years comprise:

- total fixed payments of 500 for five years (i.e. 100 per year); and
- variable payments based on 2% of sales for each year.

L concludes that the contract includes two components – the lease of a property and the maintenance (non-lease component). The stand-alone prices for the two components are determined as follows:

– observable stand-alone price for the lease: 500; and

– estimated stand-alone price for the maintenance, based on the expected costs plus an appropriate margin: 200.

In this case, the total contract consideration (fixed payments of 500 and variable payments of 200) is allocated to the components as follows.

Component	Stand-alone price	%	Allocation of fixed payments
Lease of property	500	71.43%	357
Maintenance	200	28.57%	143
	700		**500**

In contrast to Example 17, the variable payments do not represent a stand-alone price for the maintenance. Therefore, both fixed and variable payments are allocated to the lease and non-lease components based on the relative stand-alone prices for the two components. Variable payments are expensed as they are incurred for both lease and non-lease components.

Example 19 – Allocation of property taxes

IFRS 16.15, B33

Lessee B enters into a five-year lease for an apartment. The lease payments are 100,000 per year. The contract includes additional maintenance costs of 4,000 per year.

B does not apply the practical expedient to combine lease and non-lease components.

Under the lease agreement, B is contractually obliged to reimburse the lessor for property taxes levied on property owners. Annual property tax is determined at 0.2% of the assessed value.

Payment of property taxes does not transfer a good or service to B and is therefore not a component. Therefore, B includes the reimbursement of property taxes in the consideration that it allocates to the lease and non-lease components identified in the contract.

Based on observable prices for a similar lease and services in the market, B concludes that:

– the stand-alone price of the lease is 100,000 per year plus reimbursement of property taxes; and

– the stand-alone price of the maintenance services is a fixed payment of 4,000 per year.

B allocates 100,000 and any reimbursement of property taxes to the lease component and 4,000 to the non-lease component.

Can a lessee allocate costs that do not transfer a good or service to the lessee (e.g. property tax) entirely to the lease component?

IFRS 16.13–14, B33

It depends.

A real estate lease contract often requires the lessee to compensate the lessor for costs relating to the asset – e.g. property tax and insurance cost.

A question arises over whether the property tax and insurance cost can be allocated fully to the lease component when the contract also includes a non-lease component. The new standard does not provide any exception to the allocation requirements, which means that the total consideration (including property tax or insurance) is allocated to all identified components based on the relative stand-alone price.

However, if all components in the contract are priced at stand-alone prices and the stand-alone price of the lease component includes property tax and insurance cost, then a relative stand-alone price basis allocation would result in these payments being allocated entirely to the lease component.

If variable payments are recognised as they arise, then do they still need to be allocated to components?

IFRS 16.53, 90, A

Yes. Although the recognition and measurement of some variable payments may be the same, regardless of whether they are allocated to lease and/or non-lease components, an allocation is generally still required for presentation and disclosure purposes.

The new standard requires:

– lessees to disclose the expense relating to variable lease payments that are not included in the measurement of lease liabilities;

– finance lessors to disclose income relating to variable lease payments that are not included in the measurement of the net investment in the lease; and

– operating lessors to disclose income relating to variable lease payments that do not depend on an index or rate.

IFRS 15.114

Under IFRS 15, a lessor is required to disclose a disaggregation of revenue from contracts with customers, which will include revenue from non-lease components.

5 Reallocating the consideration

Reallocation of consideration is required on a lease modification or reassessment.

5.1 Modification of contracts

IFRS 16.A

A lease modification is a change in the lease that was not part of the original terms and conditions of the lease. The new standard distinguishes between lease modifications that represent, in substance:

- the creation of a new lease that is separate from the original lease; and
- a change in the scope of, or consideration paid for, the existing lease.

IFRS 16.45–46, 80

Lease modifications that are not accounted for as separate leases are accounted for as at the effective date of the lease modification. The lessee and lessor are required to remeasure the lease payments to account for the modification. The remeasurement of lease payments is based on the revised terms and conditions of the lease and a revised discount rate.

For more guidance on accounting for modifications, see our publication Lease modifications.

5.1.1 Lessee modifications

A modification that is a separate lease

IFRS 16.44

When a lease contract is modified, the lessee assesses whether it is accounted for as a separate lease. A lessee accounts for a lease modification as a *separate lease* if both of the following conditions exist:

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount equivalent to the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

In this case, the lessee:

- accounts for the separate lease in the same way as any new lease; and
- makes no adjustment to the initial lease.

A modification that is accounted for as a separate lease is recognised as a new lease. The lessee separates lease and non-lease components in the 'new' lease, and allocates the consideration to these components as at the commencement date. The allocation basis is the relative stand-alone prices as at the commencement date of the 'new' lease (see Section 4.4).

A modification that is not a separate lease

IFRS 16.45–46

A lessee accounts for a modification that is *not a separate lease* by remeasuring the lease liability at the effective date of the modification, using a discount rate determined on that date and:

– *for modifications that decrease the scope of the lease:* decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, and recognising a gain or loss that reflects the proportionate decrease in scope; and

– *for all other modifications:* making a corresponding adjustment to the right-of-use asset.

The following modifications are examples of those that would not be accounted for as *a separate lease*:

– increase in scope not at stand-alone price;

– decrease in scope;

– increase in lease term; and

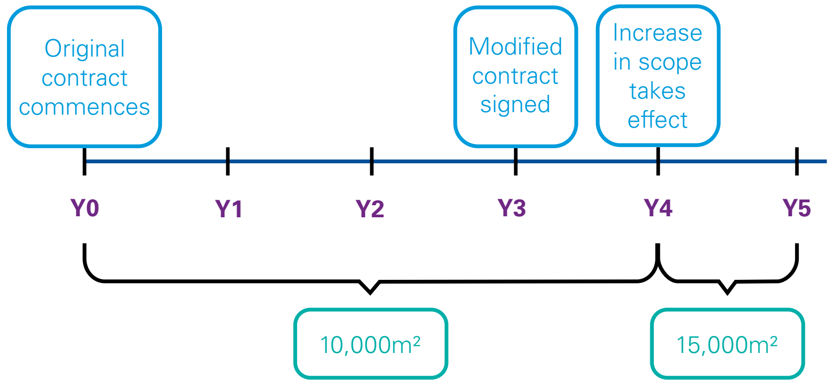
– change in consideration.

The new standard does not provide specific guidance on the lessee's allocation of consideration when a contract is modified. It appears that the lessee should use the relative stand-alone prices as at the effective date of the modification to allocate consideration to the components in the modified contract so that they reflect the current market price for each contract component. This is because, by definition, the scope of payments in the modified contract is different from that in the original contract.

Example 20 – Modification that is not a separate lease

Lessee Y enters into a lease for a five-year term with Lessor L for part of a retail building. Under the lease, Y pays 10,000 per year to obtain the right to use 10,000m^2 of the retail space.

At the end of Year 3, Y and L sign a modified contract. Under the modified contract, Y will lease 15,000m^2 of retail space for the last year of the lease. The modified lease has an increase in scope because there is an additional right to use one or more underlying assets – i.e. Y leases an additional 5,000m^2 of retail space effective from the end of Year 4. Under the modified contract, Y agrees to pay an additional 2,000 for the additional space for the last year of the lease. Y concludes that the price for the additional space is not commensurate with the stand-alone price and, therefore, the modification is not accounted for as a separate lease.



The modified contract is signed at the end of Year 3. This is the date when both Y and L agree to the lease modification; therefore, this is the *effective date of the modification*.

At the end of Year 3, the effective date of the modification, Y and L sign a modified contract that includes two lease components – i.e. the original office space and the new office space. The first component starts immediately but the second component is forward-starting.

At the end of Year 3, Y determines the amounts to be recognised in respect of each component. This includes allocating the total consideration for the modified contract between the two separate lease components, based on the relative stand-alone price of each component at the effective date of the modification.

	Stand-alone price	%	Allocation
10,000m^2 for Years 4 and 5	20,000	80%	17,600
Additional 5,000m^2 for Year 5	5,000	20%	4,400
	25,000		**22,000**

Y remeasures the lease liability for each component by discounting the allocated lease payments at a revised discount rate. The amount allocated to the original lease component is accounted for from the effective date of the modification. It is acceptable to account for the portion allocated to the new lease component at the commencement date of the new office space at the end of Year 4 – i.e. when L grants Y the additional right to use the 5,000m^2. At that time, Y recognises the lease liability and right-of-use asset for the new office space based on amounts determined at the effective date of the modification – i.e. at the end of Year 3.

5.1.2 Lessor modifications

Lessor modification to finance lease that is a separate lease

IFRS 16.79, BC238–BC239

A lessor's accounting for a modification to a finance lease depends on whether the modification, in substance, represents the creation of a new lease that is separate from the original lease. The lessor assesses whether the modification is a separate lease using the same criteria as a lessee and accounts for such a modification as a separate lease.

A modification to a finance lease that is accounted for as a separate lease is recognised as a new lease. The lessor separates the lease and non-lease components from the 'new' lease and allocates the consideration to these components in accordance with IFRS 15's allocation guidance. The allocation basis is the relative stand-alone prices as at the commencement date of the new lease (see Section 4.3).

Lessor modification to finance lease that is not a separate lease

IFRS 16.80

When a modification to a finance lease is not a separate lease, the lessor assesses whether the classification of the lease would have been different had the modified terms been effective at the date of inception.

IFRS 16.80(a)

If the lease would have been classified as an operating lease, then the lessor accounts for the lease modification as a termination of the original lease and the creation of a new lease from the effective date of the modification. When the modified lease contract includes multiple lease and non-lease components, the lessor allocates the consideration to the components in accordance with IFRS 15's allocation guidance (see Section 4.3).

IFRS 16.80(b)

If the lease would have been classified as a finance lease had the modification been effective at the date of inception, then the lessor accounts for it in accordance with the modification guidance of IFRS 9.

IFRS 16 does not provide specific guidance on the lessor's allocation when a finance lease is modified. The remeasurement is based on the revised terms and conditions of the lease and a revised discount rate.

Therefore, it appears that the relative stand-alone prices as at the effective date of the modification should be used when the lessor allocates consideration to the components in the modified contract. This ensures that the price for each component of the contract reflects the current market price.

Lessor modification to operating lease

IFRS 16.87

A lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification. It considers any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease and allocates the consideration based on the relative stand-alone prices as at the commencement date of the new lease (see Section 4.3).

5.2 Remeasurement of lease payments

5.2.1 Lessee reassessment

IFRS 16.36(c), 39–43, B42(a)(ii)

A lessee remeasures the lease liability to reflect changes in the lease payments as follows.

Lessee remeasures lease liability using revised lease payments and…	
An *unchanged* discount rate when:	**A *revised* discount rate when:**
– the amount expected to be payable under the residual value guarantee changes; – future lease payments change to reflect market rates (e.g. based on a market rent review) or a change in an index or rate[1] used to determine the lease payments; or – the variability of payments is resolved so that they become in-substance fixed payments.	– future lease payments change as a result of a change in floating interest rates; – the lease term changes; or – the assessment of the exercise of a purchase option changes.

Note

1. Other than changes in floating interest rates.

If the consideration has been allocated initially to multiple lease and non-lease components, then on remeasurement of the lease liability the revised consideration is reallocated to the components.

In this case, two allocation bases could be considered: the unchanged stand-alone prices as at the commencement date, or the revised stand-alone prices as at the remeasurement date. In the absence of clear guidance in the new standard, it appears that the lessee should adopt one of the following two approaches as an accounting policy, to be applied consistently.

- *Approach 1:* Allocate the consideration based on the stand-alone prices for the separate lease and non-lease components at the remeasurement date. Because the remeasurement reflects current economic conditions (e.g. CPI or market rent review), the allocation basis is also based on current market conditions.

IFRS 16.BC194

- *Approach 2:* Whether to update the stand-alone prices for the lease and non-lease components that are used to reallocate the remeasured contract consideration depends on the type of remeasurement:
  - *using an unchanged discount rate:* allocate the consideration based on the unchanged stand-alone prices. The remeasurement of lease payments reflects changes in a judgement or estimate; or
  - *using a revised discount rate:* allocate the consideration based on the updated stand-alone prices. The remeasurement of lease payments reflects current economic conditions.

Example 21 – Lessee reallocation: Change in CPI

Lessee E leases a machine from Lessor R for five years. As part of the contract, R will maintain the machine for E.

Initial allocation

E pays a fixed amount of 120,000 per year during the first three years for the lease and the maintenance. Payments for Years 4 and 5 will be adjusted by the cumulative CPI changes at the end of Year 3 compared with the commencement date of the lease.

E concludes that the contract has two components: the lease of the machine and the maintenance (non-lease component).

As at the lease commencement date, E allocates the total consideration in the contract to these components using their relative stand-alone prices at that date.

	Stand-alone prices	%	Allocation
Machine lease	525,000	83.33%	500,000
Maintenance	105,000	16.67%	100,000
	630,000		**600,000**

Remeasurement and reallocation

At the end of Year 3, the payments for Years 4 and 5 are adjusted to 125,000 per year, according to the CPI change for the three years. The remaining consideration is 250,000 (125,000 x 2).

We believe that E may choose to reallocate the remaining consideration in the contract using:

- *Approach 1:* the stand-alone prices as at the remeasurement date; or
- *Approach 2:* the stand-alone prices as at the commencement date, because E uses an unchanged discount rate to remeasure the lease liability.

	Approach 1			Approach 2		
	Remeasurement date stand-alone price	%	Allocation	Commencement date stand-alone price	%	Allocation
Machine lease	220,000	81.48%	203,703	525,000	83.33%	208,333
Maintenance	50,000	18.52%	46,297	105,000	16.67%	41,667
	270,000		**250,000**	**630,000**		**250,000**

Example 22 – Lessee reallocation: Purchase option

Retailer R enters into a contract with Lessor B to lease a building for 10 years. In addition to the right to use the building, B agrees to provide maintenance of the building and security services.

R has an option to purchase the building at the end of the lease term. At the commencement date, R concludes that it is not reasonably certain to exercise the purchase option.

R identifies the following lease and non-lease components:

- lease of the building;
- maintenance; and
- security services.

R allocates the consideration in the contract to the lease and non-lease components on the basis of the relative stand-alone price of the lease and the aggregate stand-alone price of the other services.

At the end of Year 7, R makes a strategic decision to invest in the building to expand its operations and concludes that it is reasonably certain to exercise the purchase option. R determines revised lease payments to reflect the amounts payable under the purchase option, and reallocates the consideration to the components.

A lessee remeasures the lease liability using a revised discount rate. Therefore, we believe that R should reallocate the modified consideration using updated stand-alone prices, using either Approach 1 or 2.

Can a lessee use unchanged stand-alone prices for all types of remeasurement?

IFRS 16.BC193–BC194

No. We believe that a lessee cannot use unchanged stand-alone prices when it remeasures the lease liability using a *revised* discount rate. The lessee may elect an accounting policy to use unchanged stand-alone prices when remeasuring the lease liability using an *unchanged* discount rate.

In many cases, the lessee does not reassess the discount rate during the lease term. This is generally consistent with the effective interest method that is used when accounting for financial instruments. However, the new standard requires a lessee to remeasure the lease liability using revised payments and a *revised* discount rate when there is a change in the lease term or a change in the assessment of whether a purchase option is reasonably certain to be exercised. In these circumstances, 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).

This 'fresh look' concept of using a revised discount rate extends to the stand-alone prices used for reallocation. We believe that in this case it would be inappropriate to continue to use unchanged stand-alone prices.

Does a lessee reallocate the consideration when there is any change in the variable payments?

IFRS 16.14, Ex12, 15.85

Generally, yes. However, a lessee does not reallocate the contract consideration when variable payments incurred are allocated only to one or more, but not all, components.

Under IFRS 15, variable consideration can be allocated entirely to one or more, but not all, performance obligations in the contract if specific criteria are met. As explained in Section 4.5, it appears that it is acceptable for a lessee to apply this guidance when allocating variable payments in a contract that contains a lease component, as follows.

- If variable payments represent the stand-alone price of a specific component and other payments represent the stand-alone prices of other components, then the variable payments should be allocated to that specific component.
- If variable payments do not represent the stand-alone price of a specific component, or other payments do not represent the stand-alone prices of other components, then the total consideration, including fixed and variable amounts, should be allocated to all of the components in the contract.

Using this guidance, if the lessee allocates variable payments to a single lease or non-lease component, then all such variable payments are allocated to the same component – there is no need to reallocate them among multiple components.

For example, in a real estate lease a lessee may reimburse the lessor's property taxes (which are variable payments), in addition to the fixed rent. In this case, if all of the components in the contract are priced at stand-alone prices and the stand-alone price of the lease component includes property taxes, then the relative stand-alone price basis allocation would result in these payments being allocated entirely to the lease component when they are incurred (see Example 19).

5.2.2 Lessor reassessment

IFRS 16.21

The new standard does not require a lessor to reassess the lease payments after the lease commencement date. However, the lessor is required to revise the lease term if there is a change in the non-cancellable period of a lease – e.g. if:

- the lessee exercises a renewal option that was not previously included in the lessor's determination of the lease term;
- the lessee does not exercise an option that was previously included in the lessor's determination of the lease term; or

– an event occurs that contractually obliges (or prohibits) the lessee's exercise of an option, which was previously excluded (or included) in the lessor's determination of the lease term.

If the consideration has been allocated initially to multiple lease and non-lease components, then on the revision of the lease term the revised consideration is reallocated to the components.

IFRS 16.17, 15.87–88

The new standard requires the lessor to apply the allocation guidance in IFRS 15 to allocate the consideration to lease and non-lease components. Under IFRS 15, the transaction price is allocated based on the relative stand-alone selling prices as at contract inception. When the transaction price changes subsequently – e.g. on the resolution of uncertain events or other changes in circumstances that affect the amount of consideration to which a company expects to be entitled – the changes in the transaction price are allocated to performance obligations on the same basis as at contract inception.

Although the lessor is required to apply IFRS 15 for the initial allocation of the consideration, it is not clear whether the allocation guidance for changes in the transaction price also applies for the lessor's reallocation on remeasurement of the lease payments when there is a change in the non-cancellable period.

In the absence of clear guidance in the new standard, it appears that the lessor should adopt one of the following two approaches as an accounting policy.

– *Approach 1:* Allocate the consideration based on the stand-alone prices for the lease and non-lease components determined at the remeasurement date. The change in the non-cancellable period represents a change in the economics of the lease. To allocate the 'in-effect' new consideration, it is appropriate to use the updated stand-alone prices for allocation.

IFRS 16.BC194

– *Approach 2:* Allocate the consideration based on the unchanged stand-alone prices for the lease and non-lease components, determined at commencement date. Under this approach, the lessor applies IFRS 15's guidance for reallocation, which requires a lessor to use the same basis as at contract inception, except for a contract modification. The changes in the non-cancellable period do not arise from a modification.

Example 23 – Lessor reallocation: Changes in the non-cancellable period

Lessee E leases a machine from Lessor R for three years. As part of the contract, R will provide maintenance for the period.

E pays a fixed amount of 120,000 per year in arrears. E has a renewal option for an additional three years, which is not reasonably certain to be exercised at the commencement date. The total consideration at the commencement date is 360,000 (120,000 x 3).

R concludes that the contract has two components – the lease of the machine and the maintenance (non-lease component) – and allocates the consideration in the contract to those components as follows.

	Stand-alone prices	%	Allocation
Machine lease	330,000	83.33%	300,000
Maintenance	66,000	16.67%	60,000
	396,000		**360,000**

At the end of Year 2, E decides to exercise its three-year renewal option, triggering a reassessment of the lease term. The remaining lease term at the end of Year 2 is four years and the remaining consideration is 480,000 (120,000 x 4).

We believe that R may choose to reallocate the revised consideration in the contract using:

– *Approach 1:* the stand-alone prices as at the remeasurement date; or

– *Approach 2:* the stand-alone prices as at the commencement date.

	Approach 1			Approach 2		
	Remeasurement date stand-alone prices	%	Allocation	Commencement date stand-alone prices	%	Allocation
Machine lease	480,000	86.49%	415,135	330,000	83.33%	400,000
Maintenance	75,000	13.51%	64,865	66,000	16.67%	80,000
	555,000		**480,000**	**396,000**		**480,000**

Is a lessor required to remeasure the lease receivable to reflect changes in the lease payments?

IFRS 16.21, BC231

It depends. The new standard is silent on whether a lessor remeasures the lease receivable to reflect changes in the payments, except in the circumstance described below.

The new standard carried forward substantially all of IAS 17's lessor accounting requirements, which did not require reassessment or remeasurement of the lease receivable after commencement of the lease. However, the new standard requires the lessor to revise the lease term when there is a change in the non-cancellable period. In this case, the lessor remeasures the lease payments.

It is not clear whether the lessor can remeasure the lease payments in other circumstances, using the guidance for lessees by analogy.

Does a lessor reallocate variable payments when there is a change in non-cancellable period?

IFRS 16.21, 15.85

Generally, yes. However, a lessor does not need to reallocate the consideration when variable payments are allocated initially only to one component. This is similar to the lessee reallocation (see 5.2.1).

Under IFRS 15, the variable consideration can be allocated entirely to one or more, but not all, performance obligations in the contract if specific criteria are met. Using this guidance, if the lessor allocates variable payments to a single lease or non-lease component, then all such variable payments are allocated to the same component – there is no need to reallocate them among multiple components.

Appendix I – IFRS 16 at a glance

Topic	Key facts
Lease definition	– New lease definition with an increased focus on control of the underlying asset

Lessee accounting model	– Single lease accounting model
	– No lease classification test
	– Most leases on-balance sheet:
	  - lessee recognises a right-of-use asset and lease liability
	  - treated as the purchase of an asset on a financed basis

Lessor accounting model	– Dual lease accounting model for lessors – Lease classification test based on IAS 17 *Leases* classification criteria – Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset – Operating lease accounting model based on IAS 17 operating lease accounting
Practical expedients and targeted reliefs	– Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under the new standard is 12 months or less and that do not contain a purchase option – Portfolio-level accounting permitted for leases with similar characteristics if the effect on the financial statements does not differ materially from applying the requirements to individual leases – Optional lessee exemption for leases of low-value items – e.g. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate
Effective date	– Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 *Revenue from Contracts with Customers* is also adopted – Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

Appendix II – List of examples

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

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The text of this publication refers to IFRS 16 and to selected other current standards in issue at 31 August 2019.

Further analysis and interpretation will be needed for a company to consider the impact of IFRS 16 in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change. Therefore, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

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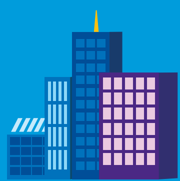

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