



# Leases Transition Options

**What is the best option for your business?**

IFRS

November 2016

---

[kpmg.com/ifrs](http://kpmg.com/ifrs)



# Contents

---

<b>Which option is best?</b>	<b>1</b>
<b>1 Choosing the best option</b>	<b>2</b>
1.1 Key considerations	2
1.2 Options and expedients	3
<b>2 IFRS 16 at a glance</b>	<b>4</b>
2.1 Key facts	4
2.2 Key impacts	5
<b>3 Identifying leases</b>	<b>6</b>
3.1 Lease definition	6
3.2 The recognition exemptions	8
<b>4 Retrospective vs modified retrospective</b>	<b>11</b>
4.1 Overview	11
4.2 Retrospective approach	12
4.3 Modified retrospective approach	14
<b>5 Modified retrospective</b>	<b>17</b>
5.1 Overview	17
5.2 Measuring the lease liability	18
5.3 Measuring the ROU asset	19
5.4 Practical expedients	23
5.5 Leases previously classified as finance leases	27
<b>6 Other transition scenarios</b>	<b>29</b>
6.1 Lessor	29
6.2 Sub-leases	29
6.3 Sale-and-leaseback	31
6.4 Investment property	33
6.5 Business combinations	34
<b>7 Disclosures</b>	<b>36</b>
7.1 Retrospective approach	36
7.2 Modified retrospective approach	37
<b>8 Effective date and early adoption</b>	<b>39</b>
<b>9 Next steps</b>	<b>41</b>
<b>Appendix – Worked example</b>	<b>43</b>
<b>About this publication</b>	<b>51</b>
<b>Keeping in touch</b>	<b>52</b>

# Which option is best?

Your choice of transition option and practical expedients will affect the costs and timing of your implementation project – and your financial statements for years to come.

In January 2016, the IASB issued IFRS 16 *Leases* – a major step towards realising its long-standing goal of bringing most leases on-balance sheet for lessees. All companies that lease major assets for use in their business will see an increase in reported assets and liabilities. This will affect a wide variety of sectors, from airlines that lease aircraft to retailers that lease stores. The larger your lease portfolio, the greater the impact on your key reporting metrics.

The standard features a single lease accounting model for lessees – with a host of different transition options and practical expedients. Many of the options and expedients can be elected independently of each other. Some can even be elected on a lease-by-lease basis.

Most of the choices you have to make on transition involve a trade-off between cost and comparability. That is, the options and expedients that simplify and reduce the costs of transition tend to reduce the comparability of your financial information.

This could affect your financial statements in your year of transition and for years to come, until the last lease in place at transition has expired.

Choosing the best transition option for your business will require thought – and probably some detailed modelling of alternative approaches.

This publication provides an overview of the transition options and expedients. To help you understand their impact, we've prepared a comprehensive example modelling how the options would affect the financial statements of a fictional company. We hope it will help you take the first step towards transition.

Kimber Bascom  
Ramon Jubels  
Sylvie Leger  
Brian O'Donovan

**KPMG's global IFRS leases leadership team**  
**KPMG International Standards Group**

## 1

# Choosing the best option

## 1.1

## Key considerations

### Why are the transition options so important?

A company's selected transition approach will have a significant impact on:

- the carrying amount of the assets and liabilities – and therefore net assets – when the company first applies IFRS 16;
- the company's profit and profit trends in the post-transition years, until the last lease in place on transition has expired;
- the costs, resources and timeline for the company's implementation project; and
- the data required to implement the standard.

### How many transition approaches are there?

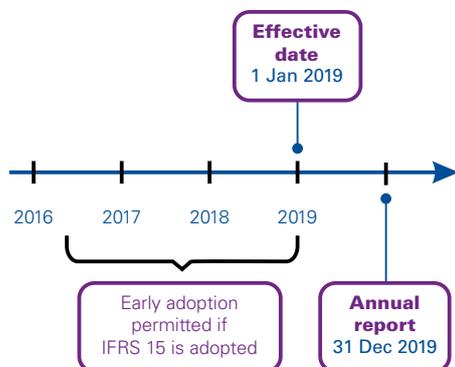
There are several transition approaches and many individual options and practical expedients that can be elected independently of each other, some on a lease-by-lease basis. For a large company, the number of permutations can be huge.

The biggest changes are for lessees, so they have more options to choose from to simplify transition. Therefore, Chapters 2–5 focus on lessees.

### Why are there so many options?

Most of the transition options involve a trade-off between the costs of implementation and the comparability of the resulting financial information, on transition and in the post-transition years.

The transition guidance has been designed to allow entities to make their own evaluation of this trade-off, based on the preferences of their stakeholders and the costs of implementation.



IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. Early adoption is permitted for companies that also adopt IFRS 15.

### How should a company get started?

- Initiate a discussion with stakeholders to understand the importance they place on having comparable trend data in the financial statements.
- Model the different transition options – using high-level assumptions or sample portfolios as necessary – to understand the potential impact on the financial statements.
- Prepare an inventory of currently available lease data and resources, to begin to estimate implementation costs for each approach.

The remainder of this publication examines each of the options and practical expedients in detail. The comprehensive example in the Appendix models the impact of the options on a fictional company.

## 1.2

## Options and expedients

The key decisions for a company relate to the effective date, and which options and practical expedients to elect. Many different combinations and permutations are possible.

The key options and expedients can be summarised as follows.

Option/expedient	Scope	Lessee or lessor?	Reference in this publication
<b>Lease definition: option to 'grandfather' the assessment of which contracts are leases</b>	– Accounting policy choice	– Lessee and lessor	3.1
<b>Recognition exemption: short-term leases</b>	– Class of underlying asset	– Lessee only	3.2
<b>Recognition exemption: leases of low-value items</b>	– Lease-by-lease	– Lessee only	3.2
<b>Retrospective vs modified retrospective</b>	– Accounting policy choice	– Lessee only	4
<b>Modified retrospective: measurement of the ROU asset</b>	– Lease-by-lease	– Lessee only	5.3
<b>Modified retrospective: practical expedients</b>	– Lease-by-lease – Discount rates – Impairment and onerous leases – Leases with a short remaining term – Initial direct costs – Use of hindsight	– Lessee only	5.4
<b>Early adoption</b>	– Accounting policy choice	– Lessee and lessor	8

Approach	2018	2019	Date of equity adjustment
Retrospective	IFRS 16*	IFRS 16	1 Jan 2018
	IAS 17*		
Modified retrospective	IAS 17	IFRS 16	1 Jan 2019

\* The company will apply IAS 17 in preparing its financial statements for 2018. It will then apply IFRS 16 to prepare comparative financial information to be included in its 2019 financial statements.

# 2

## 2.1

# IFRS 16 at a glance

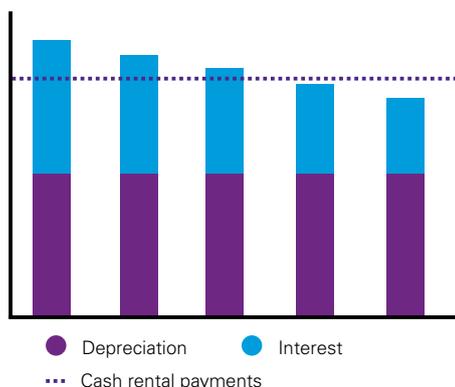
## Key facts

Impact on lessee balance sheet



Companies with operating leases will appear to be more asset-rich, but also more heavily indebted

Impact on lessee profit or loss



Total lease expense will be front-loaded even when cash rentals are constant

Topic	Key fact
<b>Lease definition</b>	<ul style="list-style-type: none"> <li>– A new lease definition with an increased focus on control of the underlying asset</li> </ul>
<b>Lessee accounting model</b>	<ul style="list-style-type: none"> <li>– Single lease accounting model</li> <li>– No lease classification test</li> <li>– Most leases on-balance sheet:                             <ul style="list-style-type: none"> <li>- lessee recognises a right-of-use (ROU) asset and lease liability</li> <li>- treated as the purchase of an asset on a financed basis</li> </ul> </li> </ul>
<b>Lessor accounting model</b>	<ul style="list-style-type: none"> <li>– Dual lease accounting model for lessors</li> <li>– Lease classification test based on IAS 17 <i>Leases</i> classification criteria</li> <li>– Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset</li> <li>– Operating lease accounting model based on IAS 17 operating lease accounting</li> </ul>
<b>Practical expedients and targeted reliefs</b>	<ul style="list-style-type: none"> <li>– 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</li> <li>– Portfolio-level accounting permitted if the effect on the financial statements does not differ materially from applying the requirements to individual leases</li> <li>– Optional lessee exemption for leases of low-value items – i.e. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate</li> </ul>
<b>Effective date</b>	<ul style="list-style-type: none"> <li>– Accounting periods beginning on or after 1 January 2019</li> <li>– Early adoption is permitted if IFRS 15 <i>Revenue from Contracts with Customers</i> is also adopted</li> <li>– The date of initial application is the beginning of the first annual reporting period in which a company first applies the standard</li> </ul>

## 2.2

## Key impacts

**Identifying all lease agreements and extracting lease data.** Lessees will now recognise most leases on-balance sheet. This may require a substantial effort to identify all lease agreements and extract all relevant lease data necessary to apply the standard. To apply the simplified model for short-term leases and leases of low-value items, a company will need to identify the lease and extract key lease terms.

**Changes in key financial metrics.** Key financial metrics will be affected by the recognition of new assets and liabilities, and differences in the timing and classification of lease income/expense. This could impact debt covenants, tax balances and a company's ability to pay dividends.

**New estimates and judgements.** The standard introduces new estimates and judgemental thresholds that affect the identification, classification and measurement of lease transactions. Senior staff will need to be involved in these decisions – both at lease commencement and at reporting dates as a result of the continuous reassessment requirements.

**Balance sheet volatility.** The new standard introduces volatility to assets and liabilities for lessees, due to the requirements to reassess certain key estimates and judgements at each reporting date. This may impact a company's ability to accurately predict and forecast results.

**Changes in contract terms and business practices.** To minimise the impact of the standard, some companies may wish to reconsider certain contract terms and business practices – e.g. changes in the structuring or pricing of a transaction, including lease length and renewal options. The standard is therefore likely to affect departments beyond financial reporting – including treasury, tax, legal, procurement, real estate, budgeting, sales, internal audit and IT.

**New systems and processes.** Systems and process changes may be required to capture the data necessary to comply with the new requirements, including creating an inventory of all leases on transition. The complexity, judgement and continuous reassessment requirements may require additional resources and controls focused on monitoring lease activity throughout the life of leases.

**Some impacts cannot yet be quantified.** Companies won't have the full picture until other accounting and regulatory bodies have responded. For example, the new accounting could prompt changes in the tax treatment of leases. And a key question for the financial sector is how the prudential regulators will treat the new assets and liabilities for regulatory capital purposes.

**Communication with stakeholders will require careful consideration.** Investors and other stakeholders will want to understand the standard's impact on the business. Areas of interest may include the effect on financial results, the costs of implementation and any proposed changes to business practices.

Our publication [First Impressions: IFRS 16 Leases](#) provides a more detailed introduction to the requirements of IFRS 16. Our full range of materials on IFRS 16 is available from [KPMG's Global IFRS Institute](#).



## 3

# Identifying leases

The first key transition question for many companies will be whether to apply the practical expedient to 'grandfather' the assessment of which transactions are leases.

## 3.1

*IFRS 16.C3, C4*

### Lease definition

On transition to IFRS 16, companies can choose whether to:

- apply the new definition of a lease to all of their contracts; or
- apply a practical expedient to 'grandfather' their previous assessment of which existing contracts are, or contain, leases.

A company that chooses to take advantage of the practical expedient:

- applies IFRS 16 to leases previously identified in accordance with IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease*;
- does not apply IFRS 16 to contracts previously identified as not containing leases in accordance with IAS 17 and IFRIC 4; and
- applies the IFRS 16 definition of a lease to assess whether contracts entered into after the date of initial application of the new standard are, or contain, leases.

*IFRS 16.C4*

If the practical expedient is chosen, then it applies to all contracts entered into before the date of initial application, and the requirements of IFRS 16 apply to contracts entered into (or changed) on or after the date of initial application.

*IFRS 16.C2*

The 'date of initial application' is the beginning of the annual reporting period in which a company first applies the standard. If a company prepares financial statements for annual periods ending on 31 December, presents one year of comparative financial information and adopts IFRS 16 in 2019, then its date of initial application is 1 January 2019.



#### What are the main pros and cons of adopting this practical expedient?

The practical expedient to grandfather the definition of a lease on transition offers considerable relief on transition. Without this relief, companies would be required to reassess all of their previous decisions about which existing contracts do and do not contain leases. The practical expedient is therefore likely to prove popular.

However, it will not be adopted by all companies. For example, a company that is a purchaser under a power purchase agreement that is an operating lease under current requirements but not a lease under IFRS 16 may prefer to apply the new definition of a lease, rather than bring the power purchase agreement on-balance sheet.

Companies will want to evaluate carefully whether to apply the new transition relief, balancing:

- the cost savings that would arise if they take the transition relief; against
- the potential impact of needing to apply the new lease accounting model to arrangements that would fall outside lease accounting under the new definition.

Other considerations will include the number, size and duration of such agreements – and the extent of inconsistency in accounting for agreements entered into before and after the date from which the company applies IFRS 16.



#### How significant are the costs of applying the new lease definition retrospectively?

For many companies, the costs could be high; this will depend on the facts and circumstances of the company.

A key reason for this is that a company will have to apply the new lease definition not only to contracts previously identified as leases – but also to all other purchase arrangements.

To mitigate the costs of applying the new lease definition retrospectively, a company could seek to develop a practical approach in which it groups similar contracts and focuses the most in-depth analysis on those groups of contracts that are more likely to be impacted by the differences in lease definition between IAS 17 and IFRS 16. However, in a large, diversified group the time and costs required to conduct – and, crucially, document – the assessment could still be high.



#### How significant is the impact on comparability of using the practical expedient?

For many companies the impact on comparability could be small; this will depend on the facts and circumstances of the company.

This will be the case for companies that identify substantially the same transactions as being leases under the old and new definitions. Although lease definition has been a key talking point as the standard was developed, for many routine transactions, the same transactions are leases under the old and new definitions – e.g. many real estate and equipment leases.

Companies will see a higher impact on comparability if they have entered into arrangements that are operating leases under IAS 17 but do not meet the new definition of a lease – e.g. some power purchase arrangements.

**Can a company choose to apply the new definition of a lease only to certain classes of transaction on transition – e.g. to power purchase agreements?**

No. Application of the practical expedient is an accounting policy choice, to be applied consistently to all contracts on transition. This means, for example, that a company takes the same approach to:

- leases of all classes of underlying asset; and
- leases in which the company is a lessee and leases in which the company is a lessor.

IFRS 16.11

**If an entity applies the practical expedient, does this determine the accounting classification of the contract for the rest of its term?**

No. The practical expedient only applies to the identification of leases on the date of initial application of the new standard. There is no exemption from the general requirement to reassess whether an arrangement is or contains a lease if the terms and conditions of the agreement are modified subsequently.

IFRS 16.11

**Does the practical expedient permit an entity to ‘grandfather’ errors or omissions in its previous assessment of which contracts are, or contain, leases?**

No. The practical expedient is not intended to be an amnesty.

During the course of the IFRS 16 implementation project, it is possible that some companies will identify errors or omissions in their previous assessment of which contracts are, or contain, leases. These should be corrected in the normal way.

## 3.2

IFRS 16.5–8, BC100

## The recognition exemptions

On transition and subsequently, a lessee can elect not to apply the lessee accounting model to:

**Short-term leases**

≤ 12 months

**Leases of low-value items**≤ USD 5,000  
for example

If a lessee elects either of these recognition exemptions, then it recognises the related lease payments as an expense on either a straight-line basis over the lease term or another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

The election for short-term leases is made by class of underlying asset, whereas the election for leases of low-value assets can be made on a lease-by-lease basis. There is an additional practical expedient for leases with a remaining term of 12 months or less on transition – see 5.4.3.



#### Why are the recognition exemptions important on transition?

The recognition exemptions are important because they impact the population of contracts that need to be restated on the date of initial application.

That is, a lessee need not calculate lease assets and lease liabilities on transition for leases to which one or both of the exemptions apply.

This means that for leases classified as operating leases under IAS 17 to which a company applies one of the recognition exemptions, there will be no adjustments necessary on transition.



#### Does application of the recognition exemptions on transition have an ongoing impact on a company's subsequent accounting?

Yes. In order to apply the recognition exemptions on transition a company will need to develop certain accounting policies and practices – and then apply them consistently in subsequent periods.

The situation is different for the two recognition exemptions, as follows.

- **Short-term leases:** The recognition exemption for short-term leases is an accounting policy election by class of underlying asset. As such, a company applies this exemption consistently on transition and subsequently. For example, if a company applies the exemption to qualifying leases of office equipment but not to qualifying leases of motor vehicles on transition, then the company applies this approach to similar new leases that it enters into after the date of initial application. However, the practical expedient on leases with a remaining term of 12 months or less on transition provides additional flexibility – see 5.4.3.
- **Leases of low-value items:** The recognition exemption for leases of low-value items is applied on a lease-by-lease basis. As such, a company need not apply the exemption to leases of the same type of underlying asset on transition and subsequently. However, in order to apply the exemption a company will need to develop policies for identifying leases of low-value items. These policies will need to be applied consistently on transition and subsequently.



**Does application of the recognition exemptions on transition reduce comparability in the future?**

There will be a reduction in comparability – on transition and subsequently – between the leases for which the company does and does not apply the exemptions.

However, there will not necessarily be any reduction in period-on-period comparability in the future. As explained above, a company applies consistent policies and practices for the exemptions on transition and subsequently.



**Are the recognition exemptions available to lessors on transition?**

No. The recognition exemptions are available only to lessees – on transition and subsequently.

# 4 Retrospective vs modified retrospective

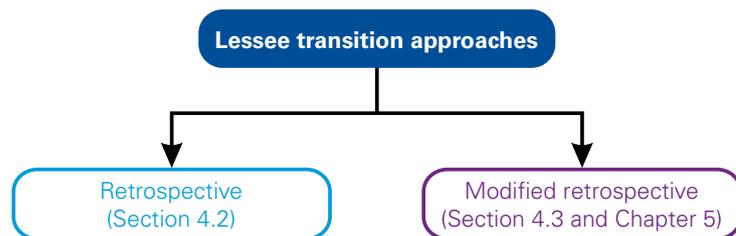
The second key transition question for many companies will be whether to apply the standard retrospectively, or using a modified retrospective approach, to leases in which they are a lessee.

## 4.1 Overview

IFRS 16.C5

A lessee is permitted to:

- adopt the standard retrospectively; or
- follow a modified retrospective approach.



IFRS 16.C6

A lessee applies the election consistently to all of its leases.

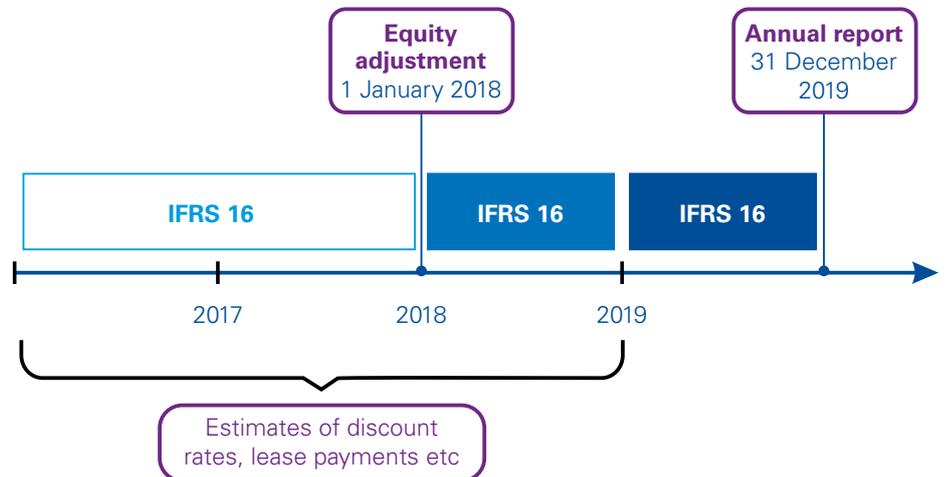
The impact of the retrospective and modified retrospective approaches can be illustrated as follows. The diagram shows a calendar year end company that presents one year of comparative financial information and adopts the new standard in its 2019 financial statements.

Approach	2018	2019	Date of equity adjustment
Retrospective	IFRS 16*	IFRS 16	1 January 2018
	IAS 17*		
Modified retrospective	IAS 17	IFRS 16	1 January 2019

\* The company will apply IAS 17 in preparing its financial statements for 2018. It will then apply IFRS 16 to prepare comparative financial information to be included in its 2019 financial statements.

## 4.2

### Retrospective approach



IFRS 16.C5(a)

Under the retrospective approach, a company applies the standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. That is, a company

- applies the standard to all leases in which it is a lessee;
- restates its prior financial information;
- recognises an adjustment in equity at the beginning of the earliest period presented; and
- makes the disclosures required by paragraph 28 of IAS 8 on a change in accounting policy.



#### Is the election to grandfather the assessment of which transactions are leases available under the retrospective approach?

Yes. The transition guidance in the new standard states that a company first chooses whether to apply the practical expedient on lease definition, and then chooses whether to apply the retrospective or a modified retrospective approach to leases in which it is a lessee.

Strictly, if a company elects the option to grandfather the assessment of which transactions are leases, then it is not following a full 'retrospective' approach in the sense that IAS 8 uses the term. In addition, other aspects of the transition guidance – e.g. for lessors (see Section 6.1) – actually prohibit a full retrospective approach.

However, the new standard uses the term 'retrospective' for the transition approach for lessees described in this section, and that is the sense in which we use the term in this publication.



### What information is needed to apply the retrospective approach?

A company will require extensive information about its leasing transactions in order to apply the standard retrospectively.

This will include historical information about lease payments and discount rates. It will also include the historical information that management would have used in order to make the various judgements and estimates that are necessary to apply the lessee accounting model – for example:

- lease term, including whether a company was reasonably certain to exercise a renewal option, or not exercise a termination option;
- whether a company was reasonably certain to exercise a purchase option;
- amounts expected to be paid under residual value guarantees; and
- amortisation and impairment of the ROU asset.

The information will be required as at lease commencement, and also as at each date on which a company would have been required to recalculate lease assets and liabilities on a reassessment or modification of the lease.



### Are there any practical expedients for companies that apply the retrospective approach?

No. Other than the practical expedient to grandfather the lease definition (see Section 3.1) and the practical relief inherent in the recognition exemptions (see Section 3.2), none of the other practical expedients included in IFRS 16 are available under the retrospective method.

For example, although the new standard permits the use of hindsight when applying a modified retrospective method (see 5.4.5), it does not permit the use of hindsight when applying the retrospective method.



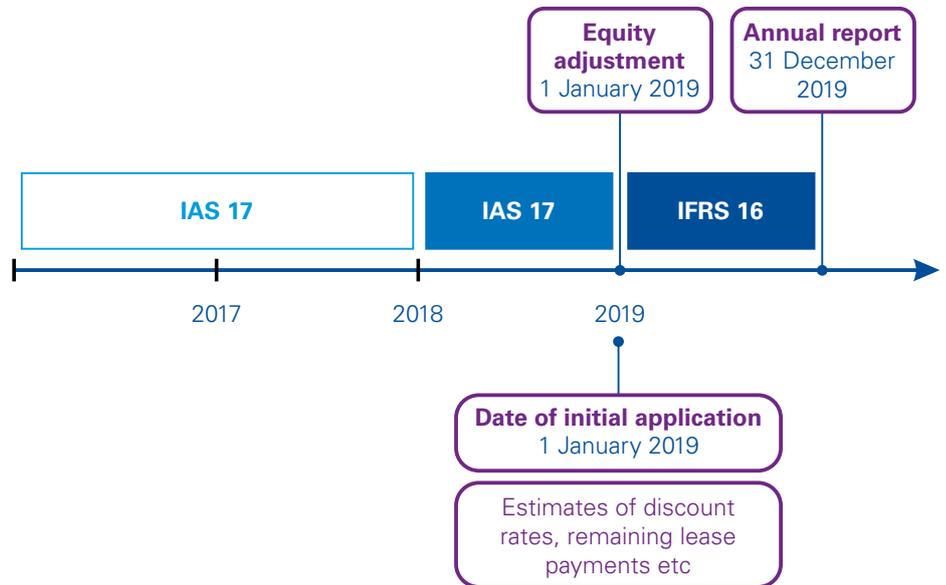
### Will any companies apply the retrospective approach?

The IASB included the retrospective approach in the new standard following feedback from preparers that it would not be possible to present truly comparable trend information within the financial statements under a modified retrospective approach.

However, it is possible that the costs and complexity of applying the retrospective approach will deter many preparers, who may prefer to follow a modified retrospective approach and produce other pro forma financial information in order to communicate comparable trend data to stakeholders.

## 4.3

### Modified retrospective approach



*IFRS 16.C5(b)*

Under a modified retrospective approach, a company applies the standard from the beginning of the current period. To do this, the company:

- calculates lease assets and lease liabilities as at the beginning of the current period using special rules included in the new standard – see Chapter 5;
- does not restate its prior-period financial information;
- recognises an adjustment in equity at the beginning of the current period; and
- makes additional disclosures specified in the new standard and is exempt from certain of the disclosures usually required by paragraph 28 of IAS 8 on a change in accounting policy – see Section 7.2.



#### What are the key benefits of a modified retrospective approach?

The key benefit is a reduction in the cost of transition.

The mechanics of applying a modified retrospective approach are discussed in Chapter 5 but, in brief, cost savings arise because:

- there is no requirement to restate comparative financial information;
- it is possible to apply a modified retrospective approach using only current period information – that is:
  - the lessee's incremental borrowing rate at the beginning of the current period; and
  - the lessee's remaining lease payments; and
- additional practical expedients are available.



### What are the disadvantages of a modified retrospective approach?

The principal disadvantage is a reduction in the comparability of the company's financial information. This arises in two ways.

Firstly, because the prior-period financial information is not restated, the current and prior-year financial information within the financial statements is not comparable. For a company with a large operating lease portfolio, the differences could be significant.

Secondly, the annual financial information in the current and subsequent years may not be comparable, due to the way in which the opening lease assets and liabilities are calculated at the date of initial application under a modified retrospective approach. This lack of comparability will then persist until all leases that are in place at the date of initial application have expired. This is explained in more detail in Chapter 5.

Another disadvantage is that a company that uses a modified retrospective approach is required to make additional disclosures, essentially to explain any difference between its reported operating lease commitments under IAS 17 and its opening lease liabilities under IFRS 16 – see Section 7.2.



### Is it possible to apply a modified retrospective approach at the beginning of the earliest period presented?

No. This is not permitted under IFRS 16.

The IASB included in the exposure draft (ED) that preceded IFRS 16 an option to apply a modified retrospective approach at the beginning of the earliest period presented. This approach would have increased the consistency of the current and prior-period financial information in the year of transition.

However, stakeholders responded that this approach would not provide sufficient relief on transition. In IFRS 16, the IASB responded to this feedback by updating the proposals in the ED so that a modified retrospective approach is applied at the beginning of the current period.

Since the publication of IFRS 16, some stakeholders have indicated that they would prefer the approach included in the ED. However, at the time of writing the IASB has no plans to amend the transition options.



**Is it possible to present in the financial statements pro forma financial information showing the impact of IFRS 16 on the prior year?**

Pro forma financial information showing the impact of IFRS 16 on the prior year could be helpful in communications with stakeholders. However, it would be non-GAAP information, subject to any local or regulatory guidance on the publication of non-GAAP information.

A company would need to think carefully about how best to prepare such pro forma information. For example, under a modified retrospective approach, lease assets and liabilities at the date of initial application are measured using the company's incremental borrowing rate at that date. A company would need to decide what discount rate to use when preparing the pro forma information: the discount rate at the date of initial application, or a discount rate representative of the company's incremental borrowing rate in the prior period?

In any case, key priorities would include:

- presenting the pro forma information in a clear way – i.e. labelled clearly to distinguish it from the IFRS financial statements; and
- explaining how the pro forma information was prepared.

# 5 Modified retrospective

A modified retrospective approach includes a number of options and practical expedients for lessees, which can have a significant impact on a company’s transition balances and post-transition financial information.

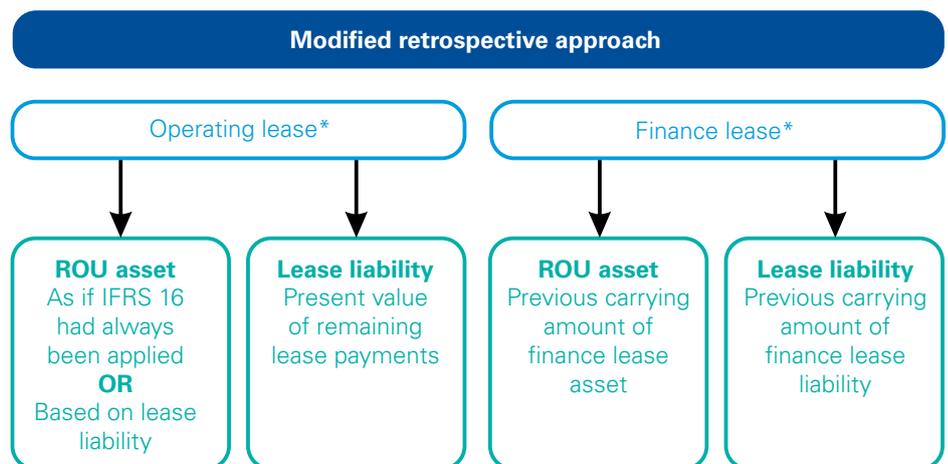
## 5.1 Overview

IFRS 16.C7

If a lessee elects to apply IFRS 16 using a modified retrospective approach, then it does not restate comparative information. Instead, the lessee recognises the cumulative effect of initially applying the standard as an adjustment to equity at the date of initial application.

IFRS 16.C8–C11

A modified retrospective approach is applied as follows.



\* As classified previously under IAS 17.

Sections 5.2–5.4 discuss transition for leases previously classified as operating leases. Section 5.5 discusses transition for leases previously classified as finance leases.

## 5.2

IFRS 16.C8(a)

### Measuring the lease liability

For leases previously classified as operating leases, a lessee measures the lease liability at the date of initial application as the present value of the remaining lease payments. The discount rate is the lessee's incremental borrowing rate at that date.



#### Example 1 – Measuring the lease liability

Retailer J leases a retail store for a fixed rental of 100 per annum, paid at the end of each year. The lease commences on 1 January 2014, when J's incremental borrowing rate is 7%. The non-cancellable period of the lease is 10 years, renewable for a further five years.

Under IAS 17, J classifies the lease as an operating lease and recognises the lease payments as an expense on a straight-line basis – i.e. operating lease expense of 100 per annum.

J adopts IFRS 16 using a modified retrospective approach with a date of initial application of 1 January 2019. At that date:

- J is not reasonably certain to exercise the renewal option. The remaining term of the lease is therefore five years; and
- J's incremental borrowing rate is 5%.

J therefore calculates its lease liability as at 1 January 2019 based on the lease payments over the remaining lease term (five years at 100 per annum) discounted at its incremental borrowing rate at that date of 5% – giving a lease liability of 433.



#### Does the lessee use the same discount rate for all of its leases?

IFRS 16.A, C8(a)

No. The lessee determines its incremental borrowing rate as at the date of initial application, in the usual way.

The definition of 'incremental borrowing rate' refers to a number of factors that may differ between leases – for example:

- the term of the arrangement;
- the value of the lease liability; and
- the economic environment.

This may result in the use of different discount rates for different leases. However, there is a practical expedient to apply a single discount rate to a portfolio of leases with reasonably similar characteristics – see Section 5.4.

IFRS 16.A



**Over what period does the lessee measure the ‘remaining lease payments’?**

The lessee estimates the remaining lease term as at the date of initial application, and measures the remaining lease payments accordingly.

If a lease contains renewal or termination options, then the lessee measures the lease payments consistently with its estimate of the lease term in the normal way. For example, a lessee includes:

- lease payments relating to an optional renewal period in the lease liability only if it assesses as at the date of initial application that it is reasonably certain to exercise the renewal option; and
- a termination penalty in the lease liability only if its assessment of the lease term as at the date of initial application assumes that it will exercise the termination option.



**How does a lessee account for the lease liability subsequently?**

After the date of initial application, the lessee applies all of the requirements of the standard to subsequent measurement of the liability. This includes, if relevant, the guidance on lease modifications and reassessments.

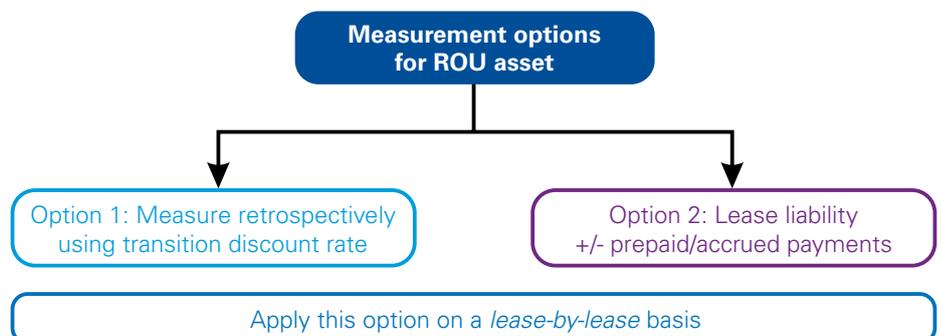
## 5.3

IFRS 16.C8(b)

### Measuring the ROU asset

For leases previously classified as operating leases, a lessee is permitted to choose, on a lease-by-lease basis, how to measure the ROU asset using one of two methods:

- *Option 1*: as if IFRS 16 had always been applied (but using the incremental borrowing rate at the date of initial application); or
- *Option 2*: at an amount equal to the lease liability (subject to certain adjustments).



IFRS 16.C8(c)

A lessee applies IAS 36 *Impairment of Assets* to assess the ROU assets for impairment at the date of initial application – but see 5.4.2 for a practical expedient.

IFRS 16.C8(b)(i)



### Example 2 – Measuring the ROU asset

Continuing Example 1, Retailer J has calculated that its lease liability on 1 January 2019 is 433. J now calculates the carrying amount of the ROU asset on that date. Assume that there are no initial direct costs.

#### Option 1 – Retrospective but using the incremental borrowing rate at 1 January 2019

J first calculates the carrying amount of the ROU asset on lease commencement – i.e. 1 January 2014. This is the present value of the lease payments over the 10-year term (10 years at 100 per annum) discounted at J's incremental borrowing rate at 1 January 2019 of 5% – giving an amount of 772.

J's accounting policy is to depreciate ROU assets on a straight-line basis over the lease term. J therefore calculates the carrying amount of the ROU asset at 1 January 2019 as  $5 / 10 \times 772 = 386$ .

Under Option 1, J's journal entry on initial recognition of this lease on 1 January 2019 is therefore as follows.

	Debit	Credit
ROU asset	386	
Lease liability		433
Retained earnings	47	

IFRS 16.C8(b)(ii)

#### Option 2 – Equal to the lease liability

Under Option 2, J measures the ROU asset at 1 January 2019 to be equal to the lease liability of 433. J's journal entry on initial recognition of this lease on 1 January 2019 is therefore as follows.

	Debit	Credit
ROU asset	433	
Lease liability		433
Retained earnings	0	

**Will the initial carrying amount of the ROU asset typically be lower under Option 1 than under Option 2?**

Yes, for a lease with regular periodic cash flows, as shown in Example 2.

This effect arises because of the different amortisation profiles of the ROU asset and the lease liability. The ROU asset is typically depreciated on a straight-line basis, whereas the lease liability is measured using the effective interest rate method. Option 1 reflects the ROU amortisation profile, whereas Option 2 reflects the lease liability amortisation profile. Therefore, Option 1 typically results in a lower carrying amount for the ROU asset at the date of initial application than Option 2.

This can have a significant effect on post-transition accounting. Option 1 typically results in a lower depreciation charge and a lower risk of impairment than Option 2. In the example above, Retailer J's depreciation charge in 2019 is  $1/5 \times 386 = 77$  under Option 1, and  $1/5 \times 433 = 87$  under Option 2.

**What are the costs and benefits of each option?**

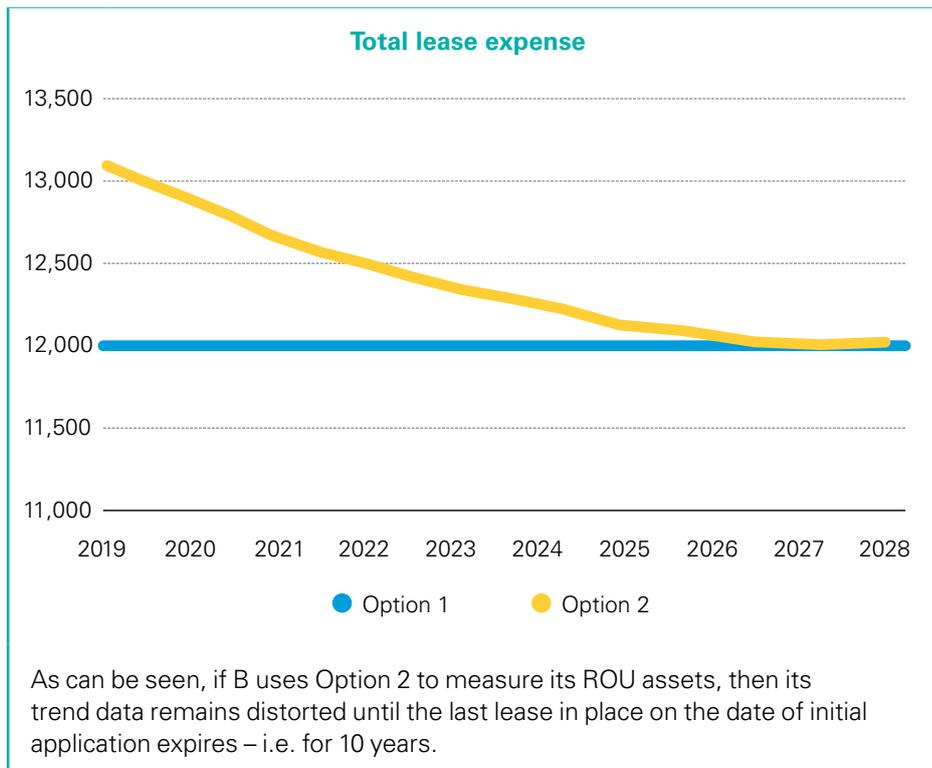
In common with the other options and practical expedients, there is a trade-off between cost and comparability. Option 2 will generally be simpler and less costly to apply, because it relies on information as at the date of initial application. It also involves less complex calculations.

However, Option 2 can lead to a significant distortion of profit or loss trend data in the years after the adoption of IFRS 16. This can be illustrated by the following example.

Airline B is a lessee in 120 leases of aircraft. Each lease has a 10-year term with annual rentals of 100. As each lease expires, B enters into a new lease on the same terms. B manages its lease portfolio so that lease renewals are evenly spread – i.e. B enters into 12 new leases a year and 12 old leases expire. Assume, for the purposes of illustration, that B's incremental borrowing rate remains constant. That is, this is a steady-state portfolio.

However, using Option 2 would significantly distort B's profit or loss account for the 10 years after transition. This can be seen in the following graph, which compares B's total lease expense assuming that:

- B uses Option 1 to measure all of its ROU assets on transition; and
- B uses Options 2 to measure all of its ROU assets on transition.



#### What is the benefit of the two options being available on a lease-by-lease basis?

The options can be elected on a lease-by-lease basis. This allows companies to make their own trade-off between cost and comparability when designing their transition approach.

In the graph above, the two lines represent the two extreme cases, in which Airline B elects Option 1 for the whole of its lease portfolio, or Option 2 for the whole of its lease portfolio. If B elected different options for different leases, then its total lease expense would lie somewhere between the two lines on the graph. That is, the area between the two lines represents the range of possible accounting outcomes post-transition. B's choices determine where in that area its post-transition lease expense will fall.

Suppose that in addition to 120 leases of aircraft, B also had 1,000 other leases. The underlying assets in those other leases – real estate, vehicles, equipment etc – are much lower in value than the leased aircraft. However, the other leases do not qualify for either of the recognition exemptions for short-term leases or low-value items.

In this case, B might conclude that the best trade-off between cost and comparability would be to use Option 1 for its large aircraft leases (to maximise comparability for its largest leases) and Option 2 for its other leases (to reduce costs for its smaller leases). Or it might decide to use Option 1 for its aircraft leases and some of its biggest real estate leases and Option 2 for other leases.

For B, the optimum trade-off will depend on factors including stakeholder preferences, the precise composition of B's lease portfolio, the completeness of B's lease data, B's lease accounting systems etc.

However, the fact that Option 1 and Option 2 can be elected on a lease-by-lease basis gives B considerable flexibility to determine its approach.

## 5.4

*IFRS 16.C10*

### Practical expedients

When applying a modified retrospective approach to leases previously classified as operating leases, a lessee may use one or more of the following practical expedients on:

- discount rates;
- impairment and onerous leases;
- leases with a short remaining term;
- initial direct costs; and
- use of hindsight.

These practical expedients can be applied independently of each other, and on a lease-by-lease basis.



#### What is the best way to assess the range of possible outcomes on transition?

*IFRS 16.BC287*

The IASB has sought to reduce transition costs by introducing a series of practical expedients. Most companies will find that they have a huge range of possible accounting outcomes on transition. In addition to assessing the balance between cost and comparability in deciding how to make the transition to the new standard, companies may also wish to complete detailed modelling to understand what their opening balance sheet and future income statements would look like in each case.

## 5.4.1

IFRS 16.C10(a)

### Discount rates

A company may apply a single discount rate to a portfolio of leases with reasonably similar characteristics.



#### Is this practical expedient different from the general guidance on portfolio accounting?

At first glance, this practical expedient seems similar to the general guidance on portfolio application. This general guidance permits a company to apply IFRS 16 to a portfolio of leases with similar characteristics.

However, there are some differences, as follows.

- Firstly, there are fewer conditions to apply the practical expedient on transition. The general guidance on portfolio application can be applied only if the company can demonstrate that the effect of applying the standard to the portfolio is not materially different from applying the standard to individual leases. In contrast, the practical expedient on transition is available whenever the leases have similar characteristics.
- Secondly, the practical expedient refers to leases with 'a similar *remaining lease term*'. This is consistent with the general focus on the remaining term in a modified retrospective approach.

Overall, the hurdle for using the practical expedient on transition is lower than the hurdle for portfolio application of the standard subsequently.

IFRS 16.B1, C10(a)

## 5.4.2

### Impairment and onerous leases

A company may rely on a previous assessment of whether leases are onerous in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to performing an impairment review. Instead, the company adjusts the carrying amount of the ROU asset at the date of initial application by the previous carrying amount of its onerous lease provision.



#### Example 3 – Onerous leases on transition

Company M leases an office building under a lease that was previously classified as an operating lease. The annual rentals are 100 paid at the end of each year and the lease term ends on 31 December 2023. M vacates the building in 2017.

The building remains vacant at 31 December 2018. However, M expects that it will be able to sub-lease the building from 1 January 2020 at an annual rental of 80. M therefore recognises an onerous lease provision at 31 December 2018, measured as follows.

	Cash outflow	Cash inflow	Net cash outflow
Year ended 31 December 2019	100	-	100
Year ended 31 December 2020	100	(80)	20
Year ended 31 December 2021	100	(80)	20
Year ended 31 December 2022	100	(80)	20
Year ended 31 December 2023	100	(80)	20
Total			<u>180</u>
Present value at 5% (risk-free rate)			<u>163</u>

M transitions to IFRS 16 using a modified retrospective approach with a date of initial application of 1 January 2019. M estimates that its incremental borrowing rate at that date is 7%. M plans to measure ROU assets for all of its real estate leases using Option 2 (see Section 5.3).

M calculates that its opening lease liability at 1 January 2019 is 410 (100 per annum discounted at 7%). M can elect to measure the ROU asset in one of two ways.

- M can measure the ROU asset at an amount equal to the lease liability: i.e. 410. M would then be required to apply IAS 36 to assess whether the ROU asset was impaired at 1 January 2019.
- M can measure the ROU asset at an amount equal to the lease liability less the onerous lease provision recognised under IAS 37: i.e.  $410 - 163 = 247$ . M would not consider whether the ROU asset was impaired at 1 January 2019.

In this example, M has elected to use Option 2 to measure its ROU asset; the practical expedient is also available if M elects to use Option 1 to measure its ROU asset.



#### Do the principles of IAS 37 apply to subsequent measurement of an ROU asset to which a company applied this practical expedient on transition?

No. The practical expedient relates only to measurement on transition. Subsequently, the company accounts for the ROU asset in accordance with IFRS 16. That is, the company depreciates the ROU asset under IAS 16 and tests it for impairment under IAS 36.

### 5.4.3

#### Leases with a short remaining term

A company may account for leases for which the lease term ends within 12 months of the date of initial application as short-term leases.



##### Example 4 – Lease with a remaining term of 12 months

Company Q leases a vehicle for use in its business for an annual rental of 100. The lease commenced on 1 January 2017. The lease includes a three-year non-cancellable period, renewable at Q's option for a further two years at the same rental. The useful life of the vehicle is 10 years.

In 2017, Q assesses that it is reasonably certain to exercise the renewal option and that the lease term is five years. Q notes that there are no indicators that the lease is a finance lease and so classifies the lease as an operating lease.

Q adopts IFRS 16 using a modified retrospective approach with a date of initial application of 1 January 2019. At that date, Q assesses that it is no longer reasonably certain to exercise the renewal option – i.e. the remaining term of the lease is one year.

Q can choose to account for the lease in one of two ways in 2019, as follows.

- Q can apply the IFRS 16 lessee model to the lease and recognise an ROU asset and a lease liability. Under this approach, Q would measure the lease liability at 100, discounted at its incremental borrowing rate at 1 January 2019. It could then measure the ROU asset retrospectively, or at an amount equal to the lease liability. As a result, Q would recognise depreciation and interest expense in 2019.
- Q can use the practical expedient to account for the lease as a short-term lease. Under this approach, Q would not recognise an ROU asset or lease liability for this lease. Instead, Q would recognise lease expense of 100 in 2019, including this expense in its disclosure of total short-term lease expense.



##### Can a company apply this practical expedient on transition even if it does not plan to use the recognition exemption for short-term leases subsequently?

Yes. The use of this practical expedient is independent of the company's ongoing accounting policy for short-term leases after transition.

- The recognition exemption for short-term leases (see Section 3.2) is an accounting policy choice by class of underlying asset. As such, it is applied consistently to leases of underlying assets in the same class and from period to period.
- The practical expedient for leases with a remaining term of 12 months at the date of initial application can be elected on a lease-by-lease basis at that date.

As such, the practical expedient offers additional relief – and additional flexibility – on transition.

## 5.4.4

IFRS 16.C10(d)

### Initial direct costs

A company may exclude initial direct costs from the measurement of the ROU asset at the date of initial application.



#### What is the impact of this practical expedient?

Use of this practical expedient will reduce the cost of transition for companies, in that they are not required to identify the initial direct costs of leases previously classified as operating leases.

The financial reporting impact of using this practical expedient will be to reduce the carrying amount of the ROU asset as at the date of initial application. In turn, this will reduce depreciation expense – and the risk of impairment – in subsequent periods.

## 5.4.5

IFRS 16.C10(e)

### Use of hindsight

A company may use hindsight – e.g. in determining the lease term if the contract contains options to extend or terminate the lease.



#### When will this practical expedient be relevant?

Although an explicit statement that a company may use hindsight is welcome, companies may find this practical expedient of limited benefit in practice.

Similar to the other practical expedients, it is available only when a company follows a modified retrospective approach. As explained in Section 4.3, a key benefit of a modified retrospective approach is that a company can transition its operating leases using information as at the date of initial application. Indeed, if a company elects a modified retrospective approach and measures its ROU assets using Option 2 (see Section 5.3), then it is required to use only current information.

However, if a company measures its ROU assets retrospectively using Option 1 (see Section 5.3), then this expedient will simplify the calculation of the ROU asset, and the documentation of that calculation. This is because a company can use its current assessment of the lease term, rather than reconstructing its initial assessment of the lease term and subsequent changes thereto.

## 5.5

IFRS 16.C11

### Leases previously classified as finance leases

Under a modified retrospective approach, for leases that were previously classified as finance lessees, a company recognises:

- an ROU asset measured initially at the previous carrying amount of the finance lease asset under IAS 17; and
- a lease liability measured at the previous carrying amount of the lease liability under IAS 17.

Subsequently, the company accounts for the ROU asset and lease liability in accordance with the general requirements of IFRS 16.



### Example 5 – Lease previously classified as a finance lease

Company R leases a vehicle for use in its business. R pays fixed annual rentals and has also issued a residual value guarantee to the lessor.

As at 31 December 2018, R recognises the following assets and liabilities under IAS 17.

	<b>31 December 2018 Debit/(Credit)</b>
Finance lease asset	120
Finance lease liability, calculated as:	
Present value of annual lease payments	(100)
Present value of maximum potential payout under residual value guarantee	(50)
	<u>(150)</u>

R adopts IFRS 16 using a modified retrospective approach with a date of initial application of 1 January 2019.

R notes that the market price of second hand vehicles has risen in the period since lease commencement. At 1 January 2019, R expects that it would not be required to make any payment under the residual value guarantee. That is, a lease liability calculated in accordance with IFRS 16 would include zero for the residual value guarantee.

However, under a modified retrospective approach, R makes no adjustments to its IAS 17 balances on transition. Therefore, on 1 January 2019:

- the finance lease asset is reclassified as an ROU asset measured at 120; and
- the finance lease liability is reclassified as a lease liability measured at 150: i.e. including the amount of 50 relating to the residual value guarantee.

Subsequently, R accounts for the ROU asset and lease liability in accordance with IFRS 16.

IFRS 16.27(c)

# 6 Other transition scenarios

## 6.1

IFRS 16.C14

### Lessor

Except for sub-leases (see Section 6.2), a lessor is not required to make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with IFRS 16 from the date of initial application.



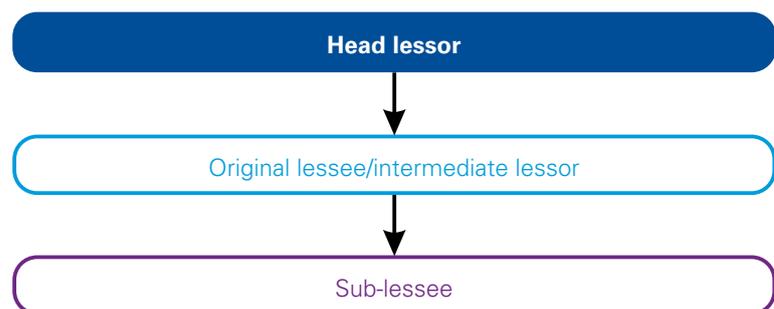
**Will a lessor's balance sheet at the date of initial application be significantly different from that under the retrospective approach?**

Not necessarily. The IFRS 16 requirements for lessor accounting are identical to IAS 17 in many respects. Therefore, for many simple leases the IAS 17 accounting up to the date of initial application will be identical to that required under IFRS 16. For such leases, the lessor's balance sheet as at the date of initial application will be identical to that under the retrospective approach.

However, differences may arise if, for example, a lease was modified between commencement and the date of initial application. As IAS 17 contains little guidance on accounting for lease modifications, it is possible that a lessor accounted for the modification differently from how it would have been required to account for the modification under IFRS 16. As noted above, the lessor is not permitted to restate the balances related to such a lease on transition.

## 6.2

### Sub-leases



IFRS 16.C15

At the date of initial application, an intermediate lessor reassesses ongoing sub-leases that were classified as operating leases under IAS 17 to determine whether each sub-lease should be classified as an operating lease or a finance lease under IFRS 16. This assessment is made on the basis of the remaining contractual terms and conditions of the head lease and sub-lease.

For sub-leases classified as operating leases under IAS 17 but finance leases under IFRS 16, a lessor accounts for the sub-lease as a new finance lease entered into at the date of initial application.



### Example 6 – Sub-lease on transition

Company Y leases an office building from Company X for 10 years in a lease (the head lease) that commences on 1 January 2014. The annual rentals under the head lease are 100, paid at the end of each year. Y subsequently leases the office building to Company Z for six years in a lease (the sub-lease) that commences on 1 January 2018. The annual rentals under the sub-lease are 110, paid at the end of each year.

Under IAS 17, Y classifies the head lease and the sub-lease as operating leases. As a result, it recognises no assets or liabilities arising from the leases. In its income statement, it recognises annual lease income of 110 arising under the sub-lease and annual lease expense of 100 arising under the head lease.

Y adopts IFRS 16 with a date of initial application of 1 January 2019. Y uses a modified retrospective approach (see Section 4.3) and uses Option 2 (see Section 5.3) to measure its ROU assets. Y's incremental borrowing rate at that date is 5%, and that is also the rate implicit in the sub-lease.

Y notes that, in the absence of the sub-lease, it would recognise the following items in relation to the head lease on 1 January 2019:

- a lease liability equal to the present value of the remaining rental: i.e.  $5 \times 100$  discounted at 5% = 433; and
- an ROU asset measured at the same amount: i.e. 433.

In assessing the classification of the sub-lease, Y notes that the sub-lease is for the whole of the remaining term of the head lease. There are no other factors suggesting that Y has retained significant risks and rewards associated with the ROU asset. Therefore, Y classifies the sub-lease as a finance lease under IFRS 16.

As a result, Y derecognises the ROU asset that arises under the head lease and recognises its net investment in the sub-lease. As at 1 January 2019, Y calculates the net investment in the sub-lease to be five payments of 110 discounted at 5% = 476.

Y's journal entry on 1 January 2019 for the head lease and sub-lease is therefore as follows.

	Debit	Credit
Net investment in sub-lease	476	
Lease liability under head lease		433
Retained earnings		43

*IFRS 16.62, 63(c), B58(b)*

*IFRS 16.67*



### What is the impact of reassessing the classification of sub-leases on transition?

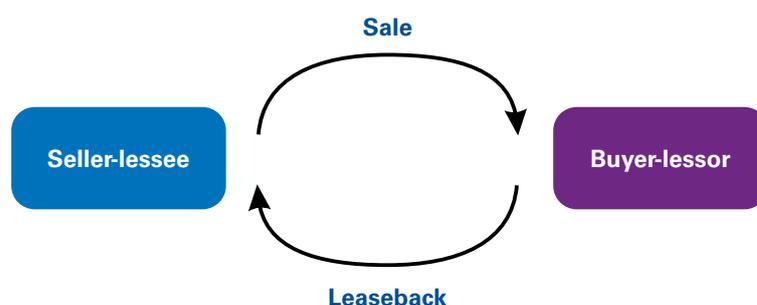
Reassessing the classification of sub-leases on transition can lead to sub-leases being reclassified as finance leases by the intermediate lessor.

Under IFRS 16, an intermediate lessor evaluates the classification of a sub-lease by reference to the ROU asset associated with the head lease and not by reference to the underlying asset. Consequently, many sub-leases that were classified by an intermediate lessor as operating leases under IAS 17 will be classified as finance leases under IFRS 16.

*IFRS 16.B58(b)*

## 6.3

### Sale-and-leaseback



*IFRS 16.C16*

A company does not reassess sale-and-leaseback transactions entered into before the date of initial application to determine whether a sale occurred in accordance with IFRS 15.

*IFRS 16.C17*

For a sale-and-leaseback transaction accounted for as a sale and finance lease in accordance with IAS 17, the seller-lessee:

- accounts for the leaseback in the same way as for any finance lease that exists at the date of initial application; and
- continues to amortise any gain on the sale over the lease term.

*IFRS 16.C18*

For a sale-and-leaseback transaction accounted for as a sale and operating lease in accordance with IAS 17, the seller-lessee:

- accounts for the leaseback in the same way as for any other operating lease that exists at the date of initial application; and
- adjusts the leaseback ROU asset for any deferred gains or losses that relate to off-market terms recognised in the statement of financial position immediately before the date of initial application.

**Example 7 – Sale and operating leaseback on transition**

In 2004, Company R sold its head office building to Company P and leased the building back for 20 years. R has an option to repurchase the building for its market value.

In assessing the classification of the leaseback under IAS 17, R noted that the exercise price of the repurchase option was at market value and therefore P retained the risk (reward) that the market value of the building changes. R also noted that there were no other indicators that the leaseback was a finance lease. R therefore accounted for this transaction as a sale and operating leaseback – i.e. R derecognised the building and recognised the rentals payable to P as an expense on a straight-line basis over the term of the leaseback.

On 1 January 2019:

- R's leaseback of its head office building has a remaining term of five years; and
- the present value of the lease payments, discounted at R's incremental borrowing rate at 1 January 2019, is 500.

R notes that its option to purchase the building means that the transaction does not meet the criteria to be recognised as a sale. That is, if R entered into the transaction on these terms after the adoption of IFRS 16, then it would account for it as a financing under IFRS 9 *Financial Instruments*, not as a sale-and-leaseback. However, because the transaction was in place at the date of initial application of IFRS 16, R continues to account for it as a sale-and-leaseback.

R elects to adopt IFRS 16 using a modified retrospective approach (see Chapter 5), to measure the ROU asset using Option 2 (see Section 5.3) and to take the practical expedient not to recognise initial direct costs (see 5.4.4).

On 1 January 2019, R recognises an ROU asset of 500 and a lease liability of 500.

*IFRS 16.99, 103, 15.B66*

*IFRS 16.C18*

**What is the main relief for sale-and-leasebacks?**

There are two significant reliefs for existing sale-and-leasebacks on transition.

Firstly, a company does not assess whether an existing sale-and-leaseback qualifies for sale-and-leaseback accounting on transition. That is, a company does not assess whether the sale leg would meet the criteria to be recognised as a sale under IFRS 15. This is an important relief because it eliminates the possibility that the company might be required to account for an existing sale-and-leaseback as financing in the scope of IFRS 9. This relief applies to seller-lessees and to buyer-lessors.

Secondly, a seller-lessee does not apply the partial gain recognition approach to sale-and-leaseback transactions entered into before the date of initial application. This decision will simplify transition for companies that have many such transactions at the date of initial application.

In other respects, the transition requirements for the leaseback leg of a sale-and-leaseback transaction are consistent with the general transition requirements for all leases. As a result, an existing sale-and-leaseback will generally come on-balance sheet for the seller-lessee, through application of the new lease accounting model to the leaseback. The only exceptions will be leasebacks to which the recognition exemptions apply.

## 6.4

IFRS 16.C9

### Investment property

A lessee measures an ROU asset that will be accounted for as investment property using the cost or fair value model in IAS 40 *Investment Property* from the date of initial application. A lessee is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in IAS 40.



#### Example 8 – Investment property on transition

Company T leases two buildings under leases that were classified as operating leases under IAS 17. T's interest in each building meets the definition of investment property.

Under IAS 17:

- T elected to classify the lease of Building 1 as a finance lease as permitted under IAS 40. As a result, T applied the fair value model to all of its investment property. As at 31 December 2018, T recognised its interest in Building 1 as investment property measured at its fair value of 500, and a finance lease liability of 100; and
- T accounted for its lease of Building 2 as an operating lease, recognising the lease rentals as an expense on a straight-line basis over the term of the lease.

T's date of initial application of IFRS 16 is 1 January 2019. T elects to adopt IFRS 16 using a modified retrospective approach.

T obtains a third party valuation of its leasehold interest in Building 2, based on which T assesses that the fair value of T's ROU asset for Building 2 is 750. T calculates that the present value of the remaining rentals payable on Building 2, discounted at its incremental borrowing rate at 1 January 2019, is 200.

T therefore recognises the following balances on 1 January 2019.

	Building 1	Building 2	Total
Investment property	500	750	1,250
Lease liability	(100)	(200)	(300)
<b>Total</b>	<b>400</b>	<b>550</b>	<b>950</b>

T records a credit to equity of 550 on 1 January 2019, on recognition of the ROU asset and lease liability for Building 2.

IAS 40.6

T notes that it will be required to make the disclosures required under IAS 40 and IFRS 13 *Fair Value Measurement* in respect of both buildings in its financial statements for 2019 onwards.



### Does a company always measure ROU assets that meet the definition of investment property at fair value?

On transition to IFRS 16, companies will be required to assess whether leased property that is not used by the company in its business meets the definition of investment property. For ROU assets for which this is the case, a company applies its existing accounting policy to measure its investment property using either the fair value or cost model.

However, a company will be required to measure the fair value of ROU assets that meet the definition of investment property, in order to comply with the disclosure requirements in IAS 40.

## 6.5

IFRS 16.C19

## Business combinations

IFRS 16 makes consequential amendments to IFRS 3 *Business Combinations*. If a lessee previously recognised an intangible asset for a favourable operating lease, or a liability for an unfavourable operating lease, then it derecognises that asset or liability on transition to IFRS 16. It adjusts the carrying amount of the ROU asset by the amount of the asset or liability derecognised.



### Example 9 – Operating lease previously acquired in a business combination

Company P acquired Company S four years ago. At the date of acquisition, S was a lessee in a lease of real estate with a remaining term of eight years. The rentals in the lease were below the then-market value. P therefore recognised an intangible asset of 80 as part of the purchase accounting.

On P's date of initial application of IFRS 16:

- S's lease of real estate has a remaining term of four years;
- the carrying amount of the intangible asset relating to the favourable lease is 40; and
- the present value of the lease payments is 200.

P elects to adopt IFRS 16 using a modified retrospective approach. For this lease, P elects to measure the ROU asset using Option 2 – i.e. at an amount equal to the lease liability, adjusted as appropriate.

On the date of initial application, P:

- derecognises the intangible asset of 40;
- recognises a lease liability measured at the present value of the remaining lease payments – i.e. 200; and
- recognises an ROU asset measured at the amount of the lease liability plus the previous carrying amount of the intangible asset – i.e.  $200 + 40 = 240$ .

IFRS 16.C9



#### When is this adjustment required?

This adjustment is required under each of the transition approaches for leases in which the company acquired is a lessee in an operating lease. That is, the adjustment is required irrespective of whether the lessee applies IFRS 16 using:

- the retrospective approach;
- a modified retrospective approach measuring the ROU asset based on the lease liability; or
- a modified retrospective approach measuring the ROU retrospectively using the incremental borrowing rate at the date of initial application.

Generally, no adjustments are made for leases in which the company acquired is a lessor.

## 7

# Disclosures

The disclosure requirements relate primarily to leases in which the company is a lessee. They depend on the transition approach selected – with important additional disclosures when a company uses a modified retrospective approach.

## 7.1

## Retrospective approach

If a company follows the retrospective approach, then the required disclosures on transition are as follows.

*IFRS 16.C1*

*IFRS 16.C4*

*IAS 8.28*

### Disclosures required under IFRS 16

- If a company applies IFRS 16 early (see Chapter 8), then it discloses this fact.
- If a company uses the practical expedient for lease definition (see Section 3.1), then it discloses this fact.

### Disclosures required under IAS 8

- The fact that IFRS 16 has been adopted.
- The nature of the change in accounting policy.
- Transitional provisions:
  - a statement that the transitional provisions in IFRS 16 have been applied;
  - a description of the transitional provisions adopted; and
  - the transitional provisions that might impact future periods.
- For the current period, and each prior period presented:
  - the amount of the adjustment to each financial statement line item affected; and
  - the amount of the adjustment to basic and diluted earnings per share (if IAS 33 *Earnings per Share* applies).
- The amount of the adjustment relating to earlier periods, to the extent practicable.
- If retrospective application has been impracticable, then an explanation of why this was the case and how and from when IFRS 16 has been applied.

## 7.2

## Modified retrospective approach

If a company follows a modified retrospective approach, then the required disclosures on transition are as follows.

*IFRS 16.C1*

*IFRS 16.C4*

*IFRS 16.C13*

*IFRS 16.C12*

### Disclosures required under IFRS 16

- If a company applies IFRS 16 early (see Chapter 8), then it discloses this fact.
- If a company uses the practical expedient for lease definition (see Section 3.1), then it discloses this fact.
- If a company uses any of the practical expedients relating to operating leases (see Section 5.4), a statement of which practical expedients have been used.
- The weighted-average incremental borrowing rate used to measure lease liabilities at the date of initial application.
- An explanation of any difference between:
  - the present value of the operating lease commitments disclosed in the previous set of annual financial statements, discounted at the rate used to calculate lease liabilities at the date of initial application; and
  - the lease liabilities recognised at that date.

### Disclosures required under IAS 8

- The fact that IFRS 16 has been adopted.
- The nature of the change in accounting policy.
- Transitional provisions:
  - a statement that the transitional provisions in IFRS 16 have been applied;
  - a description of the transitional provisions; and
  - the transitional provisions that might impact future periods.
- The amount of the adjustment relating to earlier periods, to the extent practicable.

*IFRS 16.C12, IAS 8.28*



### To what extent do the additional disclosures required under a modified retrospective approach eliminate the cost savings under this approach?

The key additional disclosure required if a company applies a modified retrospective approach is the explanation of the relationship between the operating lease commitments disclosed previously under IAS 17, and the opening lease liabilities recognised on adoption of IFRS 16.

Clearly, preparing and presenting this disclosure will involve some cost. The disclosure also risks highlighting any inadequacies in the disclosures previously made under IAS 17. However, many companies considering a modified retrospective approach may conclude that this is a price worth paying.

The costs of preparing this additional disclosure will typically be far less than the incremental costs of applying the standard retrospectively. IFRS 16 requires an 'explanation', not a reconciliation per se – though many companies may conclude that a reconciliation is the best way to present the explanation. Even when a reconciliation is presented, the costs of preparing a high-level reconciliation will be less than the more detailed analysis required to restate comparatives fully.

Further, if a company has concerns about the accuracy and completeness of its current operating lease disclosures, then this is a matter to address as a priority. It is clearer than ever that analysts rely on these disclosures currently. And stakeholders will be looking for a clear presentation of the impact of adopting IFRS 16 – including how the new lease balances relate to existing financial information – whichever transition method is followed.

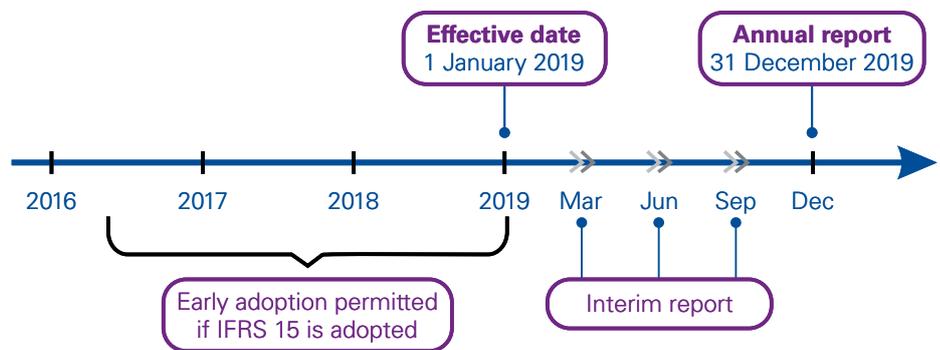
# 8 Effective date and early adoption

Early adoption has advantages, but could place additional pressure on preparers at a time of major accounting change.

IFRS 16.C1

The new standard is effective for annual reporting periods beginning on or after 1 January 2019.

Early adoption is permitted for companies that also adopt IFRS 15.



## Why did the IASB choose a 2019 effective date?

The IASB staff conducted outreach on the effective date and found that a majority of companies:

- considered that they would need two to three years to implement the new standard following publication – though some argued for an effective date as late as 2020 or 2021; and
- would prefer to adopt the new leases standard after IFRS 15, though some wanted the option to adopt both standards at the same time.

In contrast, users of financial statements generally wanted companies to apply the IASB's new standards on financial instruments, leases and revenue at the same time – i.e. from 2018.

The IASB settled on 2019, influenced by preparer concerns about their ability to successfully adopt the new standards in the same year.



### Is early adoption worth considering?

The possibility of adopting IFRS 16 at the same time as IFRS 15 may be attractive to some. And companies may simply prefer to adopt the three major standards together, to avoid disruption and maintain clearer trend information in future years.

However, companies may face capacity constraints in their finance and accounting policy functions during such a period of major accounting change. For practical reasons, they may prefer to spread the implementation effort.

## 9

## Next steps

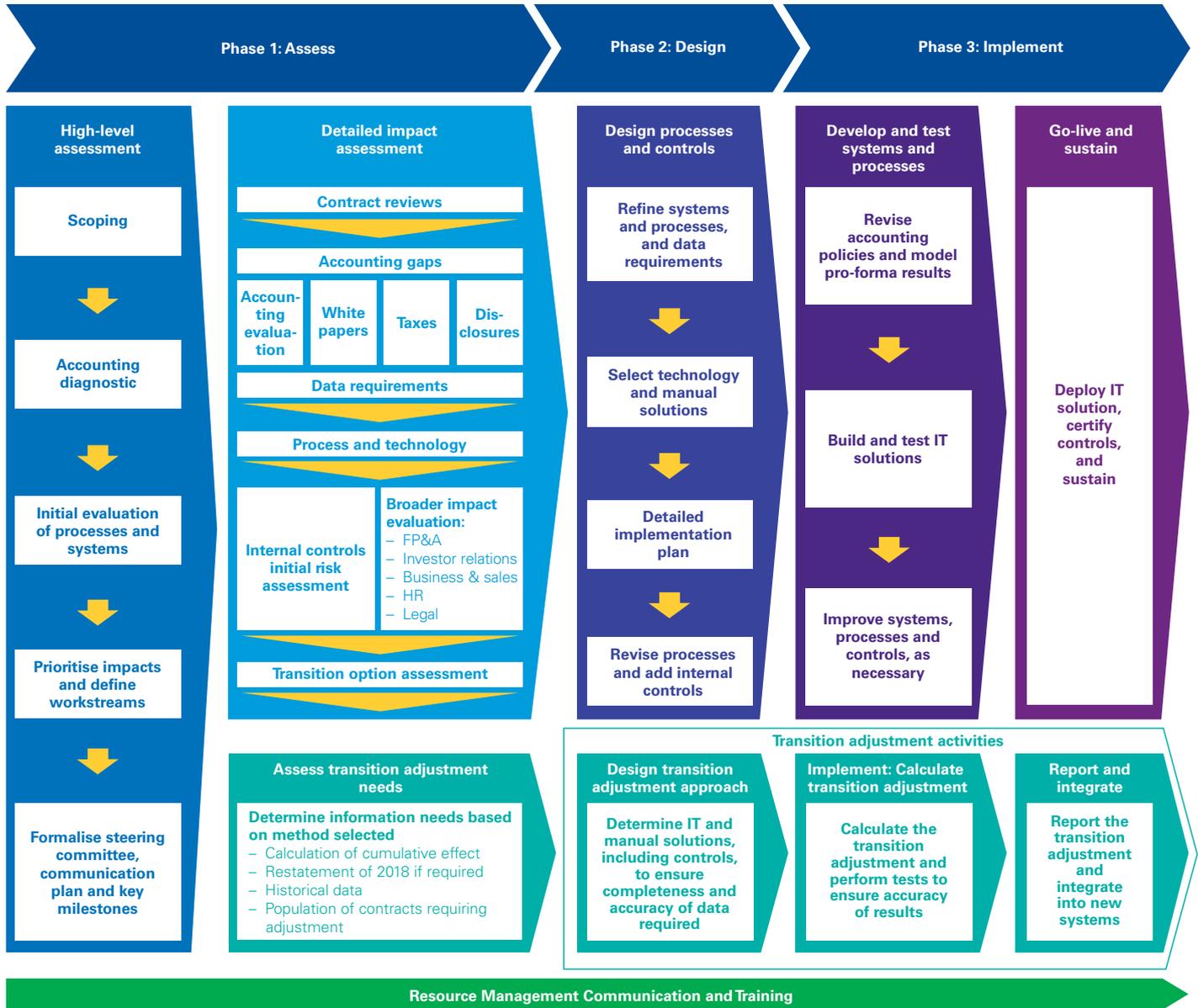
The choice of transition option will have a significant impact on the extent of data gathering and the timing of system and process changes, and should be considered as soon as possible.

We recommend that companies consider both the quantitative effects of each method *and* the relevant qualitative factors, including stakeholder expectations. Advance planning will allow time for unanticipated complexities, and will offer greater flexibility in maximising the use of internal resources by spreading the required work over a longer period.

Companies should therefore take steps to understand IFRS 16 and to evaluate the effects of the transition options on their financial reporting.

You should consider completing the following actions.

- Determine the population of contracts that may need to be restated. This may include identifying any individually significant contracts impacted by the new lease definition that should be assessed separately, and portfolios of contracts with similar characteristics that can be evaluated in the aggregate.
- Prepare an inventory of currently available lease data and resources.
- Assess the information that will be needed to comply with IFRS 16. Compare this with currently available information to identify potential gaps that should be considered in the broader implementation of IFRS 16.
- Model the impact of the different transition options – using high-level assumptions or sample portfolios as necessary – to estimate the impact on net assets and equity on the date of initial application, and on the profit or loss account trends in the years after transition.
- Identify the qualitative factors that may influence your choice of transition option. Key stakeholders may need to be engaged to understand which factors are most relevant.
- Ensure that transition options are evaluated in conjunction with the broader implementation effort for the new standard. Consider implementing a sub-group within the overall project team responsible for implementation, to focus on transition option considerations.
- Document your assessments and calculations.
- Develop an implementation plan. An example transition project plan that highlights the key steps involved in undertaking a successful transition project is shown over the page.



# Appendix – Worked example

This worked example illustrates the impact on the financial statements of a fictional company of adopting IFRS 16 using a variety of different transition options.

## 1 Scenario

Propola plc is a retailer that sells clothes made with ethically sourced cotton. It prepares financial statements for annual periods ending on 31 December, and includes one year of comparatives in its financial statements.

Propola has been trading for many years. The business is mature with generally stable financial results.

Propola purchases power from a supplier of renewable energy under a long-term power purchase agreement. It leases the stores from which it operates, the vehicles that it uses to make deliveries, and a variety of point-of-sale and other IT equipment used in its stores.

## 2 Lease information

Propola has completed an inventory of leases in which it is a lessee, which it has categorised into four groups for the purposes of its IFRS 16 implementation project. Propola does not act as a lessor.

### 2.1 Power purchase agreement

Under IFRIC 4, Propola classifies this contract as a lease. However, Propola has concluded that this contract is not a lease under IFRS 16 because Propola does not have the right to direct the use of the generating plant.

Power purchase agreement	
Number of contracts	1
Commencement date	1 January 2008
Term	20 years
Incremental borrowing rate:	
– On 1 January 2008	12%
– On 1 January 2019	6%
Lease payments, made annually in advance	2,500

## 2.2 Stores

Propola operates from 10 leased stores. The store leases each have a term of 10 years. When each lease expires, Propola enters into a new lease with a term of 10 years. The contracts are leases under IFRIC 4 and under IFRS 16.

Stores	
Number of contracts at any point in time	10
Commencement date	New leases signed on 1 July each year
Term	10 years
Incremental borrowing rate:	
– Up to 31 December 2017	8%
– From 1 January 2018	4%
Lease payments, made quarterly in advance	100

## 2.3 Vehicles

Propola leases 20 vehicles to transport stock and make deliveries. The vehicle leases each have a term of five years and when each lease expires Propola enters into a new lease with a term of five years. The contracts are leases under IFRIC 4 and under IFRS 16.

Vehicles	
Number of contracts at any point in time	20
Commencement date	New leases signed on 1 January, 1 April, 1 July and 1 September each year
Term	5 years
Incremental borrowing rate:	
– Up to 31 December 2017	10%
– From 1 January 2018	5%
Lease payments, made monthly in advance	20

## 2.4 Point-of-sale and other IT equipment

Propola has many leases of point-of-sale and other IT equipment. The annual lease payments under these leases are 2,000. Propola intends to apply the recognition exemption for leases of low-value items to these leases.

### 3 IAS 17 approach

Under IAS 17, Propola classifies all leases as operating leases. In the year ended 31 December 2018, it recognises total operating lease expense of 13,300, calculated as follows.

IAS 17 lease expense	
Power purchase agreement	2,500
Stores (10 stores x 100 paid quarterly)	4,000
Vehicles (20 vehicles x 20 paid monthly)	4,800
<b>Total for leases other than low-value leases</b>	<b>11,300</b>
Point-of-sale and other IT equipment	2,000
<b>Total</b>	<b>13,300</b>

Propola recognises no assets or liabilities for these leases in its balance sheet at 31 December 2018 under IAS 17. (This assumes, for simplicity, that there are no lease incentives or initial direct costs.)

### 4 IFRS 16: Scenarios

To assess the impact of IFRS 16 on its balance sheet, Propola models the following scenarios.

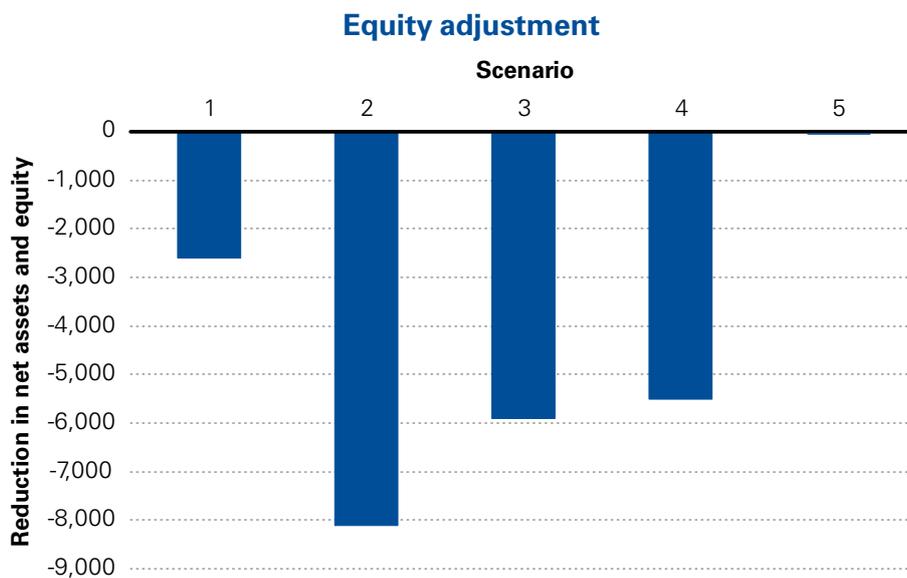
Scenario	Retrospective / modified retrospective	Grandfather lease definition?	Measurement of ROU asset
1	Retrospective	No	Retrospective
2	Retrospective	Yes	Retrospective
3	Modified retrospective	Yes	Option 1
4	Modified retrospective	Yes	Option 1 for power purchase agreement (PPA) and property leases Option 2 for vehicle leases
5	Modified retrospective	Yes	Option 2

#### 4.1 IFRS 16: Balance sheet impact

Propola calculates the new lease assets and liabilities that it would recognise under each scenario as at 1 January 2019 as follows.

Scenario	1 (Retro exc PPA)	2 (Retro inc PPA)	3 (Mod retro, Option 1)	4 (Mod retro, Option 1 / 2)	5 (Mod retro, Option 2)
<b>ROU asset</b>	23,800	32,900	40,200	40,600	46,100
<b>Lease liability</b>	(26,400)	(41,000)	(46,100)	(46,100)	(46,100)
<b>Equity adjustment</b>	(2,600)	(8,100)	(5,900)	(5,500)	0

#### 4.2 IFRS 16: Understanding the balance sheet impact



#### Reduction in net assets and equity

Under all scenarios, Propola recognises new assets and new liabilities.

In Scenarios 1–4, the carrying amount of the lease liabilities exceeds the carrying amount of the ROU assets, resulting in a reduction in net assets and in equity at 1 January 2019. This effect arises from the different amortisation profiles of the ROU assets (straight-line) and the lease liability (effective interest rate method). This effect will be seen by many companies in practice.

In contrast, there is no impact on net assets or equity in Scenario 5. This is because in this scenario Propola measures all ROU assets using Option 2 – i.e. equal to the lease liability on 1 January 2019.

### **Impact of the practical expedient on lease definition**

The practical expedient on lease definition is the only difference between Scenarios 1 and 2. For Propola, applying the practical expedient brings the power purchase agreement on-balance sheet. This increases Propola's assets and liabilities, and decreases equity, on transition.

IFRS 16.BC274

The IASB has indicated that it has identified examples of contracts that are leases under IFRIC 4 but not under IFRS 16. However, the IASB has not identified examples of contracts that become leases under IFRS 16.

Companies that, like Propola, identify transactions that are leases under IFRIC 4 but not under IFRS 16 will find that applying this practical expedient decreases equity at the date of initial application.

### **Measurement differences between Scenarios 2, 3, 4 and 5**

The same population of leases, including the power purchase agreement, comes on-balance sheet in Scenarios 2, 3, 4 and 5. However, there are important measurement differences between the scenarios, as follows.

- *Scenario 2 vs Scenario 3*: The impact on equity is smaller in Scenario 3 than in Scenario 2. This arises for two reasons.
  - Firstly, Scenario 2 follows the retrospective method and therefore uses discount rates at commencement, whereas Scenario 3 follows a modified retrospective approach and therefore uses discount rates at 1 January 2019, which are lower. The use of lower discount rates increases the lease liability. This effect will generally be seen in practice in jurisdictions in which prevailing interest rates have fallen in recent years.
  - Secondly, the use of a lower discount rate also increases the ROU asset in Scenario 3 compared with Scenario 2. Furthermore, the lower discount rate has a bigger impact on the ROU asset because it is applied over a longer period – i.e. from lease commencement, not just from the date of initial application. This means that the ROU asset increases by more than the increase in the lease liability.
- *Scenario 3 vs Scenario 4*: The impact on equity reduces further in moving from Scenario 3 to Scenario 4. The lease liability remains the same but the ROU asset reduces because Scenario 4 uses Option 2 to calculate the ROU assets for some leases. That is, the ROU asset is set to equal the lease liability for some leases.
- *Scenario 4 vs Scenario 5*: In Scenario 5, there is no impact on equity. This is because Scenario 5 uses Option 2 to calculate the ROU asset for all of Propola's leases.

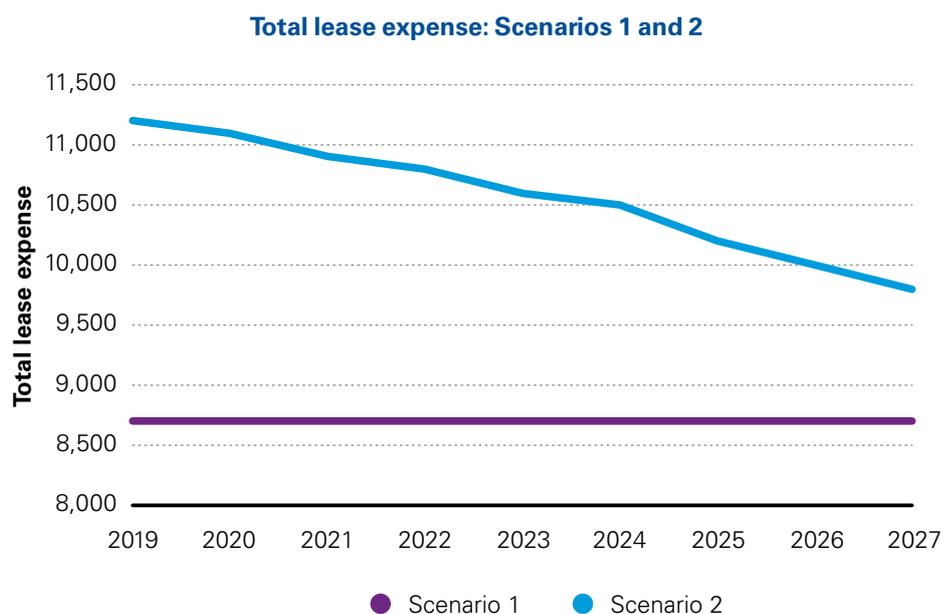
### 4.3 IFRS 16: Post-transition profit and loss trends

Propola calculates the total lease expense (i.e. depreciation plus interest) that it would recognise under each scenario as at 1 January 2019 as follows.

	31 Dec 2019	31 Dec 2020	31 Dec 2021	31 Dec 2022	31 Dec 2023	31 Dec 2024	31 Dec 2025	31 Dec 2026	31 Dec 2027
<b>Scenario 1</b>	8,700	8,700	8,700	8,700	8,700	8,700	8,700	8,700	8,700
<b>Scenario 2</b>	11,200	11,100	10,900	10,800	10,600	10,500	10,200	10,000	9,800
<b>Scenario 3</b>	11,200	11,200	11,000	10,900	10,800	10,700	10,600	10,400	10,300
<b>Scenario 4</b>	11,462	11,311	11,115	10,965	10,829	10,734	10,576	10,439	10,294
<b>Scenario 5</b>	12,200	12,000	11,800	11,600	11,400	11,300	11,100	11,000	10,800

### 4.4 IFRS 16: Understanding post-transition profit or loss

Scenarios 1 and 2 can be compared as follows.

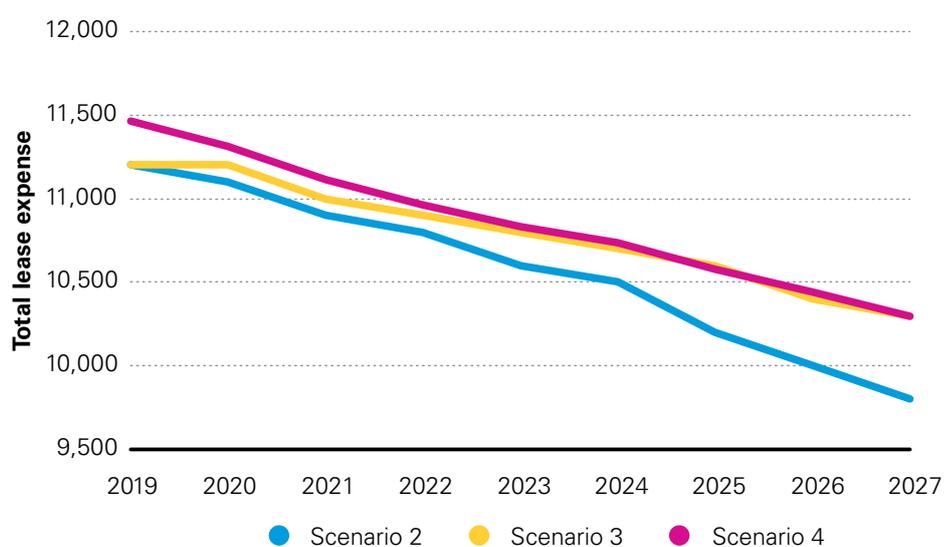


Scenario 1 shows the retrospective approach with no practical expedients. This results in straight-line total lease expense under IFRS 16. This is because this scenario includes only the property and vehicle leases. Both of these portfolios are in a steady state and so the front-loading of total lease expense for each individual lease averages out across the portfolio. The power purchase agreement is treated as a service contract. The related costs (not included above) will be recognised as an operating expense as they are incurred.

In Scenario 2, Propola uses the practical expedient on lease definition and therefore includes the power purchase agreement in its lease accounting. This has two effects.

- Firstly, total lease expense increases (and other operating costs decrease) due to the inclusion of the power purchase agreement.
- Secondly, total lease expense is no longer straight-line. This is because the front-loaded profile of total lease expense on the power purchase agreement is material to the analysis – and there are no other similar leases and therefore no averaging of the front-loading effect.

#### Total lease expense: Scenarios 2, 3 and 4



The other scenarios can be analysed as follows.

- *Scenario 2 vs Scenario 3*: Total lease expense appears broadly similar in these two scenarios. However, the components of lease expense are significantly different.
  - Interest expense is lower in Scenario 3 than Scenario 2, due to the use of discount rates determined at 1 January 2019, which are lower than the discount rates determined at lease commencement. Therefore, the interest cover ratio is higher in Scenario 3. This will generally be the case for lessees in jurisdictions in which interest rates have fallen in recent years.
  - Depreciation of the ROU asset is higher in Scenario 3 than in Scenario 2 due to the higher initial carrying amount of the ROU asset (as explained in Chapter 4 above).
- *Scenario 3 vs Scenarios 4 and 5*: In moving from Scenario 3 to Scenarios 4 and 5, Propola makes increasing use of Option 2 to measure its ROU assets. As a result, the front-loading of total lease expense becomes progressively more pronounced, for the reasons discussed in Section 5.3.

## 5 Conclusion

This example illustrates that even a company with a relatively small portfolio of leases has a variety of transition options under IFRS 16. The different transition options have a significant effect on Propola's net assets and equity as at 1 January 2019 and on its profit or loss account trends for years afterwards.

The example also illustrates how complex the decision on transition option can be. For Propola, Scenario 5 is the simplest to apply and results in no reduction in net assets as at 1 January 2019. However, this option creates the greatest distortion in profit or loss trends after transition. Having completed this scenario analysis, Propola will now need to discuss the results with key stakeholders in order to make an informed decision.

The scenario analysis is not sufficient to allow Propola to decide how to move forward. However, for most companies this kind of scenario analysis is likely to be a necessary step in choosing the best transition option.

# About this publication

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

This edition considers the requirements of IFRS 16 *Leases* published by the IASB in January 2016.

The text of this publication refers to IFRS 16 and to selected other current standards in issue at 1 November 2016.

Further analysis and interpretation will be needed for an entity 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. Accordingly, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

## Acknowledgements

We would like to acknowledge the efforts of the following members of the KPMG International Standards Group, who were the principal authors of this publication: Almudena Cossio, Sylvie Leger, Brian O'Donovan, Frank Richter, Anisa Vallee.

We are grateful for the assistance of Charlotte Lo of KPMG LLP in the UK and David Maxwell of Classic Technology Limited.

We would also like to thank the members of KPMG's global IFRS leases topic team for their contribution:

Kimber Bascom (leader)	US
Zola Beseti	South Africa
Archana Bhutani	India
Judit Boros	Hungary
Yen San Chan	Singapore
Una Curtis	Ireland
Karine Dupre	France
Ramon Jubels	Brazil
Wolfgang Laubach	Germany
Sylvie Leger	Canada
Andrew Marshall	UK
Brian O'Donovan (deputy leader)	UK
Julie Santoro	US
Patricia Stebbens	Australia
Mag Stewart	Canada
Beth Zhang	China

# Keeping in touch



Visit [kpmg.com/ifrs](http://kpmg.com/ifrs) for the latest on IFRS.

Whether you are new to IFRS or a current user, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists.

You can also follow our [LinkedIn showcase page](#) for the latest content and topical discussion.

## Helping you deal with IFRS today...



### Insights into IFRS

Helping you apply IFRS to real transactions and arrangements.

### Guides to financial statements

Illustrative IFRS disclosures and checklists of currently effective requirements.



### Newly effective standards



### US GAAP

## ... and prepare for IFRS tomorrow



### IFRS news



### IFRS newsletters



### IFRS for banks



### IFRS 15 for sectors

## Major new and forthcoming standards



Revenue



Financial instruments



Leases



Insurance contracts (under development)

## Amendments to existing standards



Business combinations and consolidation



Presentation and disclosures



For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 15-day trial, go to [aro.kpmg.com](http://aro.kpmg.com) and register today.

[kpmg.com/ifrs](http://kpmg.com/ifrs)

Publication name: *Leases Transition Options*

Publication number: 134212

Publication date: November 2016

© 2016 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

KPMG International Standards Group is part of KPMG IFRG Limited.

KPMG International Cooperative ('KPMG International') is a Swiss entity that serves as a coordinating entity for a network of independent firms operating under the KPMG name. KPMG International provides no audit or other client services. Such services are provided solely by member firms of KPMG International (including sublicensees and subsidiaries) in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any other member firm, nor does KPMG International have any such authority to obligate or bind KPMG International or any other member firm, nor does KPMG International have any such authority to obligate or bind any member firm, in any manner whatsoever.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.