KPMG

Lease payments

What's included in the lease liability?

IFRS 16

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Contents

Determining the lease liability

IFRS 16 *Leases* requires lessees to bring most leases onto the balance sheet. The lease liability is measured at the present value of the lease payments. But which lease payments should be included in the lease liability, initially and subsequently?

The answer to this question will determine the scale of the impact of the new standard for lessees. In many ways, the new requirements are mercifully simple – e.g. lessees do not need to forecast future payments that depend on sales, usage or inflation. However, the detailed rules are different from current practice in important ways.

One key difference is that certain lease payments are reassessed over the term of the lease, and the lease liability adjusted accordingly. This introduces new balance sheet volatility. It also requires new systems and processes to determine the revised lease payments and recalculate the lease liability.

The new standard has a less dramatic impact on lessors. For them, a key focus will be allocating the consideration in contracts with multiple components to determine the lease payments. This will sometimes be a disclosure-only question, but those disclosures could be sensitive for some lessors.

This publication provides an overview of how to determine the lease payments, initially and subsequently. We hope it will help you as you prepare to adopt the new standard.

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1 At a glance

1.1 Key facts

What's included in the lease liability

IFRS 16.26

At the commencement date, a lessee measures the lease liability as the present value of lease payments that have not been paid at that date.

IFRS 16.27

The payments included comprise:

– fixed payments (including in-substance fixed payments), less any lease incentives receivable;

– variable lease payments that depend on an index or rate;

– amounts expected to be payable by the lessee under residual value guarantees;

– the exercise price of a purchase option that the lessee is reasonably certain to exercise; and

– payments for terminating the lease unless it is reasonably certain that early termination will not occur.

What's excluded from the lease liability

IFRS 16.12, 15, BC135

In practice, lease contracts may contain payments that are excluded from the lease liability, such as:

– non-lease components – e.g. payment for services; and

– variable lease payments that depend on sales or usage of the underlying asset.

Lessees are required to separate lease and non-lease components of a contract, unless they apply the practical expedient in paragraph 15 allowing them not to separate the two.

The lessor perspective

IFRS 16.A

Lessors generally apply the same guidance on lease payments as lessees, though there are some differences in the definition and no practical expedient to combine lease and non-lease components.

Transition considerations

IFRS 16.C5, C8

The information on lease payments required by a lessee on transition will depend on the transition method.

– A lessee that adopts IFRS 16 retrospectively will require extensive historical information about all leases that remain in place at the beginning of the earliest comparative period presented.

– A lessee that follows a modified retrospective approach can elect to transition using only information about remaining lease payments at the date of initial application.

IFRS 16.C14, C18, BC289

Except for sub-leases and sale-and-leaseback transactions, a lessor is not required to make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with the new standard from the date of initial application.

1.2 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 leases with payments that should be included in the lease liability, and whether they need to be subsequently reassessed for changes in lease payments.

New estimates and judgements. The new standard introduces new estimates and judgements that affect the measurement of lease liabilities. A lessee determines the liability on commencement and may be required to revise it – e.g. if the assessment of whether an option is reasonably certain to be exercised, or if the amount expected to be paid under a residual value guarantee changes. This will require ongoing monitoring and increase financial statement volatility.

Balance sheet volatility. The new standard introduces financial statement volatility to gross 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 and will require ongoing monitoring (see 3.1.2 and Section 6.2).

Changes in contract terms and business practices. To minimise the impact of the new standard, some companies may wish to reconsider certain contract terms and business practices – e.g. changes in the structuring or pricing of a lease agreement, including the type of variability of lease payments and the inclusion of options in the contract. The new standard is 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. New calculations and review processes will be needed to measure the lease liability on commencement and to subsequently identify when a lease needs to be reassessed and remeasured to reflect changes in lease payments.

Transition considerations. A key early decision is how to make the transition to the new standard. The extent of information required by lessees in 2019 will depend on the transition approach chosen – e.g. under a modified retrospective approach, historical information is not needed because liabilities for operating leases are measured based on remaining lease payments, and finance leases remeasured at the carrying amount of the lease liability under IAS 17 *Leases* (see Section 6.4).

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

Sufficient documentation. The judgements, assumptions and estimates applied in determining how to measure the lease liability on the commencement date, as well as on reassessment, will need to be documented.

2 Lease payments

Under the new standard, lessees recognise liabilities for their major leases. Identifying the relevant payments to include in the liability is key to measuring the lease liability.

2.1 What does a lessee include in its lease liability?

IFRS 16.26

At the commencement date, a lessee measures the lease liability as the present value of lease payments that have not been paid at that date. In a simple lease that includes only fixed lease payments, this can be a simple calculation.

Lease liability = **Present value of lease rentals** + **Present value of expected payments at end of lease**

Example 1 – Fixed lease payments are included in lease liabilities

Lessee B enters into a five-year lease of a photocopier. The lease payments are 10,000 per annum, paid at the end of each year.

Because the annual lease payments are fixed amounts, B includes the present value of the five annual payments in the initial measurement of the lease liability.

Using a discount rate (determined as B's incremental borrowing rate) of 5%, the lease liability at the commencement date is calculated as follows.

Year	Lease payments	Discounted
1	10,000	9,524
2	10,000	9,070
3	10,000	8,638
4	10,000	8,227
5	10,000	7,835
Lease liability at commencement date		**43,294**

2.1.1 Categories of lease payment

IFRS 16.27

The payments included in the measurement of the lease liability comprise:

- amounts expected to be payable under a residual value guarantee (see 2.1.2);
- the exercise price of an option to purchase the underlying asset that the lessee is reasonably certain to exercise (see 2.1.3);
- payments for terminating the lease unless it is reasonably certain that early termination will not occur (see 2.1.3);
- variable lease payments that depend on an index or rate (see Chapter 3); and
- fixed payments (including in-substance fixed payments (see Section 4.2)), less any lease incentives receivable.

IFRS 16.15, BC135, BC168–BC169

In contrast, the following payments are excluded from the lease liability:

- variable lease payments that depend on sale or usage of the underlying asset (see Section 4.1); and
- payments for non-lease components, unless the lessee elects to combine lease and non-lease components (see Chapter 5).

2.1.2 Residual value guarantees

IFRS 16.A

A residual value guarantee is a guarantee made to the lessor that the value (or part of the value) of an underlying asset will be at least a specified amount at the end of the lease. This guarantee is made by a party unrelated to the lessor.

IFRS 16.27(c), 42–43

If a lessee provides a residual value guarantee, then it includes in the lease payments the amount that it expects to pay under the guarantee. If the amount expected to be payable under a residual value guarantee changes, then the lessee remeasures the lease liability using an unchanged discount rate.

Example 2 – Residual value guarantees

Lessee Z has entered into a lease contract with Lessor L to lease a car. The lease term is five years.

In addition, Z and L agree on a residual value guarantee – if the fair value of the car at the end of the lease term is below 400, then Z will pay to L an amount equal to the difference between 400 and the fair value of the car.

At commencement of the lease, Z expects the fair value of the car at the end of the lease term to be 400. Z therefore includes an amount of zero in the lease payments when calculating its lease liability.

Subsequently, Z monitors the expected fair value of the car at the end of the lease term. If the expected fair value of the car falls below 400, then Z will remeasure the lease liability to include the amount expected to be payable under the residual value guarantee, using an unchanged discount rate.

IFRS 16.42(a)

Has the accounting for residual guarantees changed?

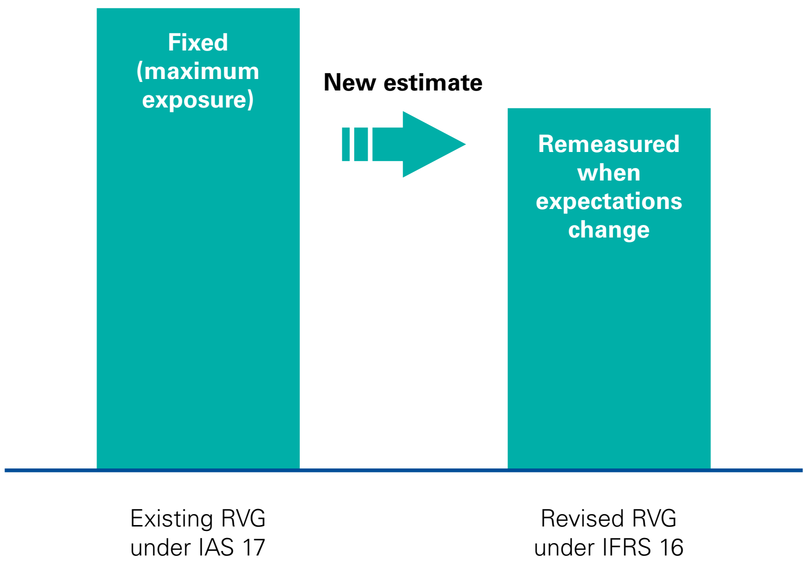
Yes – there are two important differences compared with IAS 17.

First, the amount that the lessee includes in the lease liability is different. Amounts potentially payable under residual value guarantees are included in a lessee's minimum lease payments under IAS 17. However, the amount included under IAS 17 is the maximum exposure under the guarantee, not the expected amount payable.

Second, a lessee remeasures the lease liability when there is a change in the amount that it expects to pay under a residual value guarantee. There is no such remeasurement under IAS 17, because the lessee's lease liability always includes the maximum amount payable.

Taken together, these differences mean that amounts relating to residual value guarantees included in lease payments under the new standard are often lower than under IAS 17 – but the presence of a residual value guarantee creates new volatility in the gross assets and liabilities reported by the lessee. Using the fact pattern in Example 2 above, under IAS 17 Lessee Z would disregard how much it *expects* to pay under the residual value guarantee, and include the full exposure of 400 in its minimum lease payments.

Lessees will need to carefully consider what additional processes are required to determine and document the estimate of the amount expected to be paid. They need to consider this at the commencement date and when performing subsequent remeasurements.



Is it always clear that a lease contains a residual value guarantee?

No – in some cases, a lessee will need to use judgement to identify whether a lease contains a residual value guarantee. This is because some features of a lease may function economically as residual value guarantees but be expressed in a different manner. Consider the two clauses in the following example.

Lessee Z leases new cars, typically for lease terms of five years. Z agrees to indemnify the lessors for excess wear and tear on the vehicles.

Lease A	Lease B
Indemnification clause Under this clause, Z will pay to the lessor the difference between the actual sales price of the vehicle at the end of the lease term and the 'excellent condition' value for the five-year-old vehicle in accordance with a specific residual value benchmark.	**Indemnification clause** Under this clause, Z will pay to the lessor a fixed amount per mile above the normal mileage according to a specific residual value benchmark for a five-year-old car.
Type of payment The indemnification is a residual value guarantee because the amount that the lessee can be required to pay is the difference between the actual sales price and a value determined based on a benchmark.	**Type of payment** The indemnification is a variable lease payment because it is not a guarantee of value but a payment based on use.
Accounting impact Because the indemnification is a residual value guarantee, Z includes the expected amount payable in its lease liability. Z remeasures the lease liability if its expectation of the amount payable changes.	**Accounting impact** Because the indemnification is a variable lease payment based on usage (see Section 4.1), Z does not include the amount payable in the lease liability. Instead, Z recognises the amount payable as an expense in the periods in which the liability is incurred.

2.1.3 Renewal, termination and purchase options

IFRS 16.18–20, B37–B40

At the commencement date, a lessee determines whether it is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease early. Lessees make this determination by considering all relevant facts and circumstances that create an economic incentive to exercise an option, or not to do so.

IFRS 16.18, 27(d)–(e)

The lessee determines the lease payments in a manner consistent with this assessment, as follows.

- *Renewal options:* If the lessee is reasonably certain to exercise a renewal option, then it includes in the lease liability the relevant lease payments payable in the period covered by the renewal option.
- *Termination option:* Unless the lessee is reasonably certain not to terminate the lease early, it reflects the early termination in the lease term and includes the termination penalty in the measurement of the lease liability.
- *Purchase option:* If the lessee is reasonably certain to exercise an option to purchase the underlying asset, then it includes the exercise price of the purchase option in the lease payments.

IFRS 16.36(c), 40

A lessee remeasures the lease liability, using a revised discount rate, if it changes its assessment of whether it is reasonably certain to exercise a renewal or purchase option, or not to exercise an option to terminate the lease early. (See Section 6.2 for further discussion of this reassessment.)

Example 3 – Lessee purchase option: Assessing if reasonably certain to be exercised at commencement date

Lessee E enters into a non-cancellable five-year lease with Lessor R to use a piece of equipment in an evolving area of the technology sector. There is no renewal option, but E has the option to purchase the equipment at the end of the lease for 500.

Because this piece of equipment is used in an evolving area of the technology sector, which is subject to rapid change, the fair value of the equipment at the end of the lease is subject to significant volatility – estimates range from 400 to 900. The duration of the non-cancellable period of five years is significant in this context. This reflects, for example, that newer and/or better alternative assets may be introduced during the five-year lease term.

E makes an overall assessment of whether it has an economic incentive to exercise the purchase option at the end of the lease and concludes that it is not reasonably certain to do so. This includes E's assessment of the significant volatility in the future fair value of the equipment at the end of the lease and the probability that better alternative assets may be introduced during that period.

Assessing whether E is reasonably certain to exercise the option can involve significant judgement. A shorter term (e.g. one or two years) or a different environment (e.g. lease of real estate in a historically highly predictable real estate market) could lead to a different conclusion.

Example 4 – Lessee termination option: Assessing if reasonably certain not to be exercised

Lessee B enters into a 10-year lease of a floor of an office building.

There is no renewal option, but B has the option to terminate the lease early after Year 5 with a penalty equal to three months' rent.

The annual lease payments are fixed at 100,000 per annum.

At the commencement date, the building is brand new and is technologically advanced for office buildings in the surrounding business parks, and the lease payments are consistent with the market rental rate.

Initial assessment at commencement

At the commencement date, B concludes that it is reasonably certain not to exercise the option to terminate the lease early, and therefore excludes the termination penalty from its lease liability and determines the lease term as 10 years.

Subsequent reassessment of certainty that option will be exercised

During Year 4, B sells a significant component of its business and reduces its headcount by 50%.

At the end of Year 4, similar office buildings in the area that meet B's needs for a smaller workforce are available for lease from Year 6 for annual payments of 55,000. B estimates that the cost to move its workforce would be 40,000.

IFRS 16.20–21

B concludes that the change in circumstance is significant, is within its control and affects whether it is still reasonably certain not to exercise the termination option.

To evaluate whether it is still reasonably certain that it will not terminate the lease early, B compares the future cash outflows as follows.

Year	Existing lease ('000)	New lease ('000)
6	100	120*
7	100	55
8	100	55
9	100	55
10	100	55
Total	**500**	**340**

* *Determined as annual lease (55) + penalty (25) + moving costs (40) = 120.*

B makes an overall assessment of whether it now has an economic incentive to terminate the lease early, including consideration of the cost saving of moving to a smaller office space.

Because the cost saving of moving to a smaller office space far exceeds the penalty for early termination, at the end of Year 4 B concludes that it is no longer reasonably certain not to exercise the option to terminate early at the end of Year 5. Note that in practice B would consider the time value of money when making this assessment.

B includes the termination penalty (25,000) in its lease payments and also determines that the remaining lease term has been reduced to one year.

B remeasures its lease liability using a revised discount rate. Any net remeasurement of the lease liability is adjusted against the right-of-use asset.

How have the accounting consequences of the 'reasonably certain' threshold changed?

The new standard retains the 'reasonably certain' threshold when assessing renewal, termination and purchase options. This threshold is familiar from IAS 17, though there is additional guidance on how to apply it.

More importantly, the accounting consequences of concluding that a lessee is reasonably certain to exercise such an option are different. Under IAS 17, this conclusion typically impacts the assessment of lease classification:

- if a lessee is reasonably certain to exercise a renewal option, then this increases the lease term, making it more likely that the lease is a finance lease; and
- if a lessee is reasonably certain to exercise a purchase option, then this is itself an indicator that the lease is a finance lease.

Under the new standard, this conclusion generally impacts the measurement of the lease liability, because the lease payments are determined in a manner consistent with the conclusion on whether the lessee is reasonably certain to exercise the option.

Another key difference is that under IAS 17 a lessee does not reassess the likelihood that it would exercise an option unless there is a change in the terms and conditions in the lease. Under the new standard, a lessee reassesses whether it is reasonably certain to exercise an option after the occurrence of a significant event or a significant change in circumstance that would impact the assessment and is within the lessee's control (see Section 6.2).

The new requirement to remeasure the lease liability introduces new financial statement volatility in gross assets and liabilities. Lessees will need to develop new processes to keep these options under review and to document their assessment at each reporting date.

2.2 Lessor considerations

Unlike lessees, who now apply a single lease accounting model under the new standard, lessors continue to classify their leases using the dual model that exists under IAS 17 – as either a financing or an operating lease. The lease classification test for lessors is essentially unchanged.

On commencement of a finance lease, a lessor derecognises the underlying asset and recognises a finance lease receivable. The finance lease receivable is measured at the present value of the future lease payments plus any unguaranteed residual value accruing to the lessor.

However, lease payments are defined differently for lessees and lessors.

What are the key differences in how lessees and lessors identify lease payments?

IFRS 16.A, 15, 20–21, 27(c)–(e), 40, 70(c)–(e)

The key differences in how lessees and lessors identify lease payments are as follows.

	Lessee	**Lessor**
Residual value guarantee	Includes in lease payments amounts *expected* to be payable under residual value guarantees that it provides to the lessor.	Includes in lease payments residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
Non-lease components	If a lessee uses the practical expedient in paragraph 15 of the new standard not to separate non-lease components, then it includes in the lease payments the associated payments allocated to non-lease components.	Excludes payments allocated to non-lease components from the lease payments.
Reassessment of initial assessment	Both use the same guidance for assessing whether they are reasonably certain to exercise options to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. However, unlike lessees, lessors do not reassess their initial assessment of lease term and purchase options.	

The IASB has noted that most constituents did not consider symmetry between lessee and lessor accounting to be a high priority. The inconsistencies noted above were acknowledged by the IASB as it finalised the standard. The risk is that these inconsistencies may give rise to structuring opportunities in more complex arrangements.

3 Payments that depend on an index or rate

Under the new standard, lessees and lessors never estimate the future value of an index or rate in order to calculate lease assets and lease liabilities.

3.1 Overview

3.1.1 Initial measurement of the lease liability

IFRS 16.27(b)

Variable lease payments that depend on an index or rate are initially included in the lease liability using the index or rate as at the commencement date of the lease.

IFRS 16.28

This approach applies to, for example, payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate (e.g. LIBOR) or payments that are adjusted to reflect changes in market rental rates.

3.1.2 Reassessment of the lease liability

IFRS 16.36(c), 39

After the commencement date, lessees are required to remeasure the lease liability to reflect changes to the lease payments arising from changes in the index or rate. Any remeasurement is generally adjusted against the right-of-use asset.

IFRS 16.42(b), 43, B42

Lessees reassess the lease liability by discounting the revised lease payments in the following scenarios.

Lessee remeasures lease liability using revised lease payments and...

an unchanged discount rate when:

- future lease payments change to reflect market rates (e.g. based on a market rent review) or a change in an index or rate* used to determine the lease payments; or
- the variability of payments is resolved so that they become in-substance fixed payments.

a revised discount rate when:

- future lease payments change as a result of a change in floating interest rates.

* Other than changes in floating interest rates.

Does this accounting approach represent a change in practice?

Yes – the new standard's approach to accounting for payments that depend on an index or a rate is a change in practice for most companies. Under IAS 17, the usual practice is to treat these payments as contingent rents, recognised in the period in which they are incurred.

The new approach is simple to apply, insofar as lease payments are always based on current information. For example, a lessee is never required to forecast the future amount of an index or a rate. However, remeasuring the lease liability for changes in the value of an index or rate introduces new balance sheet volatility in gross assets and liabilities, and system challenges.

3.2 Payments that depend on an index

IFRS 16.27(b)

On lease commencement, variable lease payments that depend on an index are measured using the index as at the commencement date of the lease.

IFRS 16.42(b), 43

When the change in future lease payments is a result of a change in an index (or rate), the lessee remeasures the liability using an unchanged discount rate.

Example 5 – Payments that depend on an index

IFRS 16.27–28, 39, 42(b), 43, IE6

Company Y rents an office building. The lease term is five years and the initial annual rental payment is 2.5 million. Payments are made at the end of each year. The rent will be reviewed every year and increased by the change in the CPI. The discount rate is 5%.

Initial measurement of the lease liability

To measure the lease liability on commencement, Y assumes an annual rental of 2.5 million.

Year	Lease payments ('000)	Discounted ('000)
1	2,500	2,381
2	2,500	2,268
3	2,500	2,160
4	2,500	2,057
5	2,500	1,959
Lease liability at commencement date		**10,825**

Subsequent reassessment of lease liability

During Year 1, the CPI increases from 100 to 105 (i.e. the rate of inflation over the preceding 12 months is 5%).

Because there is a change in the future lease payments resulting from a change in the CPI, which is used to determine those lease payments, Y needs to remeasure the lease liability.

At the end of Year 1, Y calculates the lease payment for Year 2 as 2.6 million (2.5 million x (105 / 100)).

Accordingly, Y remeasures the lease liability as follows. The subsequent remeasurement of the lease liability is adjusted against the right-of-use asset.

Year	Lease payments ('000)	Discounted ('000)
2	2,625	2,500
3	2,625	2,381
4	2,625	2,268
5	2,625	2,160
Lease liability at end of Year 1		**9,309**

Example 6 – Amortisation of lease liability and change in payment linked to an index

Lessee Y enters into a lease for a five-year term with Lessor L for a retail building, commencing on 1 January. Y pays 155 per year, at the end of each year.

Y's incremental borrowing rate is 5.9%. Additionally, the lease contract states that the lease payments for each year will increase on the basis of the increase in the CPI for the preceding year.

At the commencement date, the CPI for the previous year is 120 and the lease liability is 655, based on annual payments of 155 discounted at 5.9%.

Assume that initial direct costs are zero and there are no lease incentives, prepayments or restoration costs. Y records the following entries for Year 1.

	Debit	Credit
Right-of-use asset	655	
Lease liability		655
To recognise lease at commencement date		

	Debit	Credit
Depreciation expense (655 / 5)	131	
Right-of-use asset		131
Interest expense (655 x 5.9%)	39	
Lease liability (155 - 39)	116	
Cash (payment for Year 1)		155
To recognise payment and expense for Year 1		

Subsequent reassessment of lease liability at end of Year 1

At the end of Year 1, the CPI increases to 125. Y calculates the revised payments for Year 2 and beyond, adjusted for the change in CPI as 161 (155 x 125 / 120).

Because the lease payments are variable payments that depend on an index, Y adjusts the lease liability to reflect the change based on an unchanged discount rate.

The adjustment is calculated as the difference between the original lease payments (155) and the reassessed payment (161) over the remaining four-year lease term, discounted at the original discount rate of 5.9%.

	Debit	Credit
Right-of-use asset	21	
Lease liability		21
To recognise remeasurement at end of Year 1		

What common types of indices do lease payments depend on?

In practice, it is common for lease agreements to include periodic rent review clauses that depend on a published index. These clauses adjust contracted lease payments to reflect changes in inflation measures and other factors.

Common indices used include the following.

– Consumer price index (CPI).

– Producer price indices (PPIs).

– Retail prices indices (RPIs).

– House price indices.

– Average earnings indices.

When does the guidance apply?

The guidance described above applies only when the lease payments depend on the future – i.e. uncertain – level of an index. It does not apply to fixed uplifts designed to reflect expected changes in an index.

Consider two different rent adjustment clauses, as follows.

Lease A	Lease B
Rent adjustment clause The rent for Year 1 is 100. At the end of each year, the rent is adjusted to reflect the change in RPI over the preceding months. Average annual inflation over the previous three years has been 5%.	**Rent adjustment clause** The rent for the first year is 100. Rents increase by 5% in each subsequent year. This increase is designed to compensate the lessor for expected changes in RPI, because average annual inflation over the previous three years has been 5%.
Type of payment The rents depend on an index – i.e. on the future amount of RPI. On lease commencement, the lessee includes in the lease liability the annual lease payments of 100. At the end of Year 1, the lessee remeasures the lease liability to include future lease payments based on the then level of RPI.	**Type of payment** The rents are fixed; they do not depend on the future value of RPI. On lease commencement, the lessee includes in the lease liability the annual lease payments that increase by the fixed factor of 5% – that is, 100, 105, 110, 116 etc. There are no future changes in lease payments that require the lessee to remeasure the lease liability.

What if a rent review mechanism contains an embedded derivative?

IFRS 16.BC81

Under IFRS, derivatives embedded in a lease that are considered not closely related to the lease host have to be separated and accounted for under IFRS 9 *Financial Instruments*. This is because although IFRS 16 includes requirements for features of a lease that may meet the definition of a derivative (e.g. options), the new standard was not developed with accounting for derivatives in mind.

As an example, a lease agreement with variable lease payments adjusted for two times the change in CPI needs to be separated and accounted for under IFRS 9 because the feature is considered leveraged.

Conversely, an inflation-indexed embedded derivative in a lease contract may be considered closely related to the lease if:

- the index relates to inflation in the country in which the leased asset is operated; and
- the feature is not leveraged.

In this case, the feature is not separated and, instead, the whole payment is accounted for under IFRS 16.

3.3 Payments that depend on a rate

IFRS 16.27(b), 39, 42(b)

Consistent with payments that depend on an index, variable lease payments that depend on a rate are initially measured using the rate as at the commencement date of the lease.

The lease liability is subsequently remeasured if the variable lease payments change as a result of a change in the relevant rate (e.g. LIBOR).

IFRS 16.42(b), 43

The lessee remeasures the liability using an unchanged discount rate when the change in future lease payments results from a change in a rate, with the exception of floating interest rates.

In the case of a floating interest rate, the lessee revises the discount rate for the change in the interest rate.

Example 7 – Payments that depend on a rate: Initial measurement and subsequent remeasurement

Lessee C enters into a five-year lease of a car. The lease payments are paid at the beginning of each year and are determined as follows.

- The discount rate is 5%.
- On commencement, LIBOR is 2%.
- The initial fair value of the asset is 10,000.
- Annual lease payments in Years 1–4 are determined as LIBOR x 10,000, based on LIBOR at the date of payment.
- The payment in Year 5 is determined as (LIBOR x 10,000) + 10,000.

Initial measurement of the lease liability

On commencement, C determines the lease liability as follows.

- The payment of 10,000 in Year 5 is fixed, and therefore is included.
- The payments in Years 1–5 determined as LIBOR x 10,000 represent variable lease payments that depend on a rate, and therefore are also included.

At commencement, C makes the payment for Year 1 and then measures the lease liability and right-of-use asset as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
1	8,936	-	447	9,383	9,136	(1,827)	7,309
2	9,383	(200)	459	9,642	7,309	(1,827)	5,482
3	9,642	(200)	472	9,914	5,482	(1,827)	3,655
4	9,914	(200)	486	10,200	3,655	(1,827)	1,828
5	10,200	(10,200)	-	-	1,828	(1,828)	-

At commencement, C records the following entry.

	Debit	Credit
Right-of-use asset	9,136	
Lease liability		8,936
Cash		200
To recognise lease at commencement date		

At the end of Year 1, C records the following entries.

	Debit	Credit
Depreciation expense (9,136 / 5)	1,827	
Right-of-use asset		1,827
Interest expense (8,936 x 5%)	447	
Lease liability		447
To recognise depreciation and interest expense for Year 1		

At the beginning of Year 2, LIBOR increases to 2.5%. Using a revised discount rate of 4.5%, B remeasures the lease liability and right-of-use asset, and then makes payment for Year 2.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
2	9,700	(250)	425	9,875	7,626*	(1,907)	5,719
3	9,875	(250)	433	10,058	5,719	(1,907)	3,812
4	10,058	(250)	442	10,250	3,812	(1,907)	1,905
5	10,250	(10,250)	-	-	1,905	(1,905)	-

* The right-of-use asset is measured as the balance on commencement (9,136) less depreciation in Year 1 (1,827) plus the adjustment for remeasurement of the lease liability (317).

Subsequent reassessment of the lease liability – Year 2

Because the lease payments are determined using LIBOR at the date of payment, the lease payment for Year 2 is 250 (10,000 x 2.5%). C records the following entries during Year 2.

	Debit	Credit
Right-of-use asset	317	
Lease liability		317
To recognise remeasurement of lease liability at beginning of Year 2		
Depreciation expense (7,626 / 4)	1,907	
Right-of-use asset		1,907
Interest expense (9,450 x 4.5%)	425	
Lease liability (425 - 250)		175
Cash (payment for Year 2)		250
To recognise payment and depreciation for Year 2		

Subsequent reassessment of the lease liability – Year 3

At the start of Year 3, LIBOR decreases to 2.4% and C's discount rate is revised to 5.1%. C remeasures its lease liability and right-of-use asset, and then makes payment for Year 3.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
3	9,739	(240)	484	9,983	5,583	(1,861)	3,722
4	9,983	(240)	497	10,240	3,722	(1,861)	1,861
5	10,240	(10,240)	-	-	1,861	(1,861)	-

During Year 3, C records the following entries.

	Debit	Credit
Lease liability	136	
Right-of-use asset		136
To remeasure lease liability at beginning of Year 3		
Depreciation expense (5,583 / 3)	1,861	
Right-of-use asset		1,861
Interest expense (9,499 x 5.1%)	484	
Lease liability (484 - 240)		244
Cash (payment for Year 3)		240
To recognise payment and expense for Year 3		

3.4 Lessor considerations

There are no differences in the identification of lease payments for lessees and lessors regarding lease payments that depend on an index or a rate, though the accounting consequences may be different due to the different accounting models for lessees and lessors.

4 Fixed vs variable payments

Variable payments other than those that depend on an index or rate are excluded from the lease liability – but in-substance fixed payments are always included.

4.1 Payments that depend on sales or usage

IFRS 16.BC168–BC169

Variable lease payments that depend on sales or usage of the underlying asset are excluded from the lease liability. Instead, these payments are recognised in profit or loss in the period in which they occur.

Example 8 – Payments that depend on usage

Lessee B enters into a 15-year lease of a wind farm. The lease payments are based on usage.

Forecasts show that lease payments for the 'expected case' are 1 million per annum, and historical climate data indicate that lease payments for the 'extreme low case' are 700,000 per annum.

To determine the payments to include in the lease liability, B considers the following.

- The lease payments are based on usage.
- The contract does not require minimum lease payments to equal the 'expected case' lease payments.
- Similarly, the contract does not require minimum lease payments to equal the 'extreme low case' lease payments.

B concludes that although it is unlikely that the lease payments will fall below the 'extreme low case', the contract does not include any unavoidable lease payments. Therefore, the lease liability is measured at zero.

Example 9 – Variable payments that depend on sales

Company X leases a store. The annual lease payments amount to 1% of the store's revenues. There is no minimum rental payment.

Because the lease contains only variable lease payments that do not depend on an index or rate, and there is no unavoidable payment, X measures the lease liability at the commencement of the lease as zero.

Example 10 – Variable payments that are not directly proportional to sales

Company X leases a space for a new store. Historically, X's stores generate an average of 900,000 in revenue per month.

The monthly lease payments for the new store are determined with reference to staggered sales targets as follows.

- Monthly revenue up to 600,000: 0.
- Monthly revenue 600,001–1 million: 20,000.
- Monthly revenue 1,000,001–2 million: 25,000.
- Monthly revenue >2 million: 30,000.

For example, in the following scenarios, the lease payments are as follows.

Monthly revenue	Lease payments
500,000	-
800,000	20,000
2.1 million	30,000
5 million	30,000

IFRS 16.B42, BC164

X considers the following in evaluating whether the variable lease payments are in-substance fixed.

- Genuine variability in the lease payments exists.
- It is realistic that the lease payments may differ each month.
- The payments are structured as variable payments, with no mechanism to become fixed at a later date.
- If revenues fell below 600,000, then no lease payment would be required.

X concludes that even though the lease payments are not directly proportional to sales (i.e. not determined as a percentage of sales), the lease payments are still variable (i.e. there is no in-substance fixed minimum) and depend on sales. The existence of a historical average or similar benchmark also does not create a fixed minimum. Accordingly, X excludes the monthly lease payments from its measurement of the lease liability and measures the lease liability at the commencement of the lease as zero.

IFRS 16.27, 38, B42

Example 11 – Lease of steel kegs at no cost

Company B is a producer of beer that delivers goods sold to its customers in re-useable steel kegs. The customer has an obligation to return the kegs to B.

As a part of B's arrangement with its customer (Restaurant R), B provides R with the steel kegs at no cost.

In return, R agrees to the following arrangement.

- R is not required to purchase a minimum volume of beer per year.
- The price of beer is 10 per litre.
- Historical data indicate that R will purchase approximately 25,000 litres per annum, and the likelihood of purchasing less than 15,000 litres per annum is remote.

B and R conclude that:

- the contract contains a lease of the steel kegs;
- the sale of the beer is a non-lease component; and
- consideration needs to be allocated to the lease component.

To determine whether the payments are variable or in-substance fixed payments, B and R consider the following.

- Although the probability of R purchasing more than 15,000 litres per annum appears to be high, the lease payments are still based exclusively on, and vary directly with, performance or use.
- Variable lease payments based on sales or usage are excluded from the measurement of the lease liability even when there is a high probability of payment.

Accordingly, R measures the lease liability at the commencement date as zero and recognises amounts allocated to the lease component in profit or loss as the transactions occur.

R has the option to elect the recognition exemptions for short-term and low-value leases. In practice, it's likely that both recognition exemptions could apply to a lease of beer kegs; however, R may still be required to provide disclosures under IFRS 16. The recognition exemption does not apply to B.

IFRS 16.27, 38, B42

Example 12 – Lease payments based on output of solar plant

Utility Company C enters into a 20-year contract with Power Company D to purchase electricity produced by a new solar farm.

C and D assess that the contract contains a lease. There are no minimum purchase requirements, and no fixed payments that C is required to make to D. However, C is required to purchase all of the electricity produced by the solar plant at a price of 10 per unit.

C notes that it is highly probable that the solar plant will generate at least some electricity each year. However, the whole payment that C makes to D varies with the amount of electricity produced by the solar farm – i.e. the payments are fully variable.

Therefore, C concludes that there are no in-substance fixed lease payments in this contract. C recognises the payments to D in profit or loss when they are incurred.

Could a lessee's lease liability differ from the amount that it expects to pay?

Yes – as described above, lease payments that depend on a variable other than an index or rate are not included in a lessee's lease liability unless they meet the definition of an 'in-substance fixed lease payment' (see Section 4.2).

Where payments based on future activities of the lessee (i.e. on performance or usage) are avoidable and contain genuine variability, it is inappropriate to impute an 'in-substance fixed minimum' lease payment. This is because even if a 'bottom slice' of payments is highly likely to be paid, the payments still depend on an underlying variability. Identifying an in-substance minimum would create practical difficulties – e.g. identifying the point in the distribution of possible outcomes judged to be 'in-substance fixed', and determining how to apply the reassessment guidance.

Accordingly, there may be a significant difference between the amounts that a lessee expects to pay and the lease liability that it recognises.

Will we see more leases with variable lease payments in the future?

The exclusion of many variable lease payments from the lease liability has led to speculation that lessees will seek to renegotiate leases to switch from fixed to variable lease payments, and thereby reduce their reported liabilities.

For example, suppose Lessee X currently pays a fixed amount of 100,000 per annum and expects its annual sales to be 10 million per annum for the next five years. In theory, if X amended the terms of its lease contract so that future lease payments became variable and determined as 1% of sales, then X would expect to make the same lease payments – but recognise no lease liability.

Third party leases

In practice, the process of renegotiating the terms of a lease contract may not be straightforward. A change from fixed to variable lease payments would also change the risk profile of the lease, perhaps significantly. In the above example, the lessor would bear a greater risk associated with fluctuations in X's business performance. As a minimum, the lessor would be likely to seek a higher return from X for accepting this risk. Some lessors may refuse to accept this risk altogether.

Intra-group leases

There may be greater scope to amend lease terms when lessees and lessors belong to the same consolidated group. In these circumstances, the right modification of lease terms could result in a considerable simplification in the accounting for intra-group leases – with no impact on the consolidated results.

4.2 In-substance fixed payments

IFRS 16.27(a), B42

The lessee includes in the lease liability fixed lease payments, including in-substance fixed lease payments. 'In-substance fixed payments' are payments that are structured as variable lease payments, but which – in substance – are unavoidable. Examples include:

- payments that have to be made only if an event occurs that has no genuine possibility of not occurring;
- there is more than one set of payments that a lessee could make, but only one of those sets is realistic; and
- there are multiple sets of payments that a lessee could realistically make, but it has to make at least one set of payments.

IFRS 16.38, B42(c)

Example 13 – Minimum lease payments

Lessee D enters into a five-year lease for a piece of machinery.

The contract sets out the lease payments as follows.

- If D uses the machinery within a given month, then an amount of 2,000 accrues for that month.
- If D does not use the machinery within a given month, then an amount of 1,000 accrues for that month.

Payments are made at the end of the year.

D considers the contract and notes that although the lease payments contain variability based on usage, and there is a realistic possibility that D may not use the machinery in some months, a monthly payment of 1,000 is unavoidable. Accordingly, this is an in-substance fixed payment, and is included in the measurement of the lease liability.

At commencement, using a discount rate of 5%, the lease liability is calculated as follows.

Year	Lease payments	Discounted
1	12,000	11,429
2	12,000	10,884
3	12,000	10,366
4	12,000	9,872
5	12,000	9,402
Lease liability at commencement date		**51,953**

At commencement, D records the following entry.

	Debit	Credit
Right-of-use asset	51,953	
Lease liability		51,953
To recognise lease at commencement date		

Due to project delays, D only uses the machinery in the last four months of Year 1. At the end of the year, D records the following entries.

	Debit	Credit
Depreciation expense (51,953 / 5)	10,391	
Right-of-use asset		10,391

	Debit	Credit
Lease expense	4,000	
Interest expense (51,953 x 5%)	2,598	
Lease liability (12,000 - 2,598)	9,402	
Cash (payment for Year 1)		16,000
To recognise payment and expense for Year 1		

Example 14 – Minimum lease payment with no commercial substance

IFRS 16.B42(b)

R, an established retailer, leases space for a store within a mature retail development from Company Q. Under the terms of the lease, R is required to operate the store during normal working hours. R is not permitted to leave the store vacant or to sub-let the store.

The contract states that the annual rentals payable by R will be:

– 100 if R makes no sales at the store; or

– 1 million if R makes any sales at the store during the term of the lease.

R concludes that the lease contains in-substance fixed lease payments of 1 million per annum. R notes that this amount is not a variable payment that depends on sales. This is because there is no realistic possibility that R will make no sales at the store. R is an established retailer and has agreed to operate the store during normal working hours.

Example 15 – Multiple options at end of non-cancellable period

IFRS 16.B42(c)

Lessee T leases a machine that has an expected useful life of five years. The non-cancellable period of the lease is three years.

At the end of Year 3, T has to either:

– purchase the machine for 200; or

– extend the lease for two years, by agreeing to pay 105 at the end of each year.

T assesses at lease commencement that it is not reasonably certain to purchase the machine at the end of three years; nor is it reasonably certain to extend the lease for two years.

That is, if T were to consider the purchase option and the renewal option separately, then it would include neither the exercise price of the purchase option nor the rentals payable in the renewal period in the lease liability at lease commencement.

However, T concludes that the arrangement contains an in-substance fixed payment at the end of Year 3. This is because under all options, T is required to make a payment. The amount of the in-substance fixed payment is the lower of the present value of the exercise price of the purchase option (200) and the present value of the annual rentals in the renewal period (two payments of 105).

Will identifying in-substance fixed payments require judgement?

In many cases, identifying an in-substance fixed payment will be straightforward. The IASB believes that the guidance on in-substance fixed payments is consistent with current practice under IAS 17.

However judgement will be required in some cases. This can be seen by comparing Examples 13 and 14 above. In each case, there is a payment that appears to depend on sales or usage, but in the latter case it is in-substance fixed. The distinguishing feature of Example 14 is that there is no genuine underlying variability. The conclusion in Example 14 is clear; however, judgement would be required if, for example, the lower band of lease payment applied up to some higher level of sales (as illustrated in Example 10).

4.3 Variable payments that become fixed

IFRS 16.B42(a)(ii)

If a lease payment is initially variable but subsequently becomes fixed, then it is treated as an in-substance fixed payment when the underlying variability is resolved. The payment is therefore included in the lease liability from that point onwards.

Example 16 – Payments initially unknown but partially fixed at the end of Year 1

Lessee B enters into a 20-year lease of an item of machinery. The lease payments are paid at the end of each year and are determined as follows.

- Years 1–10: initially unknown but fixed at the end of Year 1 based on the capacity achieved in the second half of Year 1.
- Year 11 onwards: variable, based on a fixed price per tonne processed.

The capacity of the machine is unknown until it has been installed and it has been operating for a year.

In this scenario, the lease payments can be categorised as follows.

- Year 1: the lease payment is variable and determined based on the capacity achieved in the second half of the year.
- Years 2–10: lease payments become fixed for these years based on the actual capacity achieved in the second half of Year 1.
- Years 11–20: lease payments are variable and based on usage.

Initial measurement of the lease liability

At commencement, the future lease payments are unknown and B measures the lease liability as zero. B's discount rate is 5%.

Subsequent measurement of the lease liability as payments become fixed

At the end of Year 1, the lease liability becomes fixed at 2,000 per annum based on the capacity achieved in the second half of the year. Using an unchanged discount rate, the lease liability is calculated as follows.

Year	Lease payments	Discounted
2	2,000	1,905
3	2,000	1,814
4	2,000	1,728
5	2,000	1,645
6	2,000	1,567
7	2,000	1,492
8	2,000	1,421
9	2,000	1,354
10	2,000	1,289
Lease liability at end of Year 1		**14,215**

At the end of Year 1, B records the lease liability with the following entry.

	Debit	Credit
Right-of-use asset	14,215	
Lease liability		14,215
To recognise lease as payments become fixed		

Subsequent measurement of the lease liability – Year 2

At the end of Year 2, B records the following entries.

	Debit	Credit
Depreciation expense (14,215 / 19)	748	
Right-of-use asset		748
To recognise depreciation of the ROU asset over the remaining lease term		
Interest expense (14,215 x 5%)	711	
Lease liability (2,000 - 711)	1,289	
Cash (payment for Year 2)		2,000
To recognise payment and expense for Year 2		

4.4 Lessor considerations

There are no differences in the identification of lease payments for lessees and lessors regarding lease payments that depend on an index or a rate, though the accounting consequences may be different due to the different accounting models for lessees and lessors.

IFRS 16.65

One key distinction is that for a lessor the presence of variable lease payments may affect lease classification.

What is the impact of variable payments on lease classification for a lessor?

Under the new standard, lessors retain the IAS 17 dual accounting model and continue to classify leases as either an operating or a finance lease.

IFRS 16.63

Like IAS 17, the new standard includes indicators that individually or in combination would normally result in a lease being classified as a finance lease – e.g. if the lease term represents a major part of the economic life of the underlying asset.

IFRS 16.65

However, if a lease includes a high proportion of lease payments based on sales or usage (as illustrated in Examples 8 and 12 above), then this could indicate that the lease should be classified as an operating lease. This is because the lessor retains substantially all of the risks and rewards incidental to ownership of the underlying asset through the variability in the lease payments.

5 Lease and non-lease components

The combined effect of the new leases and revenue standards will increase the focus on the identification of components – impacting lessees and lessors.

5.1 Lease and non-lease components

IFRS 16.12, 15, BC135(b)

In practice, contracts may contain both lease and non-lease components such as payments for services.

The new standard requires a lessee to separate the lease and non-lease components of a contract, unless it applies the practical expedient not to separate the two (see Section 5.3) and account for the contract as a single lease component.

Step 1: Identify the component(s)

IFRS 16.B32–B33

Lessees and lessors consider the right to use an asset as a separate lease component if it meets the following criteria:

– the lessee can benefit from using that underlying asset either on its own or together with other resources that are readily available; and

– the asset is neither highly dependent on, nor highly inter-related with, the other assets in the contract.

Charges for administrative tasks or other costs incurred associated with the lease that do not transfer a good or service to the lessee do not give rise to a separate component. However, they are part of the total consideration that the lessee allocates to the identified components.

Step 2: Account for the component(s)

Lessee perspective

IFRS 16.13–14, 16, BC137

Lessees allocate the consideration in the contract to the identified components based on the relative stand-alone prices of the lease components and the aggregate of the non-lease components, and account for non-lease components in accordance with the applicable accounting standards.

Lessees determine the relative stand-alone prices of lease and non-lease components based on the price that a lessor would charge a company for a similar component separately.

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

Lessor perspective

IFRS 16.17, BC135(a), BC136

If a contract contains a lease component and one or additional lease or non-lease components, then IFRS 16 requires a lessor always to allocate the consideration in a contract following the approach in IFRS 15 *Revenue from Contracts with Customers*.

The following table summarises the process for accounting for lease and non-lease components from both perspectives.

<table>
<tr><th></th><th>Lessee</th><th>Lessor</th></tr>
<tr><td>When there is an observable stand-alone price for each component</td><td>Unless the practical expedient is elected (see below), separate and allocate based on the relative stand-alone price of components</td><td rowspan="2">Always separate and allocate following the IFRS 15 approach – i.e. on a relative stand-alone selling price basis</td></tr>
<tr><td>When there is not an observable stand-alone price for some or all components</td><td>Maximise the use of observable information</td></tr>
<tr><td>Taxes, insurance on the property and administrative costs</td><td colspan="2">Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract</td></tr>
<tr><td>Practical expedient accounting policy election by class of underlying asset</td><td>Combine lease and any associated non-lease components and account for them as lease components</td><td>N/A</td></tr>
</table>

Example 17 – Non-lease components excluded from lease liability

Lessee B enters into a five-year lease of a photocopier.

The lease payments are 10,000 per annum. The contract includes additional maintenance costs of 500 per annum.

B considers the contracted payments and separates the service component of the contract (i.e. maintenance costs) as a non-lease component. B notes that, based on observable prices, the lease and non-lease components are priced at their stand-alone prices.

Because the annual lease payments are a fixed amount, B includes the present value of the five annual payments of 10,000 in the initial measurement of the lease liability. B excludes the maintenance costs from the lease liability and recognises an expense as the maintenance costs are incurred.

Example 18 – Lessee allocation of consideration to lease and non-lease components

Lessee L enters into a five-year contract with Lessor M to use a ship, including crew.

The contract includes maintenance services provided by M. M obtains its own insurance for the ship. Annual payments are 20,000, including 3,000 for maintenance services and 500 for insurance costs. L is able to determine that similar maintenance services and insurance costs are offered by third parties for 2,000 and 500 a year, respectively. L is also able to determine that similar leases for ships without a crew are offered by third parties for 15,000 a year and, using a cost-plus calculation, L estimates the annual cost of crew hire to be 5,000. Payments are made at the end of each year.

In this case, L determines that:

- the observable stand-alone price for maintenance services is 2,000;
- the estimated stand-alone price for the crew is 5,000;
- the observable stand-alone price for the lease is 15,000; and
- the insurance cost does not transfer a good or service to L and therefore is not a separate component.

Consequently, L estimates the stand-alone price of the lease as follows.

Observable stand-alone price: maintenance	A	2,000
Estimated stand-alone price: crew	B	5,000
Observable stand-alone price: lease	C	15,000
Total	D = A + B + C	22,000
Lease component as a percentage of total observable/estimated prices	E = C / D	68%
Allocation of consideration (20,000) to lease	E x 20,000	13,636

Using a discount rate of 5%, the lease liability at the commencement date is calculated as follows.

Year	Lease payments	Discounted
1	13,636	12,987
2	13,636	12,368
3	13,636	11,779
4	13,636	11,218
5	13,636	10,684
Lease liability at commencement date		**59,036**

5.2 Insurance

IFRS 16.B32–B33

Lease arrangements often require the lessee to make payments for certain costs related to the leased asset – e.g. insurance. As discussed in Section 5.1, typically, no distinct good or service is transferred to the lessee in exchange for these payments – that is, they do not relate to a separate component of the contract.

The payments can be made directly by the lessee to a third party or the lessee can reimburse the lessor for a payment that it has made.

When the payments are part of the lease payments, lessees need to consider the specific facts and circumstances to determine whether they should be included in the lease liability. For example, such payments are excluded from the lease liability if they are variable and they vary on the basis of something other than an index or rate.

Example 19 – Reimbursement of insurance costs

Lessee B enters into a five-year lease for an apartment.

B is contractually obliged to reimburse the lessor for costs related to insurance. At commencement, the amount of the insurance premiums is known to both parties but the amount is not specified in the contract.

Furthermore, the cost of insurance may vary over time – e.g. if the lessor moves to another insurance company that requires a lower premium or if premiums are refunded.

To determine whether insurance premiums should be included in the lease liability, B considers the following.

- At commencement, the insurance premiums may vary in subsequent periods.
- The premiums do not depend on an index or rate.

Accordingly, B concludes that this portion of the payment is a variable lease payment, which it excludes from the measurement of the lease liability.

5.3 Combining lease and non-lease components

IFRS 16.12, 15, B32–B33

As a practical expedient, a lessee is permitted to combine lease and non-lease components and account for them as a single lease component. This election is applied consistently by each class of underlying asset and cannot be applied to embedded derivatives that meet the criteria in paragraph 4.3.3 of IFRS 9.

However, even if the lessee applies the practical expedient to treat multiple lease and non-lease components as a single lease component, the nature of the individual components – i.e. whether they are fixed or variable depending on a rate or index – does not change.

Example 20 – Lease with fixed lease and non-lease components

Lessee B enters into a five-year lease for an apartment from Lessor R. The lease payments are 10,000 per annum, paid at the end of the year.

The contract includes additional maintenance costs of 500 per annum, increased by 5% annually.

To determine which payments are included in the lease liability, B considers the following.

- The lease payments of 10,000 per annum are fixed.
- B has elected to apply the practical expedient to combine lease and non-lease components.
- The maintenance costs are fixed (including a fixed escalation).

At commencement, B measures the lease liability as the present value of the remaining five payments – assuming an annual increase of 5% *on the maintenance cost only*.

Using a discount rate of 5%, B measures the lease liability on commencement as follows.

Year	Lease payments	Discounted
1	10,500	10,000
2	10,525	9,546
3	10,551	9,114
4	10,579	8,703
5	10,608	8,312
Lease liability at commencement date		**45,675**

In contrast, R is not permitted to combine the lease and maintenance components. Instead, R accounts for the lease component in accordance with IFRS 16 and the maintenance services in accordance with IFRS 15.

In practice, this is likely to be an operating lease. This means that R will recognise all of the amounts payable by B as income over the term of the lease. However, R will be required to disclose separately its lease income (under IFRS 16) and revenue from contracts with customers (under IFRS 15).

How will the new standard affect accounting for non-lease components?

IFRS 16.15, BC135

The objective of the new standard is to change the accounting for leases and not the accounting for services. Accordingly, the new standard applies only to the lease components of any contract, unless the practical expedient is applied.

In permitting this practical expedient, the IASB's intention was to reduce cost and complexity for some lessees, without creating significant issues of comparability.

In addition, applying the practical expedient can impact the presentation of expenses by a lessee. Typically, non-lease components are executory contracts and the related expense is an operating expense charged in arriving at earnings before interest, taxation, depreciation and amortisation (EBITDA).

However, if a non-lease component is accounted for as part of the lease, then the related expense is presented in profit or loss as depreciation of the right-of-use asset and interest expense. Because neither of these amounts is charged in arriving at EBITDA, one consequence of applying the practical expedient is to increase EBITDA.

6 More complex scenarios

Additional considerations will apply when identifying which lease payments to include in the lease liability in the following scenarios.

6.1 'Higher of' and 'lower of' clauses

Some lease contracts may specify that the lease payments are calculated periodically as the 'higher of' or 'lower of' two amounts. Often, these amounts are based on an index or a rate.

Although both payment clauses are structured to be variable, leases with a 'higher of' clause may effectively include an in-substance fixed payment – because there may be a minimum payment that a lessee has no genuine possibility of avoiding, and the variability in the lease payment may exist only in how much the actual payment will exceed that minimum amount by.

On the other hand, 'lower of' clauses generally do not have an unavoidable amount and, therefore, are accounted for as variable lease payments.

Example 21 – 'Higher of' clause

Lessee X enters into a 10-year lease of retail space. Lease payments are made in advance at the beginning of each year.

The first lease payment is 50,000 and subsequent lease payments increase annually by the *higher* of the increase in CPI for the preceding 12 months and 5%.

The CPI is 100 on lease commencement and 107 at the end of Year 1 – i.e. inflation is 7% during the first year. X's discount rate is 4.5%.

At commencement date

On commencement, X makes payment for the first year and determines that the contract includes an in-substance fixed minimum (with a fixed escalation of 5% per annum). X includes the present value of the remaining nine payments – assuming an annual increase of 5% each year in its lease liability – and measures the lease liability and right-of-use asset as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
1	460,905	-	20,741	481,646	510,905	(51,091)	459,814
2	481,646	(52,500)	19,312	448,458	459,814	(51,091)	408,723
3	448,458	(55,125)	17,700	411,033	408,723	(51,091)	357,632
4	411,033	(57,881)	15,892	369,044	357,632	(51,091)	306,541
5	369,044	(60,775)	13,872	322,141	306,541	(51,091)	255,450
6	322,141	(63,814)	11,625	269,952	255,450	(51,091)	204,359
7	269,952	(67,005)	9,133	212,080	204,359	(51,091)	153,268
8	212,080	(70,355)	6,378	148,103	153,268	(51,091)	102,177
9	148,103	(73,873)	3,340	77,570	102,177	(51,091)	51,086
10	77,570	(77,570)	-	-	51,086	(51,086)	-

On commencement, X records the following entry.

IFRS 16.24(b)

	Debit	Credit
Right-of-use asset	510,905	
Lease liability		460,905
Cash		50,000
To recognise lease on commencement and payment in advance for Year 1		

During Year 1, X records the following entries.

	Debit	Credit
Depreciation expense (510,905 / 10)	51,091	
Right-of-use asset		51,091
Interest (460,905 x 4.5%)	20,741	
Lease liability		20,741
To recognise depreciation and interest expense for Year 1		

Subsequent remeasurement at beginning of Year 2

At the beginning of Year 2, X adjusts the remaining lease payments based on the higher of the increase in CPI (7%) and 5%. Accordingly, X increases the lease payments to 53,500 (50,000 x 107 / 100).

The payment determined for Year 2 (53,500) becomes the new base payment. To remeasure the lease liability at the beginning of Year 2, the new base payment is increased by 5% (the minimum annual increase) for the remainder of the lease.

Using an unchanged discount rate, X remeasures the lease liability and right-of-use asset as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
2	490,819	(53,500)	19,679	456,998	468,987	(52,110)	416,877
3	456,998	(56,175)	18,037	418,860	416,877	(52,110)	364,767
4	418,860	(58,984)	16,194	376,070	364,767	(52,110)	312,657
5	376,070	(61,933)	14,136	328,273	312,657	(52,110)	260,547
6	328,273	(65,030)	11,846	275,089	260,547	(52,110)	208,437
7	275,089	(68,281)	9,306	216,114	208,437	(52,110)	156,327
8	216,114	(71,695)	6,499	150,918	156,327	(52,110)	104,217
9	150,918	(75,280)	3,404	79,042	104,217	(52,110)	52,107
10	79,042	(79,042)	-	-	52,107	(52,107)	-

During Year 2, X records the following entries.

	Debit	Credit
Right-of-use asset	9,173	
Lease liability		9,173
To recognise remeasurement of lease liability at beginning of Year 2		
Depreciation expense (468,987 / 9)	52,110	
Right-of-use asset		52,110
Interest expense (437,319 x 4.5%)	19,679	
Lease liability (53,500 - 19,679)	33,821	
Cash (payment for Year 2)		53,500
To recognise payment and expense for Year 2		

Example 22 – 'Lower of' clause

Lessee X enters into a 10-year lease of retail space. Lease payments are made in advance at the beginning of each year.

The first lease payment is 50,000 and subsequent lease payments increase annually by the *lower* of the increase in CPI for the preceding 12 months and 5%.

The CPI is 100 on lease commencement and 104 at the end of Year 1 – i.e. inflation is 4% during the first year. X's discount rate is 5%.

At commencement date

To calculate the lease liability, X measures it at the present value of the remaining nine payments of 50,000. The remaining lease periods are not adjusted because future CPI rates are unknown.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
1	355,390	-	17,770	373,160	405,390	(40,539)	364,851
2	373,160	(50,000)	16,158	339,318	364,851	(40,539)	324,312
3	339,318	(50,000)	14,466	303,784	324,312	(40,539)	283,773
4	303,784	(50,000)	12,689	266,473	283,773	(40,539)	243,234
5	266,473	(50,000)	10,824	227,297	243,234	(40,539)	202,695
6	227,297	(50,000)	8,865	186,162	202,695	(40,539)	162,156
7	186,162	(50,000)	6,808	142,910	162,156	(40,539)	121,617
8	142,910	(50,000)	4,648	97,618	121,617	(40,539)	81,078
9	97,618	(50,000)	2,382	50,000	81,078	(40,539)	40,539
10	50,000	(50,000)	-	-	40,539	(40,539)	-

On commencement, X records the following entry.

IFRS 16.24(b)

	Debit	Credit
Right-of-use asset	405,390	
Lease liability		355,390
Cash		50,000
To recognise lease on commencement and payment in advance for Year 1		

During Year 1, X records the following entries.

	Debit	Credit
Depreciation expense (405,390 / 10)	40,539	
Right-of-use asset		40,539
Interest (355,390 x 5%)	17,770	
Lease liability		17,770
To recognise depreciation and interest expense for Year 1		

Subsequent remeasurement at beginning of Year 2

At the beginning of Year 2, X adjusts the remaining lease payment by 4% (the lower of CPI in the first year and 5%). Accordingly the lease payments for Year 2 and subsequently are increased to 52,000 (50,000 x 104 / 100).

The payment determined for Year 2 (52,000) becomes the new base payment. To remeasure the lease liability at the beginning of Year 2, the remaining lease periods are not adjusted because future CPI rates are unknown.

Using an unchanged discount rate, X remeasures the lease liability and right-of-use and then makes payment for Year 2.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
2	388,087	(52,000)	16,804	352,891	379,778	(42,198)	337,580
3	352,891	(52,000)	15,045	315,936	337,580	(42,198)	295,382
4	315,936	(52,000)	13,197	277,133	295,382	(42,198)	253,184
5	277,133	(52,000)	11,257	236,390	253,184	(42,198)	210,986
6	236,390	(52,000)	9,219	193,609	210,986	(42,198)	168,788
7	193,609	(52,000)	7,080	148,689	168,788	(42,198)	126,590
8	148,689	(52,000)	4,834	101,523	126,590	(42,198)	84,392
9	101,523	(52,000)	2,477	52,000	84,392	(42,198)	42,194
10	52,000	(52,000)	-	-	42,194	(42,194)	-

During Year 2, X records the following entries.

	Debit	Credit
Right-of-use asset	14,927	
Lease liability		14,927
To recognise remeasurement of lease liability at beginning of Year 2		
Depreciation expense (379,778 / 9)	42,198	
Right-of-use asset		42,198
Interest expense (336,087 x 5%)	16,804	
Lease liability		16,804
To recognise depreciation and interest expense for Year 2		

6.2 Reassessment of renewal, termination and purchase options

IFRS 16.20–21, 40

Similar to when there is a change in future lease payments (see 3.1.2), a lessee remeasures its lease liability when there is a change (on a significant event or a significant change in circumstance), within its control, that alters the likelihood that it will exercise any of the following options after the commencement date:

- option to extend the term of the lease;
- option to purchase the asset at the end of the lease; or
- option to terminate the lease early.

Generally, a corresponding adjustment is made to the right-of-use asset. The following examples illustrate the calculations and journal entries on reassessment of purchase and renewal options.

Example 23 – Lessee purchase option: Subsequent reassessment

Lessee E enters into a non-cancellable five-year lease with Lessor R to use a piece of equipment, with a plan to develop its own equipment to replace the asset, ready for use in five years' time. There is no renewal option, but E has the option to purchase the equipment at the end of the lease for 500.

The annual lease payments are fixed at 1,000 per annum, paid at the end of each year. E's incremental borrowing rate is 5%.

Initial assessment of certainty that option will be exercised

At the commencement date, E concludes that it is not reasonably certain to exercise the option. This is because E intends to develop its own equipment to replace the leased asset by the end of the lease.

At the commencement date, E measures the lease liability as follows.

Year	Lease payments	Discounted
1	1,000	952
2	1,000	907
3	1,000	864
4	1,000	823
5	1,000	784
Lease liability at commencement date		**4,330**

At the commencement date, the lease liability and right-of-use asset are expected to be amortised as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
1	4,330	(1,000)	217	3,547	4,330	(866)	3,464
2	3,547	(1,000)	177	2,724	3,464	(866)	2,598
3	2,724	(1,000)	136	1,860	2,598	(866)	1,732
4	1,860	(1,000)	93	953	1,732	(866)	866
5	953	(1,000)	47	-	866	(866)	-

On commencement, E records the following entry.

	Debit	Credit
Right-of-use asset	4,330	
Lease liability		4,330
To recognise lease at commencement date		

E records the following entries at the end of Year 1.

	Debit	Credit
Depreciation expense (4,330 / 5)	866	
Right-of-use asset		866
Interest expense (4,330 x 5%)	217	
Lease liability (1,000 - 217)	783	
Cash (payment for Year 1)		1,000
To recognise payment and expense for Year 1		

Subsequent reassessment of certainty that option will be exercised

At the end of Year 3, E makes a strategic decision to cut back on development projects, including the development of the replacement equipment.
This decision is within E's control and represents a significant change in circumstance. E determines that the fair value of the equipment at the end of the lease will be 2,000.

Accordingly, E concludes that it is now reasonably certain to exercise the option because it is unlikely to have a replacement asset available by the end of the lease, and the expected market value of the equipment at the end of the lease exceeds the exercise price by a substantial amount. E includes the exercise price in its lease payments. Assume that the appropriate discount rate is now 5.5%.

At the end of Year 3, E remeasures the lease liability and right-of-use asset using the revised discount rate of 5.5% as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
4	2,296	(1,000)	126	1,422	2,168	(1,084)	1,084
5	1,422	(1,500)	78	-	1,084	(1,084)	-

At the end of Year 3, E records the following entries.

	Debit	Credit
Depreciation expense (4,330 / 5)	866	
Right-of-use asset		866
Interest expense (2,724* x 5%)	136	
Lease liability (1,000 - 136)	864	
Cash (payment for Year 3)		1,000
To recognise payment and expense for Year 3		

* The carrying amount of the lease liability at the beginning of Year 3.

E remeasures the lease liability to include the exercise of the purchase option. The adjustment is calculated as the difference between the original lease payments and the reassessed payments over the remaining two-year lease term, discounted at the new discount rate of 5.5%.

	Debit	Credit
Right-of-use asset	436	
Lease liability		436
To recognise purchase option reassessed as reasonably certain at end of Year 3		

Example 24 – Renewal option: Subsequent reassessment

Lessee E enters into a 10-year lease of a floor of an office building, with an option to extend for five years.

The lease payments are 50,000 per year during the initial term and 55,000 per year during the optional period, all payable in advance at the beginning of each year.

At the commencement date, E concludes that it is not reasonably certain to exercise the option to extend the lease and determines that the lease term is 10 years.

The appropriate discount rate is determined as 5%.

Initial assessment

At the commencement date, E makes payment for the first year. E measures the lease liability at commencement as follows.

Year	Lease payments ('000)	Discounted ('000)
2	50	48
3	50	45
4	50	43
5	50	41
6	50	39
7	50	37
8	50	36
9	50	34
10	50	32
Lease liability at commencement date		**355**

On commencement, E records the following entry.

	Debit ('000)	Credit ('000)
Right-of-use asset	405	
Lease liability		355
Cash		50
To recognise lease at commencement date		

At the end of Year 1, E records the following entries.

	Debit ('000)	Credit ('000)
Depreciation expense (405 / 10)	41	
Right-of-use asset		41
Interest expense (355 x 5%)	18	
Lease liability		18
To recognise depreciation and interest expense for Year 1		

Subsequent reassessment of certainty that option will be exercised

In Years 5–6, E grows its business significantly, and its increasing workforce means that it needs an additional floor in the building. To minimise costs, E enters into a separate eight-year lease of another floor in the same building, which will be available for lease at the end of Year 7.

Entering into an additional lease in the same building to house a portion of E's team creates an economic incentive for E to extend the original lease at the end of the initial 10-year period.

The expansion of E's team into an additional floor is within E's control and affects whether E is reasonably certain to exercise the extension option, which was not included in the initial determination of its lease term. E would also incur additional costs if it were to lease a similar floor in a different building because its workforce would be in two different buildings, and the cost to move the entire workforce to another building would be even higher.

At the end of Year 6, E concludes that it is now reasonably certain to exercise the option to extend its original lease. Before accounting for a change in the lease term, the lease liability at the end of Year 6 (after making payment for Year 6) was 186,162.

Assuming that the appropriate discount rate decreases to 4.5%, E remeasures the lease liability and right-of-use asset, at the end of Year 6, as follows.

Year	Lease liability				Right-of-use asset		
	Beginning	Lease payment	Interest	Ending	Beginning	Depreciation	Ending
7	399,029	(50,000)	15,706	364,735	375,023	(41,669)	333,354
8	364,735	(50,000)	14,163	328,898	333,354	(41,669)	291,685
9	328,898	(50,000)	12,550	291,448	291,685	(41,669)	250,016
10	291,448	(50,000)	10,865	252,313	250,016	(41,669)	208,347
11	252,313	(55,000)	8,879	206,192	208,347	(41,669)	166,678
12	206,192	(55,000)	6,804	157,996	166,678	(41,669)	125,009
13	157,996	(55,000)	4,635	107,631	125,009	(41,669)	83,340
14	107,631	(55,000)	2,369	55,000	83,340	(41,669)	41,671
15	55,000	(55,000)	-	-	41,671	(41,671)	-

E adjusts the lease liability with the following entry.

	Debit ('000)	Credit ('000)
Right-of-use asset	213	
Lease liability		213
To recognise remeasurement at end of Year 6		

6.3 Lessor put options

IFRS 16.27(d), 70(d)

If a lease includes a put option under which the lessor can require the lessee to buy the asset at the end of the lease at a fixed price, then the lessee includes the exercise price of the option in its lease liability.

A lessor, on the other hand, needs to carefully consider all of the relevant facts and circumstances to determine whether there will be an economic incentive to exercise the put option. This assessment of whether the put option will be exercised is a critical judgement.

Are lessor put options different from residual value guarantees?

Although lessor put options function economically as a residual value guarantee, the amount to be included in the lease payments may differ.

	Lessee	Lessor
Put option	Includes in lease payments the full exercise price of the put option.	Includes in lease payments the full exercise price of the put option.
Residual value guarantee	Includes in lease payments amounts *expected* to be payable under residual value guarantees that it provides to the lessor.	Includes in lease payments residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Example 25 – Lease with a lessor put option: Assessing if reasonably certain to be exercised

Lessee B enters into a five-year lease with Lessor D for a piece of machinery.

The contract includes a put option under which D can require B to purchase the machinery at the end of the lease at a fixed price of 5,000.

Due to the nature of the machinery, its residual value at the end of the lease term is expected to be no more than 3,000.

Lessee's perspective

The exercise of the put option is out of the control of B. B does not have an unconditional right to avoid payment, and concludes that it should include the exercise price (present value of 5,000) in the measurement of the lease liability.

Lessor's perspective

At commencement, D considers whether it *expects* to have an economic incentive that makes it reasonably certain to exercise the put option at the end of the lease.

Because the exercise price significantly exceeds the expected market value of the asset at the end of the lease, D expects to have an economic incentive that makes it reasonably certain to exercise the option and, therefore, includes the exercise price in its lease payments.

6.4 Transition considerations

6.4.1 Overview

IFRS 16.C5

A key early decision is how to transition to the new standard. For many companies, the choice of transition method and which practical expedients to apply will have a major impact on the cost of implementing the new standard and the comparability of trend data in the years after transition.

The transition method will have a significant impact on the lease liability measured on the date of initial application, the extent of data gathering and the timing of system and process changes, and should be considered as soon as possible.

A lessee is permitted to:

– adopt the new standard retrospectively; or

– follow a modified retrospective approach with some optional expedients.

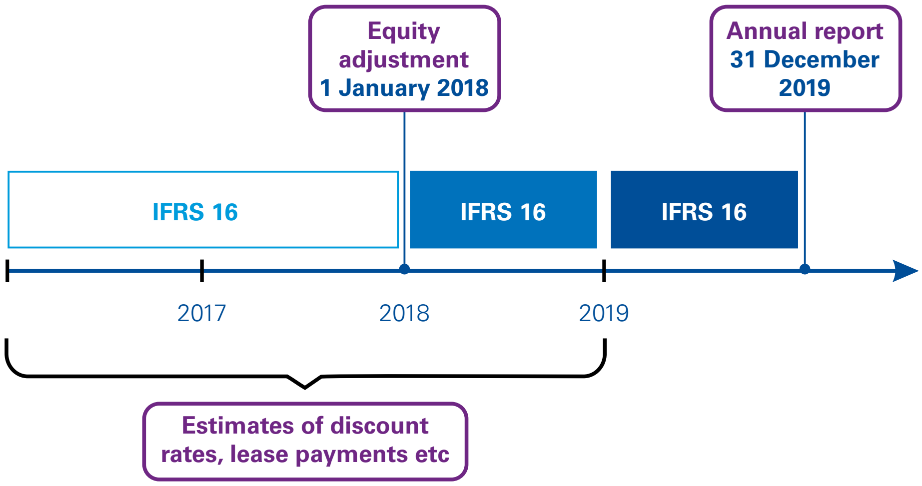
IFRS 16.C6

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

IFRS 16.C14

Except for sub-leases and sale-and-leaseback transactions, a lessor is not required to make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with the new standard from the date of transition.

6.4.2 Retrospective approach



Note: this diagram illustrates a company with a 31 December year end that presents one comparative period.

IFRS 16.C5(a)

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

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

Of the two transition methods available to a lessee, the retrospective method is the more challenging.

What information is needed to apply the retrospective approach?

A company will need extensive information about its leasing transactions to apply the new standard retrospectively.

This includes historical information about lease payments and discount rates – including the historical information that management would have used (i.e. the role of hindsight is limited) in order to make the various judgements and estimates that are necessary to apply the lessee accounting model; for example:

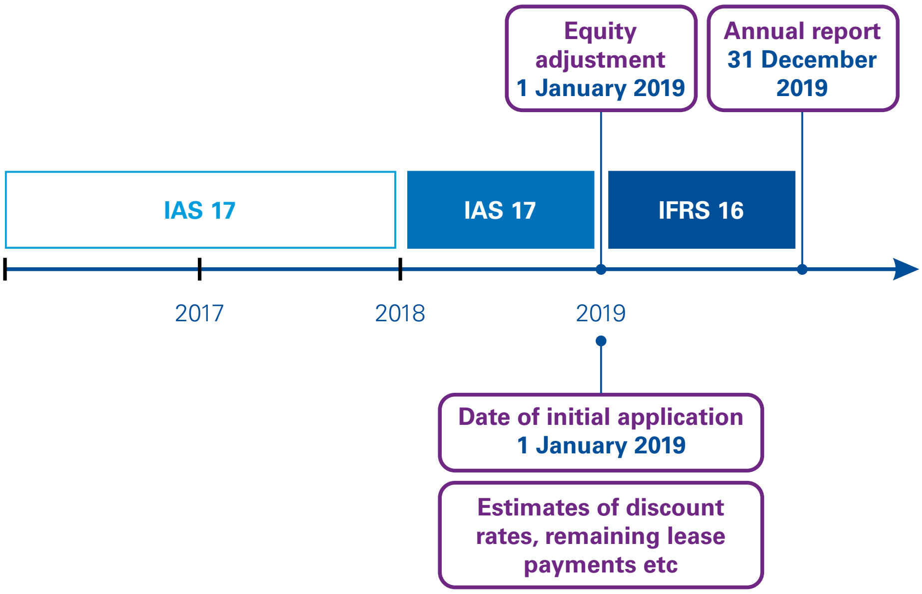
- the lease term, including whether a company was reasonably certain to exercise a renewal option or not to exercise a termination option;
- whether a company was reasonably certain to exercise a purchase option; and
- amounts expected to be paid under residual value guarantees.

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

For companies that apply the retrospective approach, are there any practical expedients around lease payments?

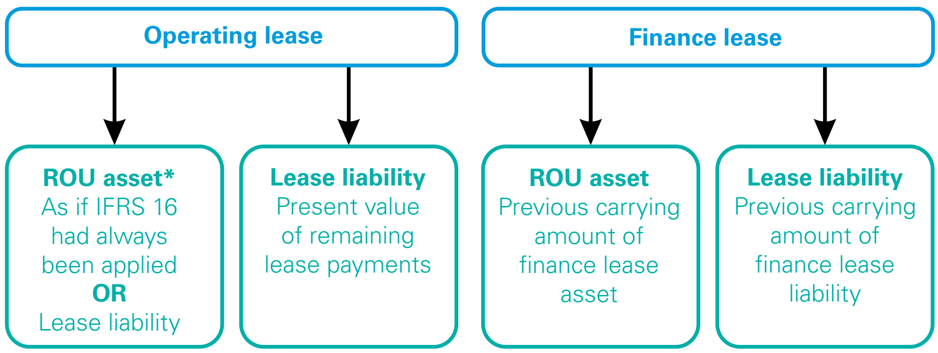
No. Further, although the new standard permits the use of hindsight when applying a modified retrospective method, it does not permit the use of hindsight when applying the retrospective method.

6.4.3 Modified retrospective approach



IFRS 16.C7–C8, C11

If a lessee elects to apply the new standard using the modified retrospective approach, then it does not restate comparative information. Instead, it measures its lease liabilities at the date of initial application as follows.



* Right-of-use asset.

Leases previously classified as operating leases

IFRS 16.C8(a)

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.

IFRS 16.C10

When applying a modified retrospective approach to previous operating leases, a lessee may use one or more of the following practical expedients to measure its lease liabilities.

- Discount rate: apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
- Leases with a short remaining term: account for leases for which the lease term ends within 12 months of the date of initial application as short-term leases.

– Use of hindsight: e.g. in determining the lease term if the contract contains options to extend or terminate the lease.

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

However, there is no practical expedient for the determination of lease payments in an arrangement that contains multiple lease and/or non-lease components.

On the date of initial application, with hindsight, a lessee determines the lease payments based on its estimate of the consideration in the contract and the stand-alone prices.

Example 26 – Determining lease payments on transition when a contract contains multiple components

IFRS 16.13–16, B32–B33

Lessee B leases a photocopier under an operating lease.

Immediately before the date of initial application, the lease has a non-cancellable term of three more years.

The lease payments are 10,000 per annum. The contract includes an additional payment for insurance costs of 100 per annum. Maintenance services are also provided by the lessor.

On transition, B does not apply the practical expedient under paragraph 15. Therefore, B accounts separately for the lease and non-lease components.

At the date of initial application, B is able to determine that similar maintenance services are offered by third parties for 1,000 a year and observable stand-alone photocopiers can be leased for 10,500 a year.

To determine the lease liability on transition, B considers the following.

– The annual lease payments of 10,000 are fixed.

– The lease contains lease and non-lease (i.e. maintenance) components.

– Consideration paid under the contract needs to be allocated to each component on the basis of its relative stand-alone price.

– The observable stand-alone price for maintenance services is 1,000.

– The observable stand-alone price for the lease is 10,500.

– The insurance cost does not transfer a good or service to the lessee and therefore is not a separate component.

Accordingly, B concludes that it should allocate 9,222 to the lease component.

Observable stand-alone price: lease	A	10,500
Observable stand-alone price: maintenance	B	1,000
Total	C = A + B	11,500
Lease component as a percentage of observable prices	D = A / C	91%
Allocation of consideration (10,100) to lease	**D x 10,100**	**9,222**

Leases previously classified as finance leases

IFRS 16.C11

When applying the modified retrospective approach to previous finance leases, a lessee measures the carrying amount of the right-of-use asset and the lease liability as the carrying amount of the lease asset and lease liability under IAS 17 immediately before the date of initial application.

What are the benefits of a modified retrospective approach?

The key benefit is a reduction in the cost of transition 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 period in which it first applies the new standard; and
  - the lessee's remaining lease payments; and
- additional practical expedients are available.

It is therefore possible for a lessee to transition to the new standard using only information about *future* lease payments – i.e. payments payable after the date of initial application. For many lessees, this will be a significant simplification – in terms of the data and the calculations required – compared with the retrospective approach.

If a lessee applies a modified retrospective approach but elects to measure the right-of-use asset for certain assets as if the new standard had always been applied, then additional information about historical lease payments will be required – e.g. information about historical changes in lease payments due to CPI adjustments or market rent reviews.

Appendix I - IFRS 16 at a glance

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

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

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

Appendix II – Lease payments at a glance

Key considerations regarding the lease payments to be included in a lessee's lease liability initially and subsequently are summarised below.

	Initial measurement of lease liability	Reassessment of lease liability
Fixed payments	– Fixed (including in-substance fixed) payments are included in lease liabilities	– Fixed payments: reassessment not applicable – Variable payments that subsequently become in-substance fixed: included in the lease liability; the discount rate is unchanged – Reassessment: adjusted against the right-of-use asset
Payments that depend on an index or rate	– Included in the lease liability and measured using the index or rate at the commencement date of the lease – Examples include payments linked to CPI, a benchmark interest rate (e.g. LIBOR) and payments that are adjusted to reflect market rental rates	– Future lease payments: remeasured based on the index or rate at the reporting date – Reassessment: adjusted against the right-of-use asset – Discount rate: unchanged, except when the payment is based on a floating interest rate
Payments that depend on sales or usage	– Excluded from the measurement of the lease liability – Recognised in profit or loss as they are incurred	– Reassessment not applicable
Amounts payable under lessee purchase, extension and early termination options	– At the commencement date: lessee assesses whether it is reasonably certain to exercise options to purchase or extend the lease – At the commencement date: lessee assesses whether it is reasonably certain not to terminate the lease early	– Reassessment: adjusted against the right-of-use asset – Discount rate: revised
Amounts payable under lessor put option	– Lessee includes the exercise price of the lessor's put option in its lease liability	– Reassessment not applicable
Residual value guarantees	– Amount expected to be payable by the lessee is included in the lease liability	– Reassessment: adjusted against the right-of-use asset – Reassessment: reflects changes in the amount the lessee expects to pay – Discount rate: unchanged

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 2017.

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

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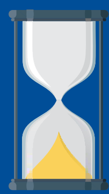

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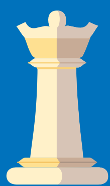

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