



IFRS 16 Leases

A more transparent balance sheet

First Impressions

IFRS

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A more transparent balance sheet

The IASB's new leases standard requires companies to bring most leases on-balance sheet, recognising new assets and liabilities.

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

Companies are currently required to disclose details of their off-balance sheet leases and many analysts use this information to adjust published financial statements. The key change will be the increase in transparency and comparability. For the first time, analysts will be able to see a company's own assessment of its lease liabilities, calculated using a prescribed methodology that all companies reporting under IFRS will be required to follow.

The impacts are not limited to the balance sheet. There are also changes in accounting over the life of the lease. In particular, companies will now recognise a front-loaded pattern of expense for most leases, even when they pay constant annual rentals. And the standard introduces a stark dividing line between leases and service contracts – leases will be brought on-balance sheet, whereas service contracts will remain off-balance sheet.

The new standard takes effect in January 2019. Before that, companies will need to gather significant additional data about their leases, and make new estimates and calculations. The new requirements are less complex and less costly to apply than the IASB's earlier proposals. However, there will still be a compliance cost. For some companies, a key challenge will be gathering the required data. For others, more judgemental issues will dominate – e.g. identifying which transactions contain leases.

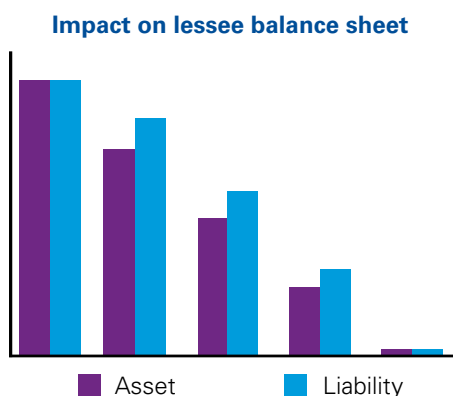
This publication provides an overview of the new standard and how it will affect financial statements. It includes examples and insights to help you assess the potential impact on your business and to assess your readiness for 2019.

Kimber Bascom
Ramon Jubels
Sylvie Leger
Brian O'Donovan

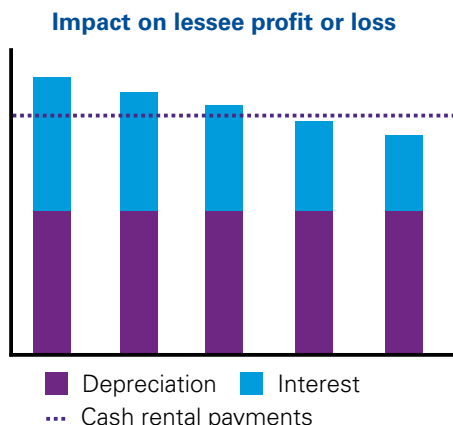
KPMG's global IFRS leases leadership team
KPMG International Standards Group

1 IFRS 16 at a glance

1.1 Key facts



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



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

Topic	IFRS 16	US GAAP standard
Lessee accounting model	<ul style="list-style-type: none"> – Single lease accounting model – No lease classification test – All leases on-balance sheet: <ul style="list-style-type: none"> - lessee recognises a right-of-use (ROU) asset and lease liability - treated as the purchase of an asset on a financed basis 	<ul style="list-style-type: none"> – Dual lease accounting model – Lease classification test based on IAS 17 <i>Leases</i> classification criteria – All leases on-balance sheet: <ul style="list-style-type: none"> - finance leases treated as the purchase of an asset on a financed basis - operating leases generally feature straight-line recognition of total lease expense
Lessor accounting model	<ul style="list-style-type: none"> – Dual lease accounting model for lessors – Lease classification test based on IAS 17 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	<ul style="list-style-type: none"> – 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 – Portfolio-level accounting permitted if it does not differ materially from applying the requirements to individual leases 	
	<ul style="list-style-type: none"> – Optional lessee exemption for leases of low-value items – i.e. assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate 	<ul style="list-style-type: none"> – No exemption for leases of low-value items
Effective date	<ul style="list-style-type: none"> – Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 <i>Revenue from Contracts with Customers</i> is also adopted 	<ul style="list-style-type: none"> – Fiscal years beginning after 15 December 2018 – Early adoption is permitted, even before adoption of the US version of the revenue standard

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 lease agreements and extract all relevant lease data necessary to apply the standard. To apply the simplified model for short-term leases and leases of low-value items, a company will need to identify the lease and extract key lease terms. (See [Section 3](#).)

Changes in key financial metrics. Key financial metrics will be affected by the recognition of new assets and liabilities, and differences in the timing and classification of lease income/expense. This could impact debt covenants, tax balances and a company's ability to pay dividends. (See [4.1](#).)

New estimates and judgements. The standard introduces new estimates and judgemental thresholds that affect the identification, classification and measurement of lease transactions. Senior staff will need to be involved in these decisions – both at lease commencement and at reporting dates as a result of the continuous reassessment requirements. (See [Sections 3 and 4](#).)

Balance sheet volatility. The new standard introduces volatility to assets and liabilities for lessees, due to the requirements to reassess certain key estimates and judgements at each reporting date. This may impact a company's ability to accurately predict and forecast results. (See [4.4.2](#).)

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

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

Some impacts cannot yet be quantified. Companies won't have the full picture until other accounting and regulatory bodies have responded. For example, the new accounting could prompt changes in the tax treatment of leases. And a key question for the financial sector is how the prudential regulators will treat the new assets and liabilities for regulatory capital purposes. (See [4.3](#).)

Transition considerations. A key early decision is how to make the 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 standard and the comparability of trend data in the years after transition. (See [Section 8](#).)

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

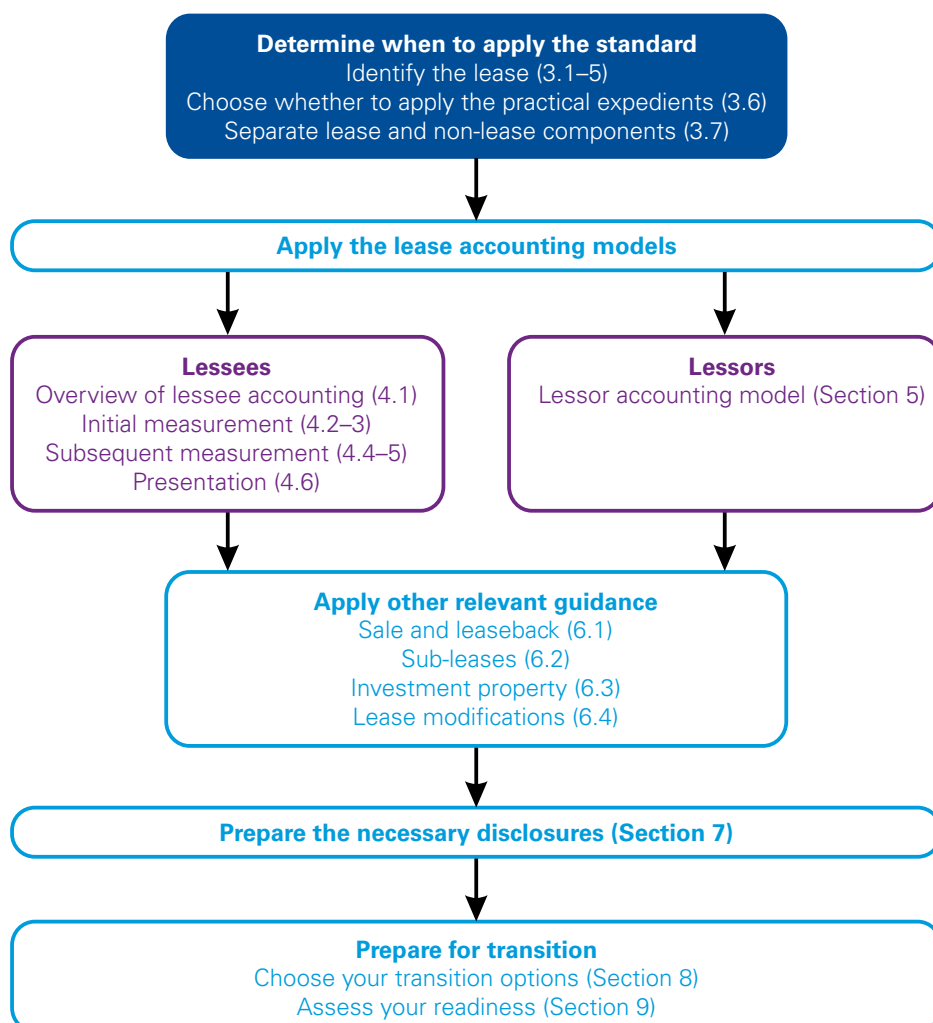
You'll get a feel for the challenge ahead by asking a few simple questions. (See [Section 9](#).)



2

Overview

The following diagram illustrates how key elements of the standard are explained throughout this publication. The corresponding section numbers are in brackets.



3

Lease definition

Lease definition is the new on/off-balance sheet test for lessees – and a key area of judgement in applying the standard.

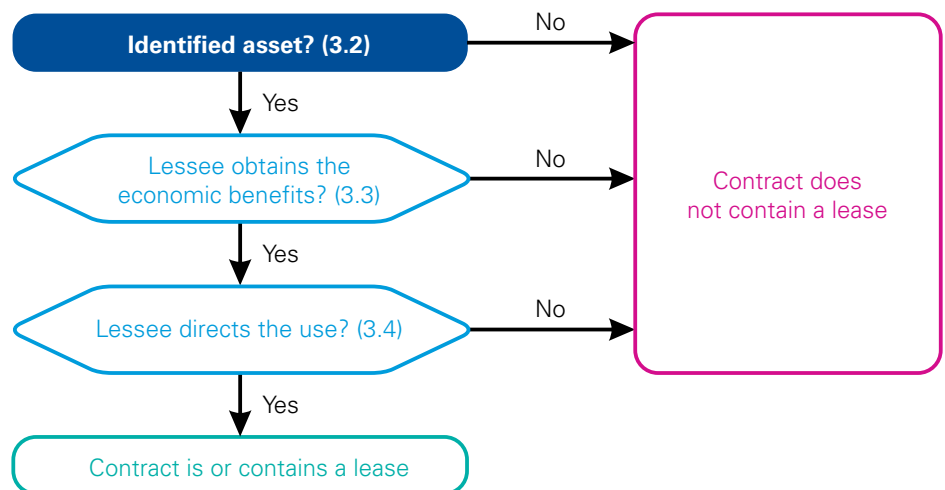
3.1

IFRS 16.9

Overview

A company assesses at inception of a contract whether that contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The key elements of the definition are therefore as follows.



However, a lessee is not required to apply the lessee accounting model to leases that qualify for certain practical expedients (see 3.6).



KPMG insight – Lease definition is the new on/off-balance sheet test

IFRS 16 eliminates the current operating/finance lease dual accounting model for lessees. Instead, there is a single, on-balance sheet accounting model, similar to current finance lease accounting. The question of whether a contract contains a lease determines whether the arrangement is recognised on- or off-balance sheet (as a service contract).

**KPMG insight – Lease definition is superficially similar to the current definition, but some details change**

On a first read, the lease definition seems consistent with current guidance. However, IFRS 16 contains additional application guidance and illustrative examples on how to apply the definition – and there are differences from current practice.

A number of arrangements that are currently accounted for as leases may fall outside the new definition. For example, an arrangement may be a lease under current guidance because the lessee obtains all of an asset's output but does not pay a fixed or market price for each unit of output. Under IFRS 16, it is also necessary to consider whether the lessee has control over the use of the underlying asset. Such an arrangement would be a lease only if the lessee controls the use of the underlying asset.

3.2

IFRS 16.B13–B20

Identified asset

A contract contains a lease only if it relates to an identified asset. An asset can be either explicitly specified in a contract or implicitly specified at the time it is made available for use by the lessee.

However, even if an asset is specified, a lessee does not control the use of an identified asset if the lessor has a *substantive right to substitute* the asset for an alternative asset during the lease term. A lessor's substitution right is 'substantive' if the lessor:

- has the practical ability to substitute the asset; and
- would benefit economically from exercising its right to substitute the asset.

A company assesses whether substitution rights are substantive at inception of the contract. At that time, a company considers all of the facts and circumstances – but not future events that are not likely to occur.

A capacity portion of an asset can be an identified asset if it is physically distinct – e.g. a floor of a building. In addition, a capacity portion that is not physically distinct is also an identified asset if it represents substantially all of the capacity of the entire asset. For example, a capacity portion of a fibre-optic cable:

- is an identified asset if it represents substantially all of the capacity of the cable; and
- is not an identified asset if it represents only part of the capacity of the cable.

**Example 1 – Substantive substitution right**

Lessee L enters into a five-year contract with a freight carrier (Lessor M) to transport a specified quantity of goods. M uses rail cars of a particular specification, and has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. The rail cars and engines are stored at M's premises when they are not being used to transport goods. Costs associated with substituting the rail cars are minimal for M.

In this case, because the rail cars are stored at M's premises, it has a large pool of similar rail cars and substitution costs are minimal, the benefits to M of substituting the rail cars would exceed the costs of substituting the cars. Therefore, M's substitution rights are substantive and the arrangement does not contain a lease.



KPMG insight – Substitution rights will be a key area of focus

Substitution rights are likely to be a key area of focus in applying the lease definition. For example, some element of substitution is often permitted in leases of fleets of vehicles, or portfolios of photocopiers and similar equipment. However, if the underlying asset is with the customer, then the costs of substitution may exceed the benefits, such that the substitution rights are not substantive.

In addition, some real estate leases permit the lessor to relocate the lessee to alternative premises in some circumstances. This may permit the lessor to relocate a lessee to another floor in an office building to accommodate a new tenant, or permit a lessor of a retail park to relocate a lessee to another site in the park to manage footfall.

A key question in such cases is assessing whether the lessor would benefit economically from the substitution, given that the assessment excludes consideration of events that were not likely to occur at inception.

3.3

IFRS 16.B9, B21–B23

Economic benefits

To determine whether a contract conveys the right to control the use of an identified asset, a company assesses whether the customer has the rights to:

- obtain substantially all of the economic benefits from use of the identified asset throughout the period of use; and
- direct the use of the identified asset (see 3.4).

The economic benefits from using an asset include its primary output, by-products and other economic benefits from using the asset that could be realised from a commercial transaction with a third party (e.g. sub-leasing the asset).

These economic benefits need to be in the defined scope of a lessee's right to use an asset – e.g. if a contract limits the use of a vehicle to only one particular territory during the period of use, then a company considers only the economic benefits from use of the vehicle within that territory, and not beyond.

IFRS 16.IE2

**Example 2 – Primary products and by-products**

Utility Company C enters into a 20-year contract with Power Company D to purchase all of the electricity produced by a new solar farm. D owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and C will receive renewable energy credits that accrue from use of the solar farm.

C has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period because it obtains:

- the electricity produced by the farm over the lease term – i.e. the primary product from use of the asset; and
- the renewable energy credits – i.e. the by-product from use of the asset.

Although D receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the *ownership* of the solar farm. The tax credits do not relate to *use* of the solar farm and therefore are not considered in this assessment.

**KPMG insight – Specific guidance on renewable energy credits and tax benefits**

Many jurisdictions have introduced tax and other benefits to stimulate investment in renewable energy technologies – e.g. wind power and solar power. Complex legal structures have been developed to enable multiple investors to invest in these technologies and receive specific benefits – e.g. different parties may be interested in obtaining the power, the renewable energy credits and the income tax benefits. The determination of which outputs should be considered in assessing whether these arrangements contain leases has been hotly debated.

IFRS 16 is more specific in this area than current guidance and has the potential to reduce diversity in assessing whether an arrangement contains a lease. However, questions may still remain, given the variety of arrangements seen in practice.

**KPMG insight – A customer may obtain substantially all of the benefits from use even if lease payments are variable**

IFRS 16.B23

The existence of variable lease payments derived from the use of an asset – e.g. a percentage of sales from use of a retail space – does not prevent a customer from having the right to obtain substantially all of the economic benefits from use of the asset. In such cases, although the customer passes on certain benefits to the supplier, the customer receives the cash flows arising from use of the asset.

IFRS 16 is explicit on this point, to reduce the risk that companies would seek to avoid lease accounting by introducing variable payments into an arrangement that would otherwise be a lease.

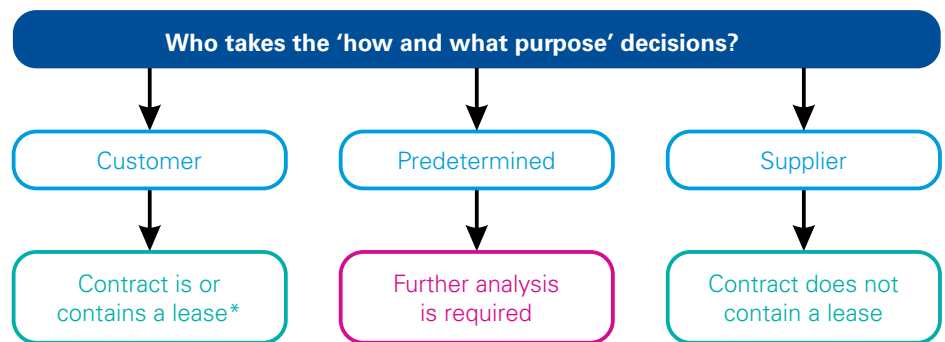
3.4

IFRS 16.B24–B27

Directing the right to use

A lessee has the right to direct the use of an identified asset in either of the following situations:

- if the lessee has the right to direct how and for what purpose the asset is used throughout the period of use; or
- if the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - the lessee has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the lessor having the right to change those operating instructions; or
 - the lessee designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.



* If other criteria are met.

In making this assessment, a company considers the decision-making rights that are most *relevant* to changing how and for what purpose the asset is used – ‘relevant’ in the sense that they affect the economic benefits derived from the use.

Examples of relevant decision-making rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used include:

- rights to change the type of output that is produced by the asset (e.g. deciding whether to use a shipping container to transport goods or for storage);
- rights to change when the output is produced (e.g. deciding when a power plant will be used);
- rights to change where the output is produced (e.g. deciding on the destination of a truck or a ship); and
- rights to change whether the output is produced, and the quantity of that output (e.g. deciding whether to produce energy from a power plant and how much energy).

Examples of decision-making rights that *do not grant* the right to change how and for what purpose the asset is used include: rights to operate an asset or rights to maintain an asset. However, such decision-making rights drive the analysis if the relevant decisions about how and for what purpose an asset is used are *predetermined*.

IFRS 16.IE2

**Example 3 – Right to direct the use**

Customer R enters into a contract with Company S, a ship owner, for the transport of cargo from A Coruña to Hartlepool on an identified ship. The contract details the cargo to be transported on the ship and the dates of pick-up and delivery. The cargo will occupy substantially all of the capacity of the ship. S operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. R is prohibited from hiring another operator for the ship during the term of the contract or operating the ship itself.

R does not have the right to control the use of the ship because it does not have the right to direct its use. R does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship is used – i.e. the journey from A Coruña to Hartlepool transporting specified cargo – is predetermined in the contract. R does not have the right to operate the ship and did not design the ship in a way that predetermined how and for what purpose it would be used. R has the same rights regarding the use of the ship as if it were only one of many customers transporting cargo on the ship. Therefore, the contract does not contain a lease.

IFRS 16.IE2

**Example 4 – Right to direct the use**

Customer T enters into a five-year contract with Company U, a ship owner, for the use of an identified ship. T decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent T from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. U operates and maintains the ship, and is responsible for safe passage.

T has the right to direct the use of the ship. The contractual restrictions are protective rights that protect U's investment in the ship and its personnel (see 3.5). In the scope of its right of use, T determines how and for what purpose the ship is used throughout the five-year period because it decides whether, where and when the ship sails, as well as the cargo that it will transport. T has the right to change these decisions throughout the period of use. Therefore, the contract contains a lease.



KPMG insight – An increased focus on control

IFRS 16 increases the focus on which party controls the use of an identified asset. Under current guidance, an arrangement may be a lease when the customer obtains substantially all of the output or other utility of the asset even if the customer does not control the use of the asset. Under IFRS 16, a lease can exist if, and only if, the customer has the right to both control the use of an identified asset *and* obtain substantially all of the economic benefits from the use of that asset. This is in contrast to a further aspect of current guidance under which an arrangement is a lease when the customer has the right to control the use of an identified asset and obtains more than an insignificant amount of the output or other utility of the asset.

This is likely to mean that some agreements that are currently treated as leases may fall outside the new lease accounting – e.g. some power purchase agreements.



KPMG insight – The assessment of whether an arrangement contains a lease may depend on who controls apparently minor decision-making rights

If the 'how and for what purpose' decisions are predetermined, then the assessment of whether an arrangement contains a lease may depend on which party has the right to operate the asset. That is, relatively minor day-to-day operational decisions may determine the assessment.

This suggests that if the parties predetermine the most important decisions, then they can opt in or out of lease accounting by choosing which party controls day-to-day operations. However, this applies only if the most important decisions are predetermined – i.e. the customer would need to forgo considerable operational flexibility to take advantage of this apparent structuring opportunity.

3.5

IFRS 16.B30

Protective rights

A contract may include certain terms and conditions designed to protect the lessor's interest in the identified asset, to protect its personnel or to ensure the lessor's compliance with laws or regulations. Such protective rights typically define the scope of the lessee's right to use an asset but do not, in isolation, prevent the lessee from having the right to direct the use of the asset within that scope.

For example, a contract may:

- specify the maximum amount of use of an asset or where or when the lessee can use the asset;
- require a lessee to follow particular operating practices; or
- require a lessee to inform the supplier of changes in how an asset will be used.

IFRS 16.IE2

**Example 5 – Protective rights**

Lessee L enters into a two-year contract with Lessor M, an aircraft owner, for the use of an identified aircraft. The contract details the interior and exterior specifications for the aircraft. There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to these restrictions, L determines where and when the aircraft will fly, and which passengers and cargo will be transported on the aircraft. M is responsible for operating the aircraft, using its own crew.

The restrictions on where the aircraft can fly define the scope of L's right to use the aircraft. In the scope of its right of use, L determines how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where and when the aircraft travels, as well as the passengers and cargo that it will transport. L has the right to change these decisions throughout the period of use.

The contractual and legal restrictions on where the aircraft can fly are protective rights and do not prevent L from having the right to direct the use of the asset.

**KPMG insight – A threefold classification of decision-making rights**

IFRS 16 effectively requires a threefold classification of decision-making rights into 'how and for what purpose' decisions, operating decisions and protective rights. The different categories of rights feature in the analysis in different ways.

- **'How and for what purpose' decisions:** These determine whether the arrangement contains a lease, unless they are predetermined.
- **Operating decisions:** These are ignored, unless the 'how and for what purpose' decisions are predetermined, in which case there is a lease if the customer makes the operating decisions.
- **Protective rights:** These typically define the scope of the lessee's right to use an asset but do not, in isolation, preclude a conclusion that there is a lease.

Assessing the categories into which decisions fall is likely to be a key area of judgement in practice.

3.6

IFRS 16.5–8

Practical expedients

A lessee can elect not to apply the lessee accounting model to:

**Short term leases**

≤ 12 months

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

- leases with a lease term of 12 months or less (i.e. short-term leases; see 4.2.2); and
- leases for which the underlying asset is of low value when it is new (even if the effect is material in aggregate).

The election for short-term leases is made by class of underlying asset, whereas the election for leases of low-value assets can be made on a lease-by-lease basis.

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

If a lessee elects the short-term lease recognition exemption and there are any changes to the lease term – e.g. the lessee exercises an option that it had previously determined it was not reasonably certain to exercise – or the lease is modified, then the lessee accounts for the lease as a new lease.

IFRS 16.B34



Example 6 – Applying the short-term leases exemption

Lessee L enters into a 10-year lease of a machine to be used in manufacturing parts for a plane that it expects to remain popular with consumers until it completes development and testing of an improved model. The cost to install the machine in L's manufacturing facility is not significant. L and Lessor M each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date.

The lease term consists of a one-year non-cancellable period because both L and M have a substantive termination right – both can terminate the lease without penalty – and the cost to install the machine in L's manufacturing facility is not significant. As a result, the lease qualifies for the short-term lease exemption.

IFRS 16.IE3



Example 7 – Applying the leases of low value exemption

Lessee B is in the pharmaceutical manufacturing and distribution industry and has the following leases:

- leases of real estate: both office building and warehouse;
- leases of office furniture;
- leases of company cars, both for sales personnel and for senior management and of varying quality, specification and value;
- leases of trucks and vans used for delivery; and
- leases of IT equipment such as laptops.

B determines that the leases of office furniture and laptops qualify for the recognition exemption on the basis that the underlying assets, when they are new, are individually of low value. B elects to apply the exemption to these leases. As a result, it applies the recognition and measurement requirements in IFRS 16 to its leases of real estate, company cars, trucks and vans.

**KPMG insight – Significant relief for preparers but a potentially material impact on the financial statements**

Applying the new definition is likely to be one of the biggest practice issues under IFRS 16. However, the significant practical expedients ease the pressure on the application of the lease definition and reduce compliance costs for preparers. The exemptions permit a lessee to account for qualifying leases in the same manner as existing operating leases and to disclose only the income statement expense relating to these leases, rather than provide detailed disclosures under IAS 17.

The exemption for leases of low-value items intends to capture leases that are high in volume but low in value – e.g. leases of small IT equipment (laptops, mobile phones, simple printers), leases of office furniture etc. IFRS 16 does not define 'low-value', but in its basis for conclusions refers to assets with a value of USD 5,000 or less when they are new. This may mean that an entity that leases many such items may avoid recognition of a lease liability that would be, in aggregate, material – e.g. a professional services firm that leases personal IT equipment for its staff.

IFRS 16.BC100**KPMG insight – Difference from US GAAP for leases of low-value items**

US GAAP preparers will not benefit from the exemption for leases of low-value items. However, if these leases are classified as operating leases under the FASB approach – generally resulting in straight-line recognition of income and expense – then this GAAP difference will typically be limited to the balance sheet.

3.7

*IFRS 16.12**IFRS 16.B32–B33*

Lease and non-lease components

If a contract is, or contains, a lease, then the company accounts for each separate lease component, separately from non-lease components.

Step 1: Identify the component(s)

A company considers the right to use an underlying 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 a company allocates to the identified components.

Step 2: Account for the component(s)

Lessee perspective

IFRS 16.13–16

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

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

The lessee determines 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.

As a *practical expedient* a lessee can elect, by class of underlying asset, not to separate lease components from any associated non-lease components. A lessee that takes this election accounts for the lease component and the associated non-lease components as a single lease component.

Unless a lessee applies the practical expedient, it accounts for non-lease components in accordance with other applicable standards.

Lessor perspective

IFRS 16.17

If a contract contains a lease component and one or more additional lease or non-lease components, then the lessor allocates the consideration in the contract in accordance with the requirements of IFRS 15 – i.e. according to the stand-alone selling prices of the goods and services included in each component.

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

	Lessee	Lessor
When there is an observable stand-alone price for each component	Unless the practical expedient is elected (see below), separate and allocate based on the relative stand-alone price of components	Always separate and allocate following the IFRS 15 approach – i.e. on a relative stand-alone selling price basis
When there is not an observable stand-alone price for some or all components	Maximise the use of observable information	
Taxes, insurance on the property and administrative costs	Activities (or costs of the lessor) that do not transfer a good or service to the lessee are not components in a contract	

Practical expedient: accounting policy election by class of underlying asset	Combine lease and any associated non-lease components and account for them as lease components	N/A
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Example 8 – Accounting for lease and non-lease components

Lessee L enters into a five-year lease contract with Lessor M to use an operating oil rig. The contract includes maintenance services provided by M. M obtains its own insurance for the oil rig. Annual payments are 2,000 (300 relate to maintenance services and 50 to insurance costs). L is able to determine that similar maintenance services and insurance costs are offered by third parties for 400 and 50 a year, respectively. L is unable to find an observable stand-alone rental amount for a similar oil rig because none is leased without related maintenance services provided by the lessor.

In this case:

- the observable stand-alone price for maintenance services is 400;
- there is no observable stand-alone price for the lease; and
- the insurance cost does not transfer a good or service to the lessee and therefore is not a separate lease component.

Therefore, L allocates 1,600 (2,000 - 400) to the lease component.



KPMG insight – Consistency with IFRS 15

Under IFRS 16, lessors allocate the consideration of a lease contract between lease and non-lease components in broadly the same way that a vendor allocates the consideration for performance obligations in a contract with customers under IFRS 15.

This broad consistency between the two standards will help to reduce the cost and complexity of applying them. This may be an important consideration for some companies when deciding whether to early adopt IFRS 16 (see [Section 8](#)).

Also, the practical expedient for lessees not to separate a lease component has the potential to reduce cost and complexity in some cases. However, lessees may find the accounting consequences unattractive. In effect, using this practical expedient results in recognition by the lessee of a liability for the service component of the contract, which would otherwise remain off-balance sheet until the lessor performs.

4

Lessee accounting

The key objective of the new standard is to ensure that lessees recognise assets and liabilities for their major leases.

4.1

IFRS 16.22

IFRS 16.47, 49

Lessee accounting model

A lessee applies a single lease accounting model under which it recognises all major leases on-balance sheet.

Balance sheet

Asset

= 'Right-of-use' of underlying asset

Liability

= Obligation to make lease payments

Profit or loss

Lease expense

Depreciation

+

Interest

=

Front-loaded total lease expense



KPMG insight – Major impacts for lessees

Currently, many analysts routinely adjust lessees' reported financial figures to reflect commitments under leases that are classified as operating leases, based on the amounts disclosed in accordance with IAS 17 and IFRS 7 *Financial Instruments: Disclosures*. These adjustments require a high degree of judgement and effort.

Bringing operating leases on the balance sheet will make companies appear to be more asset-rich but also more heavily indebted. Moreover, it will change the presentation of:

- expenses in the statement of profit or loss and other comprehensive income; and
- cash flows in the statement of cash flows (see 4.6).

The additional assets and liabilities recognised and the change in presentation will affect key performance ratios – e.g. asset ratios and debt/equity ratios – and consequently could impair the ability to satisfy any debt covenants that are not applied on a 'frozen GAAP' basis.



KPMG insight – A pre-tax accounting model

Tax considerations are often a major factor when a company is assessing whether to lease or buy an asset, and when a lessor is pricing a lease contract. However, the new requirements continue to address lessee (and lessor) accounting on a pre-tax basis.

The income tax accounting for lease contracts remains in the scope of IAS 12 *Income Taxes*. It appears that the current complexities in accounting for income taxes by lessees of on-balance sheet leases will continue. These complexities include, for example, how to apply the initial recognition exemption and whether the ‘right-of-use’ asset and the lease liability should be considered to be linked for the purposes of the income tax analysis.

IFRS 16.BC304



KPMG insight – Unlike IFRS, US GAAP retains a dual accounting model for lessees

Although IFRS 16 contains a single lessee accounting model, US GAAP will feature a dual model for lessee accounting – i.e. finance vs operating leases. Under US GAAP, finance leases will be accounted for in the same way as under the IASB’s model. Operating leases will also be presented on the balance sheet with a right-of-use asset and a lease liability.

However, for operating leases, lease expense will typically be recognised on a straight-line basis – i.e. not front-loaded – and presented as a single amount within operating expenses. In order to achieve this profile of lease expense, the lessee will measure the right-of-use asset as a balancing figure – i.e. a plug. In addition, lease payments for operating leases will be presented within operating activities in the statement of cash flows.

4.2

4.2.1

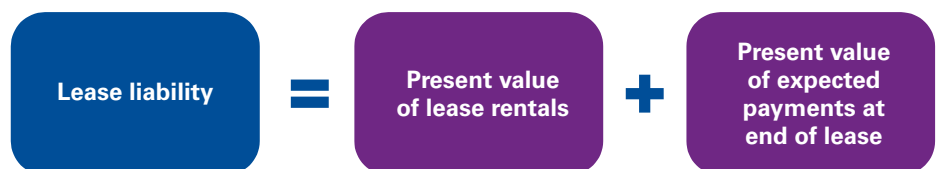
IFRS 16.26

IFRS 16.27

Initial measurement of the lease liability

Overview

At the commencement date, a lessee measures the lease liability at the present value of the future lease payments.



The key inputs to this calculation are as follows.



KPMG insight – Lease liability includes items that would be recognised separately under the financial instruments standard

Lease liabilities are financial liabilities. However, they will generally be measured in accordance with IFRS 16 – not IFRS 9 *Financial Instruments*. This will represent a considerable simplification compared with financial instruments accounting in some cases. For example, common features of lease agreements – e.g. renewal and purchase options – will not be accounted for separately, nor, potentially, result in the liability being measured at fair value.

IFRS 9.2.1(b)

4.2.2

IFRS 16.18, B35

Lease term

The lease term is the non-cancellable period of the lease, together with:

- optional renewable periods if the lessee is reasonably certain to extend; and
- periods after an optional termination date if the lessee is reasonably certain not to terminate early.

Termination options held only by the lessor are not considered when determining the lease term.

IFRS 16.A, B36

The lease term starts when the lessor makes the underlying asset available for use by the lessee. It includes any rent-free periods provided.

IFRS 16.B37

When determining the lease term, lessees consider all relevant facts and circumstances that create an economic incentive to exercise or forfeit options to renew and terminate early.

Examples of relevant facts and circumstances

Contractual/market

- Level of rentals in any secondary period compared with market rates
- Contingent payments
- Renewal and purchase options
- Costs relating to the termination of the lease and the signing of a new replacement lease
- Returning costs of the underlying asset

Asset

- Nature of item (specialised)
- Location
- Availability of suitable alternatives
- Existence of significant leasehold improvements



Example 9 – Significant economic incentive to renew

Lessee X enters into a non-cancellable lease contract with Lessor L to lease a building. The lease is for four years initially, and X has the option to extend the lease by another four years at the same rental.

To determine the lease term, X considers the following factors.

- Market rentals for a comparable building in the same area are expected to increase by 10% over the eight-year period covered by the lease. At inception of the lease, lease rentals are in accordance with current market rents.
- X intends to stay in business in the same area for at least 10 years.
- The location of the building is ideal for relationships with suppliers and customers.

X concludes that it has a significant economic incentive to extend the lease. Therefore, for the purpose of accounting for the lease, X uses a lease term of eight years.



Example 10 – No significant economic incentive to renew

Lessee Y enters into a lease of a three-year-old machine. The non-cancellable lease term is 10 years. Y has the option to extend the lease after the initial 10-year period for optional periods of 12 months each at market rents.

To determine the lease term, Y considers the following factors.

- The machine is to be used in manufacturing parts for a type of plane that Y expects will remain popular with customers until development and testing of an improved model are completed in approximately 10 years.
- The cost to install the machine in Y's manufacturing facility is not significant.
- The non-cancellable term of Y's manufacturing facility lease ends in 14 years, and Y has an option to renew that lease for another eight years.

- Y does not expect to be able to use the machine in its manufacturing process for other types of planes without significant modifications.
- The total remaining life of the machine is 25 years.

Y notes that the terms for the optional renewal provide no economic incentive and the cost to install is insignificant. Y has no incentive to make significant modifications to the machine after the initial 10-year period. Therefore, Y does not expect to have a business purpose for using the machine after the non-cancellable lease term.

Y therefore concludes that the lease term consists of the 10-year non-cancellable period only.



KPMG insight – Lease term is a critical estimate

The assessment of the lease term is a critical estimate and a key input to the amount of the lease liability. This is because the lease term determines which lease payments are included in the measurement of the lease liability.

4.2.3

IFRS 16.27

Lease payments

At the commencement date, a lessee includes the following payments relating to the use of the underlying asset in the measurement of the lease liability:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- variable lease payments that depend on an index or a 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 if the lease term reflects early termination.

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.B42

IFRS 16.27, 38, B42

**Example 11 – In-substance fixed payments**

Company W leases a production line. The lease payments depend on the number of operating hours of the production line – i.e. W has to pay 1,000 per hour of use. The annual minimum payment is 1,000,000. The expected usage per year is 1,500 hours.

This lease contains in-substance fixed payments of 1,000,000 per year, which are included in the initial measurement of the lease liability. The additional 500,000 that W expects to pay per year are variable payments that do not depend on an index or rate and, therefore, are not included in the initial measurement of the lease liability but are expensed as the 'over-use' occurs.

IFRS 16.27

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

**Example 12 – Variable payments not depending on an index or rate**

Company X leases a store. The lease payments for the store 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, X measures the lease liability at the commencement of the lease as zero.

IFRS 16.28

**Example 13 – Variable payments depending on an index**

Company Y rents an office building. The initial annual rental payment is 2,500,000. The rent will be reviewed every year and increased by the change in the consumer price index (CPI).

This is an example of a variable lease payment that depends on an index. The initial measurement of the lease liability is based on the value of the CPI on lease commencement – i.e. Y assumes an annual rental of 2,500,000. If during the first year of the lease the CPI increases by 5%, then at the end of the first year the lease liability is recalculated assuming future annual rentals of 2,625,000 (i.e. $2,500,000 \times 1.05$).

IFRS 16.27, B37

Lessees determine whether it is reasonably certain that they will exercise a purchase option considering all relevant facts and circumstances that create an economic incentive to do so. This is similar to the approach for assessing whether a lessee expects to exercise a renewal option (see 4.2.2).

If a lessee provides a residual value guarantee, then it includes in the lease payments the amount that it expects to pay under that guarantee.



Example 14 – 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 inception of the lease, Z expects that the fair value of the car at the end of the lease term will be 400.

Z therefore includes an amount of zero in the lease payments when calculating its lease liability.

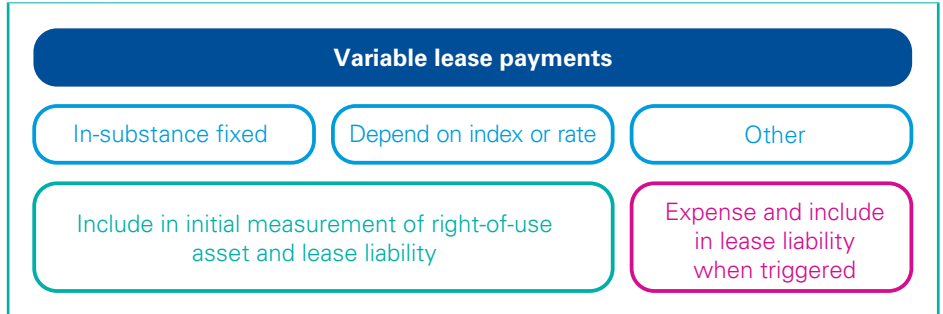


KPMG insight – Initial measurement of the lease liability includes only certain variable lease payments

Similar to current practice, the initial measurement of the lease liability includes variable lease payments that depend on an index or rate – e.g. the CPI or a market interest rate – and payments that appear to be variable but are in-substance fixed payments.

Other variable payments are excluded from the initial measurement of the lease liability. Instead, such payments – e.g. payments based on revenues or usage – are recognised in profit or loss in the period during which the event or condition that triggers those payments occurs. This has a number of important consequences.

- The requirement to expense other variable payments as they are incurred represents a considerable simplification compared with earlier drafts of the standard. Many lessees will be relieved that the IASB stepped back from its earlier proposal that an entity estimate all variable payments on lease commencement.
- A lessee's apparent indebtedness will depend on the mix of fixed and variable payments within its lease portfolio. For example, suppose that Retailer X leases a portfolio of retail outlets with fixed lease payments. Retailer Y leases a similar portfolio of retail outlets on similar terms but with a mix of fixed lease payments and lease payments that depend on turnover. X will recognise higher lease liabilities than Y – even if the total expected lease payments for X and Y are the same.
- Some power purchase agreements that are leases may result in a lease liability of zero for the lessee. For example, if a lessee enters into an agreement to purchase all of the electricity produced by a wind farm or hydroelectric plant and the lease payments all depend on the amount of electricity produced, then the lessee's lease liability will be zero.



KPMG insight – Exercise of purchase option is a critical estimate

The assessment of whether the exercise of a purchase option is reasonably certain is a critical estimate and a key input to the amount of the lease liability. Lessees have to carefully consider all relevant facts and circumstances (see 4.2.2) to determine whether there is an economic incentive to purchase.

KPMG insight – Initial measurement of residual value guarantees differs from current practice

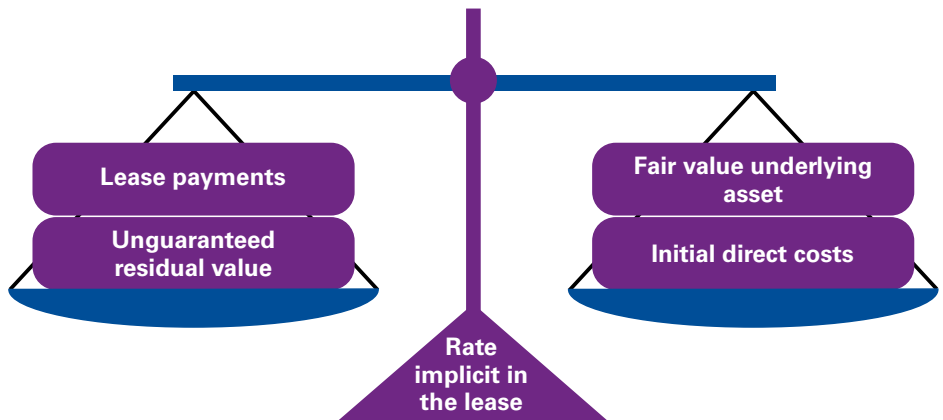
Amounts payable under residual value guarantees are currently included in a lessee’s minimum lease payments under IAS 17. However, the amount to be included under IAS 17 is the maximum exposure under the guarantee, not the expected amount payable. Therefore, amounts relating to residual value guarantees included in lease payments under IFRS 16 will usually be lower.

4.2.4

IFRS 16.26, A

Discount rate

Lessees calculate the present value of the lease payments using the interest rate implicit in the lease. This is the rate that causes the present value of the lease payments and the unguaranteed residual value to equal the sum of the fair value of the underlying asset and any initial direct costs of the lessor.



If the lessee cannot readily determine the interest rate implicit in the lease, then the lessee uses its incremental borrowing rate. This is the rate that a lessee would have to pay on the commencement date of the lease for a loan of a similar term, and with similar security, to obtain an asset of similar value to the right-of-use asset in a similar economic environment.



KPMG insight – Lessees may not be able to determine the rate implicit in the lease

Measuring the lease liability at the interest rate that the lessor charges the lessee enables the specific circumstances of a lease – including the structured financing of the arrangement or tax benefits inherent within the return agreed between the lessee and the lessor – to be captured in the lease accounting.

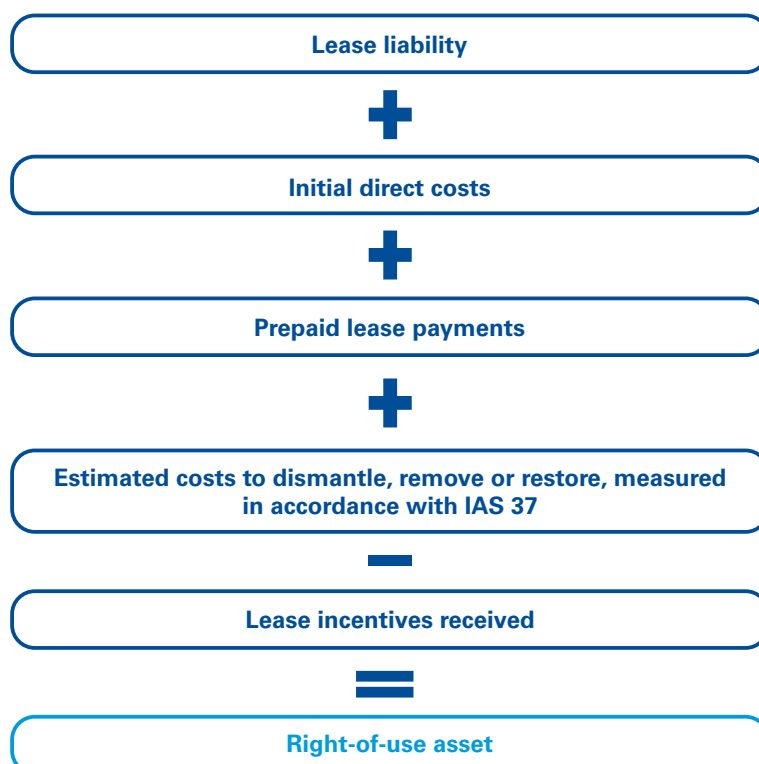
However, it may be difficult for a lessee to determine the rate that the lessor charges the lessee. For example, a lessee will often not know the amount of the lessor’s initial direct costs, or will have only limited information about the expected residual value of the underlying asset at the end of the lease term. As a result, it appears likely that lessees will often use their incremental borrowing rate.

4.3

IFRS 16.23–24

Initial measurement of the right-of-use asset

At the commencement date, a lessee measures the right-of-use asset at a cost that includes the following.





IFRS 16.A

A lessee's 'initial direct costs' are the incremental costs of obtaining a lease that would otherwise not have been incurred.

IFRS 16.IE5

Payments that a lessee receives or makes and that are related to a separate asset – e.g. reimbursements from the lessor for leasehold improvements – are not included in the measurement of the right-of-use asset, but are accounted for separately.

Typical initial direct costs of a lessee	
Include 	Exclude 
<ul style="list-style-type: none"> – Commissions – Legal fees* – Costs of negotiating lease terms and conditions* – Costs of arranging collateral – Payments made to existing tenants to obtain the lease <p>* If they are contingent on origination of the lease</p>	<ul style="list-style-type: none"> – General overheads – Costs to obtain offers for potential leases



KPMG insight – Similar to costs of acquiring other non-financial assets

Broadly, the initial measurement of a lessee's right-of-use asset (i.e. a non-financial asset) is consistent with most other non-financial assets that are measured initially at cost (e.g. assets measured in accordance with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*).



KPMG insight – Right-of-use asset is neither an intangible asset nor an item of property, plant and equipment

IFRS 16 does not specify that a right-of-use asset is in the scope of either IAS 16 or IAS 38. Instead, it appears that a right-of-use asset is a new category of asset in the scope of IFRS 16 itself.

This could have important consequences for assessing some of the impacts of the new standard. Companies won't have the full picture until other accounting and regulatory bodies have responded. For example, the new accounting could prompt changes in the tax treatment of leases. A key question for the financial sector is how the prudential regulators will treat the new assets and liabilities for regulatory capital purposes.

4.4

4.4.1

IFRS 16.36

Subsequent measurement of the lease liability

Measurement basis

After initial recognition, the lease liability is measured at amortised cost using the effective interest method.



Example 15 – Measurement at amortised cost

Lessee X has entered into a contract with Lessor L to lease a building for seven years. The annual lease payments are 450, payable at the end of each year. X's incremental borrowing rate – i.e. the effective interest rate – is 5.04%.

The initial recognition of the obligation to make lease payments is 2,600. At the end of Year 1, X pays the first annual lease payment of 450 to L: of that, 131 ($2,600 \times 5.04\%$) is interest; and 319 ($450 - 131$) is principal, which decreases the liability by 319.

The carrying amount of the liability at the start of Year 2 is 2,281 ($2,600 - 319$).



KPMG insight – No option to measure lessee's lease liability at fair value

Lessees cannot choose to measure lease liabilities subsequently at fair value. This is consistent with the measurement basis of finance lease liabilities under IAS 17.

IFRS 16.BC183

4.4.2

Reassessment of the lease liability

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

IFRS 16.40–43, B42

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

an unchanged discount rate when:

- the amount expected to be payable under the residual value guarantee changes;
- future lease payments change to reflect market rates (e.g. based on a market rent review) or a change in an index or rate* 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;
- the lease term changes; or
- the assessment of the exercise of a purchase option changes.

* Other than changes in floating interest rates.



Example 16 – Change in variable payments 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, in arrears. Y's incremental borrowing rate is 5.9%. Additionally, the lease contract states that 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. 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
<i>To recognise lease at commencement date</i>		
Depreciation	131	
Right-of-use asset		131
Interest expense (655 x 5.9%)	39	
Lease liability (155 - 39)	116	
Cash (payment for Year 1)		155
<i>To recognise payment and expenses for Year 1</i>		

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 ($155 \times 125 / 120$). Because the lease payments are variable payments that depend on an index, Y adjusts the lease liability to reflect the change. 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% (21).

	Debit	Credit
Right-of-use asset	21	
Lease liability		21
<i>To recognise remeasurement</i>		

Remeasurements of variable lease payments that depend on an index and relate to future periods are reflected in the carrying amount of the right-of-use asset (see 4.5).



KPMG insight – Reassessment is a significant difference from current lease accounting

The reassessment of key judgements – e.g. the lease term – at each reporting date is a significant change from IAS 17. It is no longer possible for companies to compute a lease amortisation schedule on lease commencement and roll that schedule forward at each reporting date. Instead, companies need to reassess key judgements and consider the need to remeasure lease balances each time they report.

Remeasurements during the lease term provide more up-to-date information to users of financial statements. However, they also introduce new volatility in reported assets and liabilities, which may impact the ability to accurately predict and forecast future financial performance. Additional resources will be focused on lease accounting not only at lease commencement, but also at each reporting date.

Significant judgement is likely to be needed in determining whether there is a change in relevant factors or a change in the lessee's economic incentive to exercise or not to exercise renewal or termination options. Additionally, it is unclear how – in practice – an entity would ignore changes in market-based factors (e.g. market rates) when performing a reassessment of the lease term.

The company's reassessment of key judgements may, in some cases, have a significant impact on the lease amounts recognised in the statement of financial position and the statement of profit or loss and other comprehensive income.

4.5

Subsequent measurement of the right-of-use asset

4.5.1

IFRS 16.29–30

IFRS 16.30(b), 38(b), 39

IFRS 16.34–35

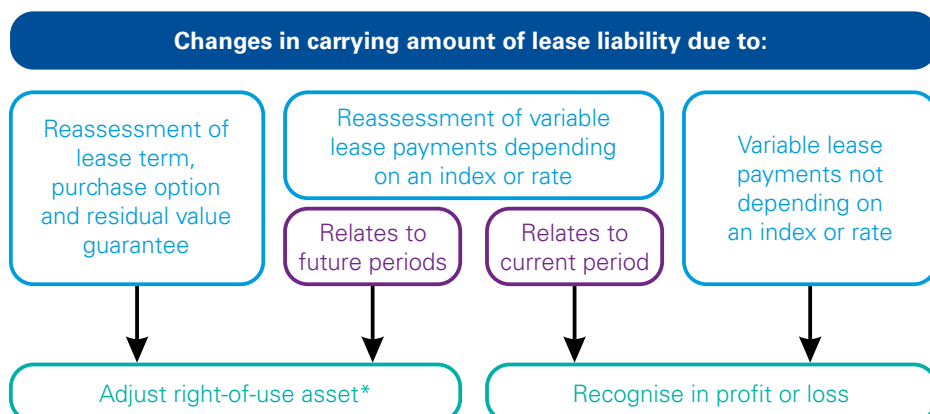
Measurement basis

Generally, a lessee measures right-of-use assets at cost less accumulated depreciation (see 4.5.2) and accumulated impairment losses (see 4.5.3).

Lessees adjust the carrying amount of the right-of-use asset for remeasurement of the lease liability (see 4.4.2), unless the carrying amount has already been reduced to zero or the change in the lease liability relates to a variable lease payment that does not depend on an index or rate.

A lessee applies alternative measurement bases in two circumstances:

- if the right-of-use asset meets the definition of investment property, then the lessee measures the right-of-use asset in accordance with its accounting policy for other investment properties, which may be at fair value (see 6.3); and
- if a lessee applies the revaluation model to a class of property, plant and equipment, then it may apply the revaluation model to all right-of-use assets that belong to the same class.



* If the carrying amount of the right-of-use asset is reduced to zero, then any further reductions are recognised in profit or loss.



KPMG insight – Subsequent measurement is always at cost if the underlying asset is an intangible

The revaluation model can only be applied to right-of-use assets for which the underlying asset is tangible. It will not be applicable if the underlying asset is an intangible for which a lessee voluntarily applied the leases requirements. However, this will only have a limited impact in practice because most intangible assets do not qualify for the revaluation model.

4.5.2

IFRS 16.31, IAS 16.60

IFRS 16.32

Depreciation of the right-of-use asset

Lessees depreciate right-of-use assets in accordance with the requirements of IAS 16 – i.e. the depreciation method reflects the pattern in which the future economic benefits of the right-of-use asset are consumed. This will often result in a straight-line depreciation charge.

Depreciation starts at the commencement date of the lease. The period over which the asset is depreciated is determined as follows:

- if ownership of the underlying asset is transferred to the lessee, or the lessee is reasonably certain to exercise a purchase option, then the depreciation period runs to the end of the useful life of the underlying asset; otherwise
- the depreciation period runs to the earlier of the end of the useful life of the right-of-use asset or the end of the lease term.



Example 17 – Depreciation period

Lessee X enters into a non-cancellable, non-renewable five-year lease with Lessor L for a machine that will be used in X's manufacturing process. The useful life of the underlying machine is 10 years and ownership remains with L.

X depreciates the right-of-use asset beginning at the commencement date over a period of five years, because it intends to use the machine for the entire lease term.

IFRS 16.31, IAS 16.43



KPMG insight – Applying the component approach

Although IFRS 16 does not specify whether a right-of-use asset is a tangible or intangible asset, it does specify that a lessee applies the depreciation requirements in IAS 16 and therefore identifies separate components for the purposes of depreciation. This could be an important practical consideration for lessees that currently lease big-ticket items under operating leases and adopt a component approach to maintenance accounting – e.g. major maintenance checks in some aircraft leases.



KPMG insight – Total lease expense is front-loaded

Lessees will generally depreciate the right-of-use asset on a straight-line basis and measure the lease liability at amortised cost using the effective interest method. As a result, the total lease expense will generally be front-loaded. The front-loaded effect arises from the combination of straight-line depreciation coupled with a declining interest expense as the lease liability is drawn down over the lease term. This front-loaded expense profile is typical of current finance lease accounting.

The front-loaded expense pattern may average out across a portfolio of leases in a large, stable business. However, there may be significant effects in aggregate for a growing business, or a business that is undertaking a major refresh of its portfolio of leased assets – e.g. an airline that is introducing a new model of aircraft across its fleet.

4.5.3

IFRS 16.33, IAS 36.63

Impairment of the right-of-use asset

Lessees apply IAS 36 *Impairment of Assets* to determine whether a right-of-use asset is impaired and to account for any impairment. After recognition of an impairment loss, the future depreciation charges for the right-of-use asset are adjusted to reflect the revised carrying amount.



Example 18 – Impairment of a right-of-use asset

Lessee Y leases a machine for its manufacturing process over a non-cancellable 10-year period. The initial carrying amount of the right-of-use asset is 1,000, which is subsequently measured at cost and depreciated on a straight-line basis over a period of 10 years – i.e. the depreciation charge per year amounts to 100.

At the end of Year 5, the cash-generating unit that includes the right-of-use asset is impaired. An impairment charge of 200 is allocated to the right-of-use asset.

Immediately before the impairment, the carrying amount of the right-of-use asset is 500. Following the impairment, the carrying amount is reduced to 300 and the future depreciation charges are reduced to 60 (300 / 5) per year.



KPMG insight – Impairment testing replaces onerous leases

In effect, the impairment test replaces the current requirement to assess whether an operating lease is onerous. Because a lessee now recognises a lease liability for its obligation to make lease payments, there is no additional provision to recognise. Instead, the lessee assesses the right-of-use asset for impairment.

Impairment testing may increase the financial reporting burden for lessees. Operating leases are currently assessed to determine whether they have become onerous, but not tested for impairment. Applying the impairment test requirements may be more complex, particularly for right-of-use assets that are not part of a larger cash-generating unit.

4.6

IFRS 16.47–50

Presentation

Lessees present leases in their financial statements as follows.

Statement of financial position	Statement of profit or loss and other comprehensive income	Statement of cash flows
<p>Right-of-use asset</p> <ul style="list-style-type: none"> – Separate presentation in the statement of financial position* or disclosure in the notes to the financial statements <p>Lease liability</p> <ul style="list-style-type: none"> – Separate presentation in the statement of financial position or disclosure in the notes 	<p>Lease expenses</p> <ul style="list-style-type: none"> – Separate presentation of interest expense on the lease liability from depreciation of the right-of-use asset – Presentation of interest expenses as a component of finance costs 	<p>Operating activities</p> <ul style="list-style-type: none"> – Variable lease payments not included in the lease liability – Payments for short-term and low-value leases (subject to use of recognition exemption) <p>Financing activities</p> <ul style="list-style-type: none"> – Cash payments for principal portion of lease liability <p>Depending on ‘general’ allocation</p> <ul style="list-style-type: none"> – Cash payments for the interest portion are classified in accordance with other interest paid

* Right-of-use assets that meet the definition of investment property are presented within investment property.



KPMG insight – More detailed presentation requirements

In general, the presentation requirements are more detailed than under IAS 17 – especially in respect of the presentation in the statement of cash flows. This may represent a change in practice for many companies.



KPMG insight – EBITDA will increase

For most leases, expenses are presented as depreciation and interest expense – except for variable payments that are expensed as they are incurred. As a result, the lessee’s EBITDA will increase.

Summary of impact on key financial ratios



Profit or loss

EBITDA

Balance sheet

Total assets

Ratios

Gearing



EPS
(in early years)

Net assets

Interest cover
Asset turnover

5

Lessor accounting

Lessor accounting remains similar to current requirements, though some details change.

IFRS 16.61–62

A lessor classifies a lease as either a finance lease or an operating lease, as follows:

- leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases; and
- all other leases are operating leases.

The lease classification test is essentially unchanged from IAS 17.



Example 19 – Lease classification

Lessor L enters into a non-cancellable lease contract with Company X under which X leases non-specialised equipment for five years. The economic life of the equipment is estimated to be 15 years and legal title will remain with L. The lease contract contains no purchase, renewal or early termination options. The fair value of the equipment is 100,000 and the present value of the lease payments amounts to 50,000.

In assessing the classification of the lease, L notes that:

- the lease does not transfer ownership of the equipment to X;
- X has no option to purchase the equipment;
- the lease term is for one-third of the economic life of the equipment, which is less than the major part of the economic life;
- the present value of the lease payments amounts to 50% of the fair value of the equipment, which is less than substantially all of the fair value; and
- the equipment is not specialised.

L notes that there are no indicators that the lease is a finance lease and that, based on an overall evaluation of the arrangement, the lease does not transfer substantially all of the risks and rewards incidental to the ownership of the equipment to X.

Therefore, L classifies the lease as an operating lease.

The lessor accounting models are also essentially unchanged from IAS 17.

Finance lease	Operating lease
Statement of financial position	
<p><i>IFRS 16.67, 83, 88</i></p> <ul style="list-style-type: none"> – Derecognise the underlying asset – Recognise a finance lease receivable 	<ul style="list-style-type: none"> – Continue to present the underlying asset – Add any initial direct costs incurred in connection with obtaining the lease to the carrying amount of the underlying asset
Statement of profit or loss	
<p><i>IFRS 16.71, 74–75, 81–82</i></p> <ul style="list-style-type: none"> – Recognise finance income on the receivable based on the effective interest method <p><i>In addition, manufacturer or dealer lessors recognise for finance leases:</i></p> <ul style="list-style-type: none"> – revenue based on the lower of the fair value of the underlying asset and the present value of the lease payments – cost of sales based on cost or carrying amount of the underlying asset, less the present value of any unguaranteed residual value – costs incurred in connection with obtaining the lease as an expense 	<ul style="list-style-type: none"> – Recognise lease income over the lease term, typically on a straight-line basis – Expense costs related to the underlying asset – e.g. depreciation

IFRS 16.67, 70, A

A lessor initially measures a finance lease receivable at the present value of the future lease payments plus any unguaranteed residual value accruing to the lessor. The lessor discounts these amounts using the rate implicit in the lease.

A lessor includes the following lease payments in the measurement of the finance lease receivable:

- fixed payments (including in-substance fixed payments), less lease incentives payable;
- variable payments that depend on an index or rate;
- residual value guarantees provided to the lessor at the guaranteed amount;
- the exercise price of purchase options if the lessee is reasonably certain to exercise; and
- termination penalties payable in accordance with the expected lease term.

IFRS 16.BC289–BC290



KPMG insight – Limited impact on lessors

The IASB's stated aim has been to minimise changes to lessor accounting. Much of the guidance in IFRS 16 on lessor accounting is a direct 'cut and paste' from IAS 17. This reflects feedback from users and other stakeholders that lessor accounting is 'not broken'.

However, there are a number of changes in the details of lessor accounting. For example, lessors apply the new:

- definition of a lease (see [Section 3](#));
- sale-and-leaseback guidance (see [6.1](#));
- sub-lease guidance (see [6.2](#)); and
- disclosure requirements (see [7.3](#)).

In addition, IFRS 16 includes specific guidance on accounting for lease modifications by lessors (see [6.4.2](#) and [6.4.3](#)).



KPMG insight – Lessor and lessee models are inconsistent

A key consequence of the decision to retain the IAS 17 dual accounting model for lessors is a lack of consistency with the new lessee accounting model. This can be seen in Example 19 above:

- the lessee applies the right-of-use model and recognises a right-of-use asset and a liability for its obligation to make lease payments; whereas
- the lessor continues to recognise the underlying asset and does not recognise a financial asset for its right to receive lease payments.

There are also more detailed differences. For example, lessees and lessors use the same guidance for determining the lease term and assessing whether purchase options are reasonably certain to be exercised. However, unlike lessees, lessors do not reassess their initial assessments 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.

6

Other lease topics

The standard includes specific guidance on other lease accounting topics that is generally more detailed and prescriptive than existing requirements.

6.1

IFRS 16.98–103

Sale-and-leaseback transactions

In a sale-and-leaseback transaction, a company (the seller-lessee) transfers an underlying asset to another company (the buyer-lessor) and leases that asset back from the buyer-lessor.

To determine how to account for a sale-and-leaseback transaction, a company first considers whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale. The company applies IFRS 15 to determine whether a sale has taken place. This assessment determines the accounting by both the seller-lessee and the buyer-lessor, as follows.

	Lessee (seller)	Lessor (buyer)
Transfer to buyer-lessor is a sale	<ul style="list-style-type: none"> – Derecognise the underlying asset and apply the lessee accounting model to the leaseback* – Measure the ROU asset at the retained portion of the previous carrying amount (i.e. at cost)* – Recognise a gain or loss related to the rights transferred to the lessor* 	<ul style="list-style-type: none"> – Recognise the underlying asset and apply the lessor accounting model to the leaseback*
Transfer to buyer-lessor is not a sale	<ul style="list-style-type: none"> – Continue to recognise the underlying asset – Recognise a financial liability under IFRS 9 for any amount received from the buyer-lessor 	<ul style="list-style-type: none"> – Do not recognise the underlying asset – Recognise a financial asset under IFRS 9 for any amount paid to the seller-lessee

* Adjustments are required if the sale is not at fair value or lease payments are off-market.

IFRS 16.IE11

**Example 20 – Sale-and-leaseback transaction when transfer is a sale: Lessee perspective**

Company C sells an office building to Company D for cash of 2,000,000. Immediately before the transaction, the building is carried at a cost of 1,000,000. At the same time, C enters into a contract with D for the right to use the building for 18 years with annual payments of 120,000 payable at the end of each year. The transfer of the office building qualifies as a sale under IFRS 15. The fair value of the office building on the date of sale is 1,800,000. Because the consideration for the sale of the office building is not at fair value, C and D make adjustments to recognise the transaction at fair value. The amount of the excess sale price of 200,000 (2,000,000 - 1,800,000) is recognised as additional financing provided by D to C. The incremental borrowing rate of the lessee is 4.5% per annum.

The present value of the annual payments is 1,459,200, of which 200,000 relates to the additional financing and 1,259,200 relates to the lease.

C recognises the transaction as follows.

- C measures the right-of-use asset retained through the leaseback of the office building as a proportion of its previous carrying amount, which is 699,556 ($1,259,200 / 1,800,000 \times 1,000,000$).
- C recognises only the portion of the gain on sale that relates to the rights transferred to D, which is 240,356. The total gain on sale of the building amounts to 800,000 ($1,800,000 - 1,000,000$), of which:
 - 559,644 ($1,259,200 / 1,800,000 \times 800,000$) relates to the right to use the office building retained by C; and
 - 240,356 ($(1,800,000 - 1,259,200) / 1,800,000 \times 800,000$) relates to the rights transferred to D.
- At the commencement date, C makes the following entries.

Debit		Credit	
Cash	2,000,000	Building	1,000,000
ROU asset	699,556	Financial liability	1,459,200
		Gain on sale-and-leaseback	240,356



KPMG insight – IFRS 16 kills sale-and-leaseback as an off-balance sheet financing proposition

Accounting for sale-and-leaseback transactions is – and remains – a complex area. However, one thing remains clear: IFRS 16 largely eliminates sale-and-leaseback transactions as a potential source of off-balance sheet finance. Under the new standard, a seller-lessee always recognises a sale-and-leaseback transaction on-balance sheet unless the leaseback is short or the underlying asset is of low value.

IFRS 16 introduces new guidance on off-market terms that helps companies to identify when a transaction is deemed to be off-market, and clarifies the appropriate accounting treatment when the terms are above-market or below-market. A company has to maximise the use of observable prices and information to determine which measure is the most appropriate to use when assessing whether terms are off-market. This may require significant judgement, especially when the underlying asset is specialised.



KPMG insight – Sale-and-leaseback guidance is different from US GAAP

There are a number of significant differences between the guidance on sale-and-leaseback transactions under the IFRS and US GAAP versions of the standard, as follows.

- **Assessing whether the transfer is a sale:** Under IFRS, the seller-lessee does not recognise a sale of the underlying asset if it has a substantive repurchase option, regardless of the exercise price of the option. Under US GAAP, the seller-lessee may recognise a sale of the underlying asset if it has a substantive repurchase option but the exercise price is fair value on exercise and the underlying asset is readily available and non-specialised.
- **Accounting for the leaseback:** Under IFRS, the seller-lessee applies the single lessee model to the leaseback. Under US GAAP, the seller-lessee classifies the leaseback as either a finance lease or an operating lease, and recognises no gain on sale if it classifies the leaseback as a finance lease.
- **Gain recognition:** Under IFRS, the seller-lessee restricts the gain that it recognises on the sale to the amount that relates to the portion of the underlying asset that has been transferred – i.e. to the buyer-lessor's residual interest in the underlying asset. Under US GAAP, the seller-lessee recognises the full gain on disposal – i.e. including the amount of the gain that relates to the portion of the underlying asset retained through the leaseback.

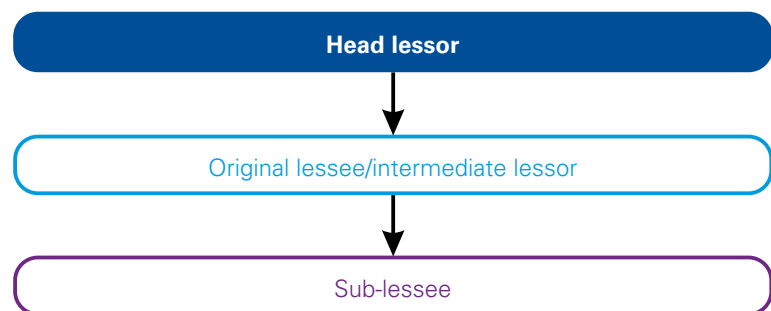
6.2

IFRS 16.3, A

Sub-leases

A sub-lease is a transaction in which a lessee (or 'intermediate lessor') grants a right to use the underlying asset to a third party, and the lease (or 'head lease') between the original lessor and lessee remains in effect.

A company applies IFRS 16 to all leases of right-of-use assets in a sub-lease. The intermediate lessor accounts for the head lease and the sub-lease as two different contracts.



IFRS 16.B58

An intermediate lessor classifies the sub-lease as a finance lease or as an operating lease with reference to the right-of-use asset arising from the head lease. That is, the intermediate lessor treats the right-of-use asset as the underlying asset in the sub-lease, not the item of property, plant or equipment that it leases from the head lessor.

IFRS 16.68

At the commencement date of the sub-lease, if the intermediate lessor cannot readily determine the rate implicit in the sub-lease, then it uses the discount rate that it uses for the head lease to account for the sub-lease, adjusted for any initial direct costs associated with the sub-lease.

However, if the head lease is a short-term lease for which the company, as a lessee, has elected the short-term lease exemption (see 3.6), then as an intermediate lessor the company classifies the sub-lease as an operating lease.



Example 21 – Sub-lease classified as a finance lease with reference to the ROU asset in the head lease

Head lease: Intermediate lessor L enters into a five-year lease for 5,000m² of office space (the head lease) with Company M (the head lessor).

Sub-lease: At the beginning of Year 3, L sub-leases the 5,000m² of office space for the remaining three years of the head lease to Sub-lessee N.

L classifies the sub-lease with reference to the right-of-use asset arising from the head lease. Because the sub-lease is for the whole of the remaining term of the head lease – i.e. the sub-lease is for the major part of the useful life of the right-of-use asset – L classifies it as a finance lease.

IFRS 16.IE6

At the commencement date of the sub-lease, L:

- derecognises the right-of-use asset relating to the head lease that it transfers to N and recognises the net investment in the sub-lease;
- recognises any difference between the carrying amounts of the right-of-use asset and the net investment in the sub-lease in profit or loss; and
- continues to recognise the lease liability relating to the head lease, which represents the lease payments owed to the head lessor.

During the term of the sub-lease, L recognises both interest income on the sub-lease and interest expense on the head lease.



KPMG insight – Difference from US GAAP

Under IFRS 16, an intermediate lessor determines the classification of the sub-lease with reference to the right-of-use asset arising from the head lease. Therefore, a 'head-lessor' might account for a head lease as an operating lease, but an intermediate lessor entering into a sub-lease on largely back-to-back terms might account for the sub-lease as a finance lease.

Under US GAAP, sub-lease classification is based on the underlying asset. This means that more sub-leases will be classified as operating leases by intermediate lessors applying US GAAP.

6.3

IAS 40.2, 30, IFRS 16.48, 56

Investment property

A company applies IAS 40 *Investment Property* to account for a right-of-use asset if the underlying asset would otherwise meet the definition of investment property.

In accordance with IAS 40, a company chooses as its accounting policy either the fair value model or the cost model for measuring its investment property. The company applies the policy to all of its investment property – i.e. it applies the same policy to owned and leased investment property. However, in either case the company complies with the disclosure requirement of IAS 40 – including disclosures of the fair value of the investment property.

**KPMG insight – Leased investment property is common in some jurisdictions**

This is important new guidance for investment property companies that hold leasehold interests, as is common in the UK, Hong Kong and elsewhere. There are two key differences.

- **The election becomes a requirement:** Previously, a company could elect on a property-by-property basis to recognise investment property held under an operating lease on-balance sheet. Now, all leasehold property will be on-balance sheet, and treated as investment property if the definition is met.
- **There is a choice of valuation basis:** Previously, if a company elected to recognise investment property held under an operating lease on-balance sheet, then it was required to apply the fair value model to all of its investment property. Now, an entity has a free choice over whether to apply the cost or fair value model to its investment property.

This new guidance may also affect companies that do not think of themselves as investment property companies. For example, a company that is managing a portfolio of leasehold properties following a restructuring or change in business model – e.g. a retailer or bank that has reduced its number of stores/branches as its business moves online – will need to assess whether each property meets the definition of investment property. If so, then the company will be required to prepare a valuation of the property, either for inclusion in its balance sheet or for disclosure, depending on its accounting policy choice.

6.4

IFRS 16.A

6.4.1

IFRS 16.44–46

Lease modifications

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease – e.g. adding or terminating the right to use one or more underlying assets.

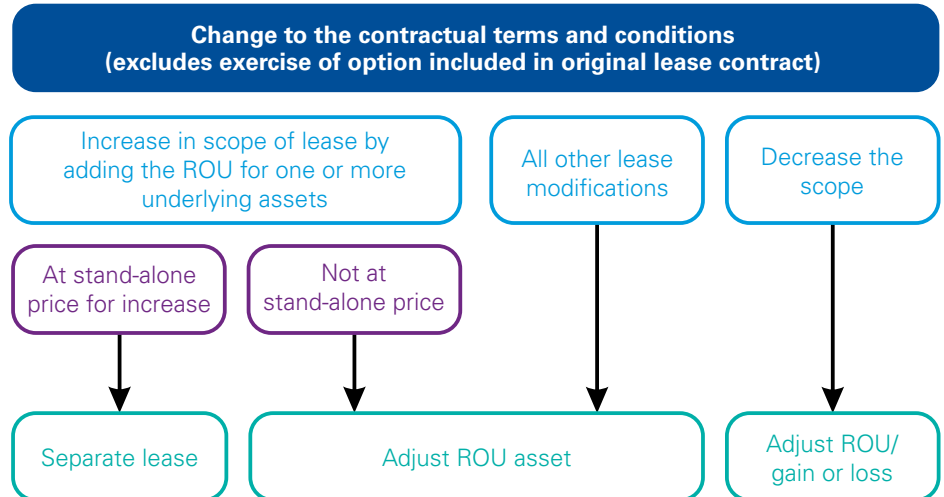
Lessee

A lessee accounts for a lease modification as a *separate lease* if both of the following conditions exist:

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

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

- for lease modifications that decrease the scope of the lease, the lessee decreases the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, and recognises a gain or loss that reflects the proportionate decrease in scope; and
- for all other lease modifications, the lessee makes a corresponding adjustment to the right-of-use asset.



6.4.2

IFRS 16.79–80

Lessor – Modifications to a finance lease

A lessor accounts for a modification to a finance lease as a *separate lease* if both of the following conditions exist:

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

If the modification is *not a separate lease*, then the lessor accounts for a modification to a finance lease as follows:

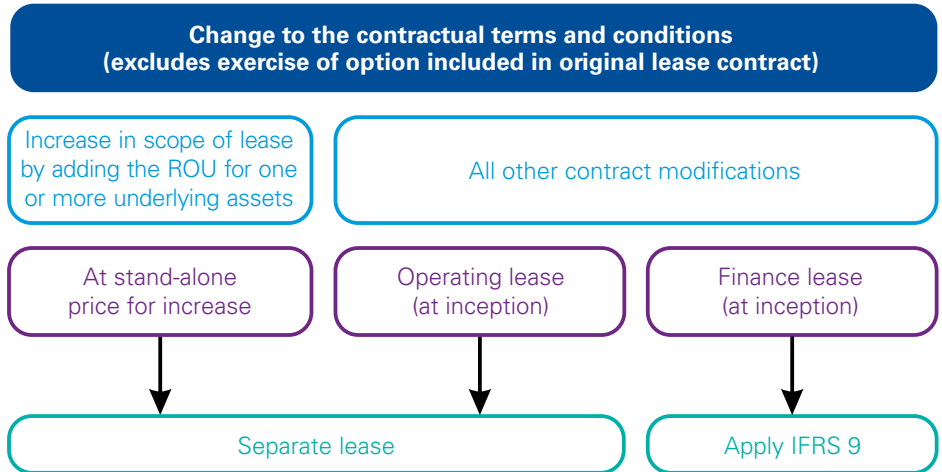
- if the lease would have been classified as an operating lease if the modification had been in effect at the inception date, then the lessor:
 - accounts for the lease modification as a new lease from the effective date of the modification; and
 - measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification; or otherwise
- applies the requirements of IFRS 9.


6.4.3

IFRS 16.87

Lessor – Modifications to an operating lease

A lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.



 **KPMG insight – More specific guidance than at present**

Many companies will welcome the introduction – for the first time in IFRS – of detailed guidance on accounting for lease modifications. This has been a significant practice issue for some years, with lease modifications becoming common in changing economic circumstances.

7

Disclosures

The new standard increases the disclosure burden for lessees and lessors.

7.1

IFRS 16.51, 89

General disclosure objective

Lessees and lessors disclose information that provides a basis for users of financial statements to assess the effects that leases have on financial position, financial performance and cash flows.



KPMG insight – Lessees and lessors focus on the disclosure objective, not on a fixed checklist

IFRS 16.BC215–BC216

The IASB aims to improve the interpretation and implementation of the disclosure requirements by including a general disclosure objective. This is intended to be a benchmark for lessees and lessors to assess whether the overall quality and informational value of their lease disclosures are sufficient.

Lessees and lessors also apply the concept of materiality to determine what should be disclosed. Therefore, it appears that the necessary disclosures could be less or more than what is listed in IFRS 16, depending on the individual situation. This is in line with the IASB's overall approach for its disclosure initiative.

IFRS 16.59, 92, B48–B52

IFRS 16 contains specific considerations for lessees to determine whether additional quantitative and qualitative information should be disclosed and lists various examples of such additional useful disclosures. Similar considerations apply to lessors. However, the guidance in IFRS 16 on additional disclosures for lessors is limited compared with that for lessees.

7.2

Disclosures for lessees

Normally, a lessee discloses at least the following information.

IFRS 16.47, 53, 58

IFRS 16.53–54

IFRS 16.53

IFRS 16.55

IFRS 16.58, 60

Quantitative information

Relating to the statement of financial position

- Additions to right-of-use assets
- Year-end carrying amount of right-of-use assets by class of underlying asset and (if they are not presented separately) the corresponding line items in the statement of financial position
- Lease liabilities and the corresponding line items in the statement of financial position if lease liabilities are not presented separately
- Maturity analysis for lease liabilities

Relating to the statement of profit or loss and other comprehensive income (including amounts capitalised as part of the cost of another asset)

- Depreciation charge for right-of-use assets by class of underlying asset
- Interest expense on lease liabilities
- Expense relating to short-term leases for which the recognition exemption is applied (leases with a lease term of up to one month can be excluded)
- Expense relating to leases of low-value items for which the recognition exemption is applied
- Expense relating to variable lease payments not included in lease liabilities
- Income from sub-leasing right-of-use assets
- Gains or losses arising from sale-and-leaseback transactions

Relating to the statement of cash flows

- Total cash outflow for leases

Other

- Amount of short-term lease commitments if current short-term lease expense is not representative for the following year

Qualitative disclosures

- Description of how liquidity risk related to lease liabilities is managed
- Use of exemption for short-term and/or low-value item leases

IFRS 16.56–57

Additional disclosures (when applicable)
<ul style="list-style-type: none"> – Disclosures required by IAS 40 for right-of-use assets qualifying as investment property – If the revaluation model of IAS 16 is applied for right-of-use assets, then: <ul style="list-style-type: none"> - Effective date of revaluation - Whether an independent valuer was involved - Carrying amount that would have been recognised under the cost model - Revaluation surplus, change for the period and any distribution restrictions

KPMG insight – More extensive disclosures for lessees

Generally, lessees have to provide more extensive disclosures than those for finance leases under IAS 17. In addition, lessees need to assess whether additional information is necessary to meet the overall objective. Therefore, more effort and judgement will be needed in the preparation of disclosures.

Users are likely to welcome the new disclosures, because they provide a basis for additional analysis.

Preparers are likely to be less impressed. The extent of the disclosure requirements suggests that the IASB does not expect users to rely solely on the quantification of the lease liability that will be included in the balance sheet.

7.3

Disclosures for lessors

Normally, a lessor discloses at least the following information.

IFRS 16.90, 93–97

Finance lease	Operating lease
Quantitative information	
<ul style="list-style-type: none"> – Selling profit or loss – Finance income on the net investment in the lease – Lease income relating to variable lease payments not included in the net investment in the lease 	<ul style="list-style-type: none"> – Lease income relating to variable lease payments that do not depend on an index or rate – Other lease income – Detailed maturity analysis of the lease payments receivable

Finance lease	Operating lease
Quantitative information (continued)	
<ul style="list-style-type: none"> – Significant changes in the carrying amount of the net investment in the lease – Detailed maturity analysis of the lease payments receivable 	<ul style="list-style-type: none"> – If applicable, disclosures in accordance with IAS 16 (separately from other assets), IAS 36, IAS 38, IAS 40 and IAS 41 <i>Agriculture</i>
Qualitative information	
<ul style="list-style-type: none"> – Significant changes in the carrying amount of the net investment in the lease 	<ul style="list-style-type: none"> – N/A

IFRS 16.93

IFRS 16.92

A lessor also discloses quantitative and qualitative information about its leasing activities, such as:

- the nature of its leasing activities; and
- how it manages risks associated with rights that it retains in underlying assets.



KPMG insight – More disclosures for lessors

Generally, lessors are asked to provide more disclosures for finance and operating leases than under IAS 17. They also need to assess whether additional information is necessary to meet the overall objective. As a result, more effort and judgement will be needed in the preparation of disclosures. However, compared with the disclosure requirements for lessees, lessors need to disclose much less.

8

Effective date and transition

The IASB proposes two approaches, which are described below. Application of either of these approaches is optional.

8.1

IFRS 16.C1

Effective date

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

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



KPMG insight – 2019 effective date reflects outreach with preparers

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

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

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

Many companies will be pleased that the IASB has been influenced more by feedback from preparers than from users. However, it is clear that the closing years of this decade will see a period of major accounting change for companies. The IASB's new financial instruments and revenue standards will take effect in 2018, followed by leases one year later.



KPMG insight – Early adoption may bring benefits, but at a cost

The possibility of adopting IFRS 16 at the same time as IFRS 15 may be attractive to some. For example, lessors who offer multiple-component contracts may prefer not to restate the same contract once in 2018 for the new revenue and financial instruments standards, and again in 2019 for the new leases standard. Other companies may simply prefer to adopt the three major standards together, to avoid disruption and maintain clearer trend information in future years.

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

8.2

IFRS 16.C3

Lease definition on transition

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

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

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

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

IFRS 16.C2

The date of initial application is the beginning of the annual reporting period in which a company first applies the standard.

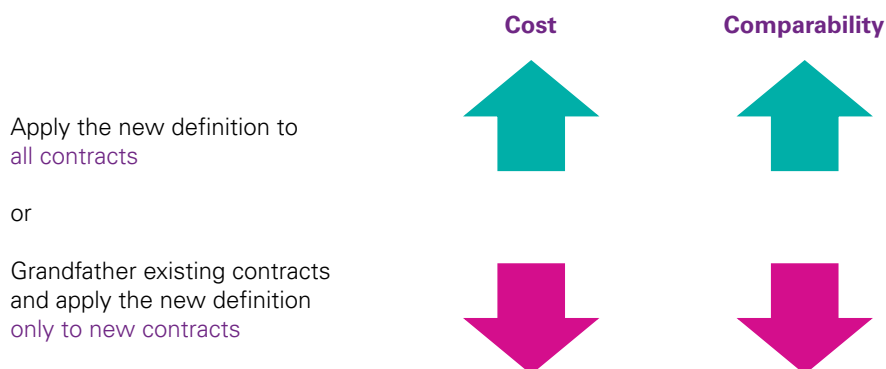
IFRS 16.C4

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



KPMG insight – Practical expedient to grandfather the definition of a lease on transition offers considerable relief on transition

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



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

Companies that are party to such agreements will want to evaluate carefully whether to apply the new transition relief, balancing:

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

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

8.3

IFRS 16.C5

IFRS 16.C6

8.3.1

IFRS 16.C7

IFRS 16.C8–C11

Lessee approach to transition

A lessee is permitted to:

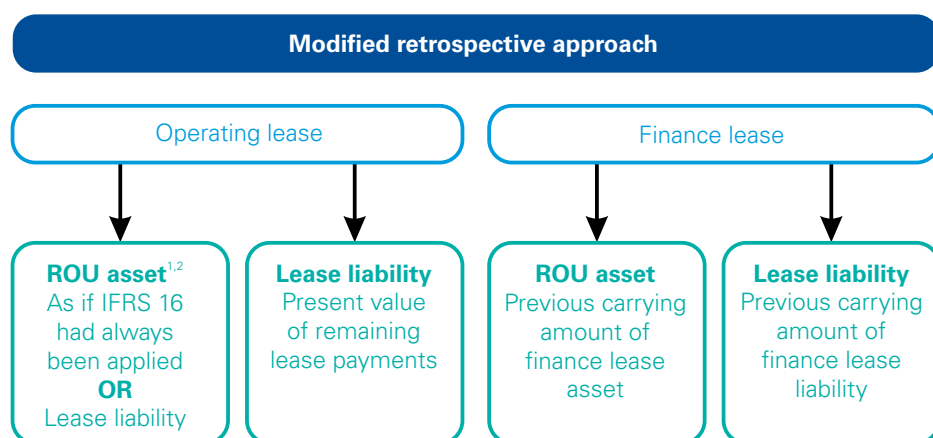
- adopt the standard retrospectively; or
- follow a modified retrospective approach.

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

Modified retrospective approach – Measurement

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

The modified retrospective approach is applied as follows.




1. Under the modified retrospective approach, a lessee chooses on a lease-by-lease basis how to measure the ROU asset on transition to IFRS 16.
2. A lessee measures an ROU asset that will be accounted for as investment property using the fair value model in IAS 40 from the date of initial application. A lessee is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in IAS 40.

IFRS 16.C8

A lessee is permitted to choose, on a lease-by-lease basis, how to measure the right-of-use asset using one of two methods:





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


KPMG insights – Each transition method has pros and cons

The IASB decided not to require lessees to follow a full retrospective approach because the costs of such an approach could be significant and might outweigh the benefits.

A full retrospective approach requires companies to determine the carrying amount of all leases in existence at the earliest comparative period as if those leases had always been accounted for in accordance with IFRS 16. That could be impracticable for companies that have thousands of leases. Because comparative information is not restated under the modified retrospective transition method, additional disclosure is required to help users of financial statements understand the effect of applying IFRS 16 for the first time.

Conversely, a full retrospective approach would provide better information to users of financial statements by increasing comparability. Some stakeholders appear keen to apply the standard retrospectively.

<p>A lessee can choose to apply the standard...</p>	<p>Cost</p>	<p>Comparability</p>
<p>Retrospectively to all accounting periods</p>		
<p>or</p>		
<p>As a 'big bang' at the date of initial application</p>		

8.3.2

IFRS 16.C10

Modified retrospective approach – Practical expedients for operating leases

When applying the modified retrospective approach to previous operating leases, a lessee may use one or more of the following practical expedients on a lease-by-lease basis.

- Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
- Rely on a previous assessment of whether leases are onerous in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to performing an impairment review.

- Account for leases for which the lease term ends within 12 months of the date of initial application as short-term leases.
- Exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.
- Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.



KPMG insights – A range of possible outcomes on transition

Applying IFRS 16 for the first time will be a time-consuming and costly process for many companies. They will be required to gather key inputs for all leases, especially for those currently classified as operating leases under IAS 17.

The IASB has sought to reduce transition costs by introducing a series of practical expedients. Some expedients are accounting policy choices, some apply by class of underlying asset and some can be elected on a lease-by-lease basis. Some companies will face a bewildering choice of combinations and permutations.

In effect, most companies will find that they have a range of possible accounting outcomes on transition. In addition to assessing the balance between cost and comparability in deciding how to make the transition to the new standard, companies may also wish to complete detailed modelling to understand what their opening balance sheet would look like in each case.

IFRS 16.BC287

8.4

IFRS 16.C14

Lessor approach to transition

Except for sub-leases and sale-and-leaseback transactions (see 8.5 and 8.6), a lessor does not make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with IFRS 16 from the date of transition.

8.5

IFRS 16.C15

Sub-leases on transition

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

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

**KPMG insights – Many sub-leases may be reclassified on transition**

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

8.6

*IFRS 16.C16**IFRS 16.C17**IFRS 16.C18*

Sale-and-leaseback on transition

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

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

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

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

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

**KPMG insights – Transition relief for sale-and-leasebacks**


The transition requirements for sale-and-leaseback transactions are consistent with the general transition requirements for all leases. Consequently, a seller-lessee is not required to perform retrospective accounting for the sale element and accounts for the leaseback in the same way as for other leases existing at the date of initial application.


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


9

Your next steps

Planning your implementation project will take time and care. However, it might be worth asking yourself a few simple questions now – just to get a feel for the scale of the challenge ahead...



Topic	Questions and comments	
Lease definition	Do you know which of your transactions are, or contain, leases?	<input type="checkbox"/>
	Will you elect to grandfather the lease definition for existing contracts on transition?	<input type="checkbox"/>
	<ul style="list-style-type: none"> – In many cases, lease definition will be obvious, and a transaction that is a lease today will be a lease in 2019. However, there are significant changes in lease definition that will affect many common transactions – e.g. power purchase agreements and transport agreements. – There is also a big decision to be made on transition – will you spend the time and cost necessary to reassess your existing transactions and thereby exclude some existing transactions from lease accounting, or grandfather existing arrangements and apply the new definition only to new arrangements? 	
Lease data	Do you have a database of all of your leases?	<input type="checkbox"/>
	Do you have the systems and processes necessary to calculate lease assets and liabilities?	<input type="checkbox"/>
	Are your current disclosures of operating lease commitments complete and accurate?	<input type="checkbox"/>
<ul style="list-style-type: none"> – Some companies have databases that capture all of their lease data – but this isn't true for everyone. Now is the time to begin to assess whether your current systems have the information necessary to apply the new standard. – The operating lease commitments note may not always be the top priority in a busy reporting season. Now is the time to check that it includes all of the leases that you will soon be bringing on-balance sheet, so that there are no surprises on transition. 		

Topic	Questions and comments	
Debt covenants	<p data-bbox="746 510 1345 573">Will application of the new standard impact your debt and other covenants?</p> <p data-bbox="1417 510 1489 573"><input type="checkbox"/></p> <ul data-bbox="746 607 1489 869" style="list-style-type: none"> – Many financial agreements feature covenants that are applied on a ‘frozen GAAP’ basis – that is, a change in accounting policy won’t affect the covenant test. But this isn’t true in all cases. – Given the scale of accounting change – with new standards on financial instruments, leases and revenue to be applied in 2018–19 – it’s time to double-check, to identify any covenants that you may wish to renegotiate before the standard becomes effective. 	
Sale-and-leaseback	<p data-bbox="746 902 1374 965">Do you understand the impact of the new standard on your sale-and-leaseback transactions?</p> <p data-bbox="1417 902 1489 965"><input type="checkbox"/></p> <ul data-bbox="746 999 1489 1384" style="list-style-type: none"> – Most companies and users know that the new leases standard eliminates sale-and-leaseback as an off-balance sheet proposition. – But there’s more than one way in which a sale-and-leaseback can come back on-balance sheet. – If the transaction is a true sale under IFRS 15, then it comes on-balance sheet like a current sale-and-finance leaseback – i.e. with the liability measured at cost. – If the transaction is not a sale under IFRS 15, then it comes on-balance sheet as a financing under IFRS 9, which may require ongoing remeasurement at fair value through profit or loss. 	
Financial ratios	<p data-bbox="746 1417 1374 1480">Do you understand the impact of the new standard on your financial ratios, KPIs etc?</p> <p data-bbox="1417 1417 1489 1480"><input type="checkbox"/></p> <p data-bbox="746 1507 1353 1599">Will optional exemptions, such as those for short-term leases and leases of low-value items, have a material impact on your financial statements?</p> <p data-bbox="1417 1507 1489 1599"><input type="checkbox"/></p> <ul data-bbox="746 1626 1489 1951" style="list-style-type: none"> – Most companies and users know that the new standard brings more leases on-balance sheet, increasing gearing etc. – But what about other effects? <ul data-bbox="778 1749 1489 1951" style="list-style-type: none"> - Detailed modelling may be required to predict the impact of the front-loaded total lease expense in moving from operating lease accounting to the ROU model. - The geography of the profit or loss account will change, as operating lease expense is replaced by depreciation/ amortisation of the ROU asset and interest expense. 	

Topic	Questions and comments 
	<ul style="list-style-type: none"> - Will you redefine non-GAAP measures such as EBITDA to reflect the new lease model? - How will you present variable lease payments? - Do you know what impact the optional exemptions will have on your KPIs? Have you decided which ones to elect?
Transition options	<p data-bbox="746 725 1342 792">Have you thought about how to transition to the new standard? <input data-bbox="1422 725 1485 792" type="checkbox"/></p> <ul style="list-style-type: none"> - The new standard will offer a wide range of transition options, featuring many practical expedients. One key question is whether to apply the standard: <ul style="list-style-type: none"> - retrospectively, which may require additional cost and effort but will result in greater consistency in comparative periods; or - as a 'big bang' on the date of initial application, which will require less historical information but may impact your trend data for many years to come.

Appendix: Comparison with US GAAP

Key aspects of the IFRS and US GAAP versions of the new leases standard are converged. Notably, both versions of the standard feature on-balance sheet lessee accounting models. However, there are a number of differences between the IFRS and US GAAP versions of the standards, including the following.

IFRS and US GAAP standards converged?			
	Lease definition	Leases on-balance sheet for lessees	Lessor accounting
	Lessee accounting model	Detailed measurement and transition requirements	Exemption for low value items

Topic	IFRS 16	US GAAP standard
Lessee accounting model	<ul style="list-style-type: none"> – Single lease accounting model – No lease classification test – All leases on-balance sheet: <ul style="list-style-type: none"> - lessee recognises an ROU asset and lease liability - treated as the purchase of an asset on a financed basis 	<ul style="list-style-type: none"> – Dual lease accounting model – Lease classification test based on IAS 17 classification criteria – All leases on-balance sheet: <ul style="list-style-type: none"> - finance leases treated as the purchase of an asset on a financed basis - operating leases generally feature straight-line recognition of total lease expense
Lessor accounting model	<ul style="list-style-type: none"> – The lessor requirements have substantially been brought forward from currently effective standards under IFRS and US GAAP. Consequently, there are a number of differences between the new IFRS and US GAAP lessor accounting requirements that reflect differences in previous requirements 	

Topic	IFRS 16	US GAAP standard
Lessor accounting model (continued)	<ul style="list-style-type: none"> - No restriction on recognising selling profit on commencement for finance leases 	<ul style="list-style-type: none"> - Selling profit not recognised on commencement of leases that qualify for finance lease classification solely due to the involvement of third parties other than the lessee, even if the carrying amount and fair value of the underlying asset are different
	<ul style="list-style-type: none"> - N/A – leveraged lease accounting does not exist under IFRS 	<ul style="list-style-type: none"> - Existing leveraged leases will be grandfathered and exempt from the new standard
Related party leases	<ul style="list-style-type: none"> - There is no specific guidance on accounting for related party leasing transactions 	<ul style="list-style-type: none"> - Account for leases between related parties based on their contractual terms, even if they differ from the substance of the arrangement - Disclose lease transactions between related parties
Practical expedients and targeted reliefs	<ul style="list-style-type: none"> - Optional lessee exemption for leases of low-value items – i.e. assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate 	<ul style="list-style-type: none"> - No exemption for leases of low-value items
Variable lease payments	<ul style="list-style-type: none"> - Lessees reassess variable lease payments based on an index or rate when: <ul style="list-style-type: none"> - Lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term) - There is a contractual change in the cash flows (i.e. when an adjustment to the lease payments based on an index or rate takes effect under the terms of the lease) 	<ul style="list-style-type: none"> - Lessees reassess variable lease payments based on an index or rate only when lease payments are remeasured for other reasons (e.g. a reassessment due to a change in the lease term)

Topic	IFRS 16	US GAAP standard
Sale and leaseback	– N/A	– If the leaseback is a finance lease, then no sale is recognised
	– Gain on sale (with market terms) restricted to the residual interest in the underlying asset	– Gain on sale (with market terms) based on the entire underlying asset
	– Any substantive repurchase option precludes sale recognition (regardless of exercise price)	– A repurchase option does not preclude sale recognition if the exercise price is fair value on exercise and the underlying asset is readily available, non-specialised equipment
Sub-leases	– A sub-lessor considers the ROU asset to be the leased asset in determining the classification of the sub-lease	– A sub-lessor considers the underlying asset to be the leased asset in determining the classification of the sub-lease
Discount rate	– N/A: there is no concept of non-public business entities under IFRS	– Non-public business entity lessees are permitted to elect as an accounting policy to use a risk-free discount rate
Effective date	<ul style="list-style-type: none"> – Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 is also adopted 	<ul style="list-style-type: none"> – Fiscal years beginning after 15 December 2018 – Early adoption is permitted, even before the adoption of the US version of the revenue standard
Presentation, disclosure and transition	– There are a number of differences in the presentation, disclosure and transition requirements. These are primarily a consequence of the differences between the lessee accounting models, and differences between other requirements of IFRS and US GAAP that affect leases – e.g. differences in the general disclosure requirements applicable to all financial liabilities.	

About this publication

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

Content

Our *First Impressions* publications are prepared on the release of a new standard, or amendment(s) to the requirements of existing standards. They include a discussion of the key elements of the new standard and highlight areas that may result in a change in practice.

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 January 2016.

Further analysis and interpretation will be needed for an entity to consider the potential impact of the proposals 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.

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Kimber Bascom (leader)	US
Archana Bhutani	India
Judit Boros	Hungary
Una Curtis	Ireland
Karine Dupre	France
Ramon Jubels	Brazil
Wolfgang Laubach	Germany
Sylvie Leger	Canada
Andrew Marshall	UK
Genevieve Naik	South Africa
Brian O'Donovan (deputy leader)	UK
Julie Santoro	US
Mag Stewart	Canada
Kenny Tan	Singapore
Beth Zhang	China

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