



IFRS 16 – An overview

Handbook

IFRS® Accounting Standards



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Lease accounting in a changing world

IFRS 16 *Leases* has now been successfully adopted by companies reporting under IFRS Accounting Standards. It is the new normal, driving consistency in lease accounting around the world - but challenges remain.

When first published, IFRS 16's 'on-balance sheet' approach had a significant effect on the financial statements of lessees with 'big-ticket' leases, from retailers to banks to media companies. Similarly, lessors were faced with new guidance on a number of aspects of leasing transactions – from separating lease and non-lease components, to more radical accounting changes for more complex arrangements such as sale-and-leaseback transactions and sub-leases.

Some years on from adoption of the standard, many of its original implementation challenges continue to raise application issues. These include deciding whether a transaction is, or contains, a lease and determining whether particular lease payments are fixed or variable in nature. Meanwhile, adopting new processes or new technologies (e.g. those relating to renewable energy and AI) are creating new challenges for companies.

This publication provides an overview of IFRS 16's accounting models for lessees and lessors. It then takes a deeper dive into critical areas such as the definition of a lease and accounting for lease modifications.

If you are looking for a practical overview of IFRS 16, or just a refresher, you've come to the right place. We have included examples and insights to help you understand the requirements and their impacts on the financial statements. If you want to know more, see our detailed publications on lease accounting at kpmg.com/ifrs16.

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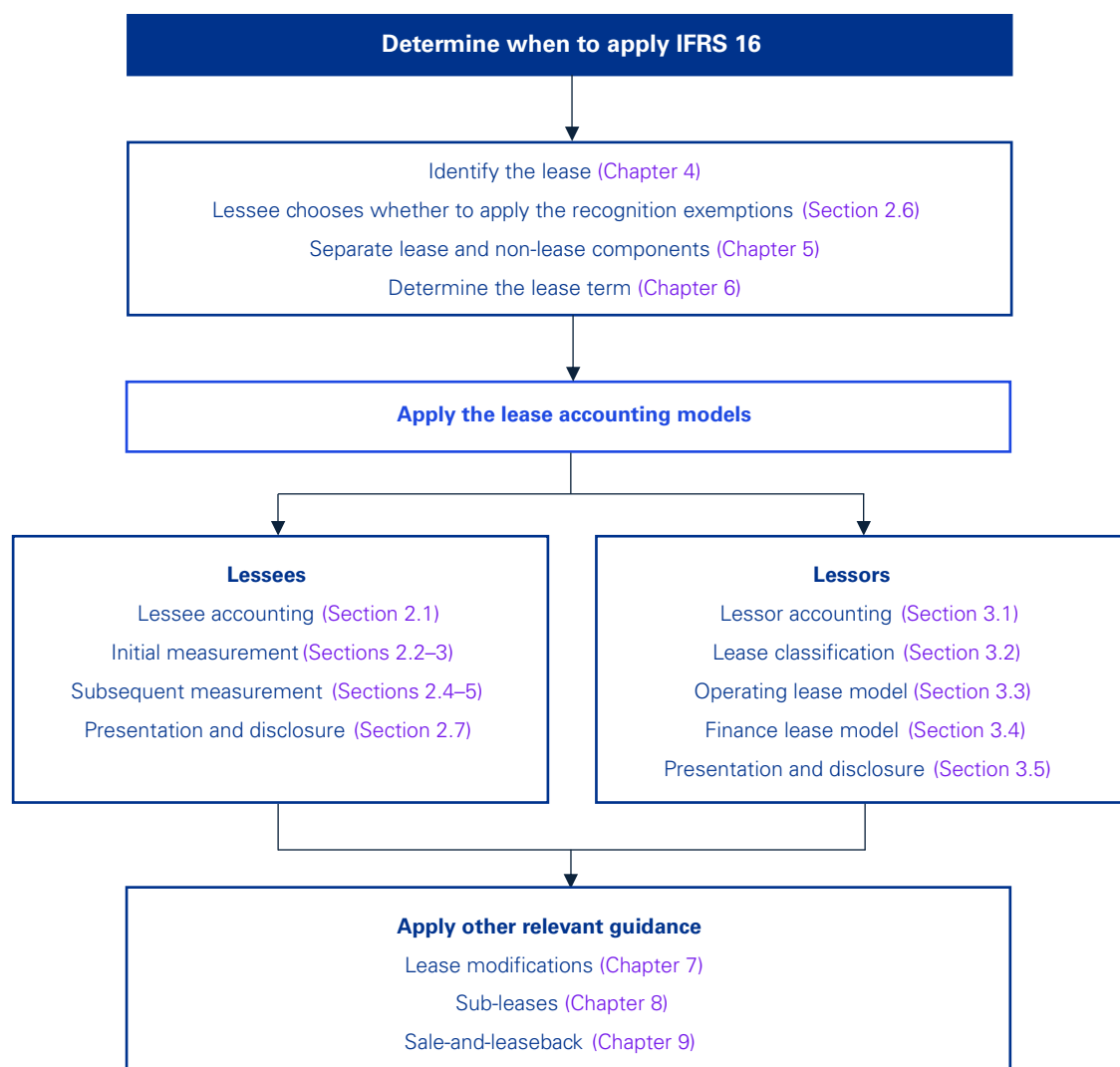
1 IFRS 16 at a glance

1.1 Key facts

This publication provides an overview of IFRS 16 and how it affects the financial statements of the lessee and the lessor. It includes examples and insights.

The publication begins with an overview of the lessee and lessor accounting models, summarising the impact of IFRS 16 on their respective financial statements. To apply their respective models, the lessee and the lessor need to follow preliminary steps that are discussed in more detail in the subsequent chapters: identify the lease (see [Chapter 4](#)), separate components (see [Chapter 5](#)) and determine the lease term (see [Chapter 6](#)). The lessee will also need to choose whether to apply the recognition exemptions (see [Section 2.6](#)).

The following diagram illustrates the relationships between key elements of the standard, and shows where each is discussed in this publication.



Many chapters include links to our more detailed guidance. You can also find more general guidance on IFRS 16 in Chapter 5.1 of our publication [Insights® into IFRS](#) and at kpmg.com/ifrs16.

1.2 Key application issues

Applying IFRS 16 involves significant judgements and accounting policy elections that may impact the recognition of assets and liabilities, and their measurement.

Applying the definition of a lease

Assessing whether an arrangement is, or contains, a lease determines whether an arrangement is on- or off-balance sheet for a customer. The assessment can be complex and is required for each new contract. It includes consideration of:

- *supplier's substitution rights*: even if the supplier has the right to substitute the leased asset, there could still be a lease unless the supplier has the practical ability to substitute the asset throughout the period of use and it would benefit economically from the substitution (see [4.2.3](#)); and
- *who takes the relevant decisions that affect the economic benefits arising from the lease asset throughout the lease term*: this assessment can be particularly judgemental when both the supplier and the customer take some decisions, or many decisions are predetermined (see [4.4.1–2](#)).

Determining the lease term

The assessment of the lease term is a critical estimate and a key input into the amount of the lease liability for the lessee. For lessees, the lease term also determines whether a lease is eligible for the recognition exemption for short-term leases. For lessors, it affects lease classification and income recognition.

- Determining the enforceable period is complex when relevant laws and regulations in the local jurisdiction create enforceable rights and obligations in addition to those set out in the written lease agreement. Determining the broader economic penalties incurred by the lessee and lessor when exercising a termination right also presents interesting challenges (see [Section 6.3](#)).
- Determining the lease term for renewable and cancellable leases, including assessing the enforceable period, was a complex implementation issue on which the IFRS Interpretations Committee has provided guidance (see [Section 6.5](#)).

Lease modifications

The guidance on lease modifications has been, and continues to be, a key area of focus for many companies. Several areas of ongoing complexity remain, including distinguishing between extinguishment of a lease liability and a lease modification (see [Chapter 7](#)).

Key accounting policy choices and exemptions

- A lessee can elect not to apply the lessee accounting model to leases with a lease term of 12 months or less that do not contain a purchase option (by class of underlying asset) and leases for which the underlying asset is of low value when it is new (on a lease-by-lease basis) (see [Section 2.6](#)).
- A lessee can elect, by class of underlying asset, to combine each lease component and any associated non-lease components and account for them as a single lease component (see [Section 5.3](#)).
- Both the lessee and the lessor may apply the standard to a portfolio of lease contracts if certain conditions are met (see [Section 5.2](#)).

2 Lessee accounting

The key objective of IFRS 16 is to ensure that lessees recognise assets and liabilities for their major leases.

2.1 Lessee accounting model

IFRS 16.22

A lessee applies a single lease accounting model under which it recognises all leases on-balance sheet, unless it elects to apply the recognition exemptions (see [Section 2.6](#)). A lessee recognises a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make payments.

IFRS 16.47–49

Statement of financial position	Statement of profit or loss
Asset = 'Right of use' of underlying asset	Lease expense Depreciation + Interest = Front-loaded total lease expense

2.2 Initial measurement of the lease liability

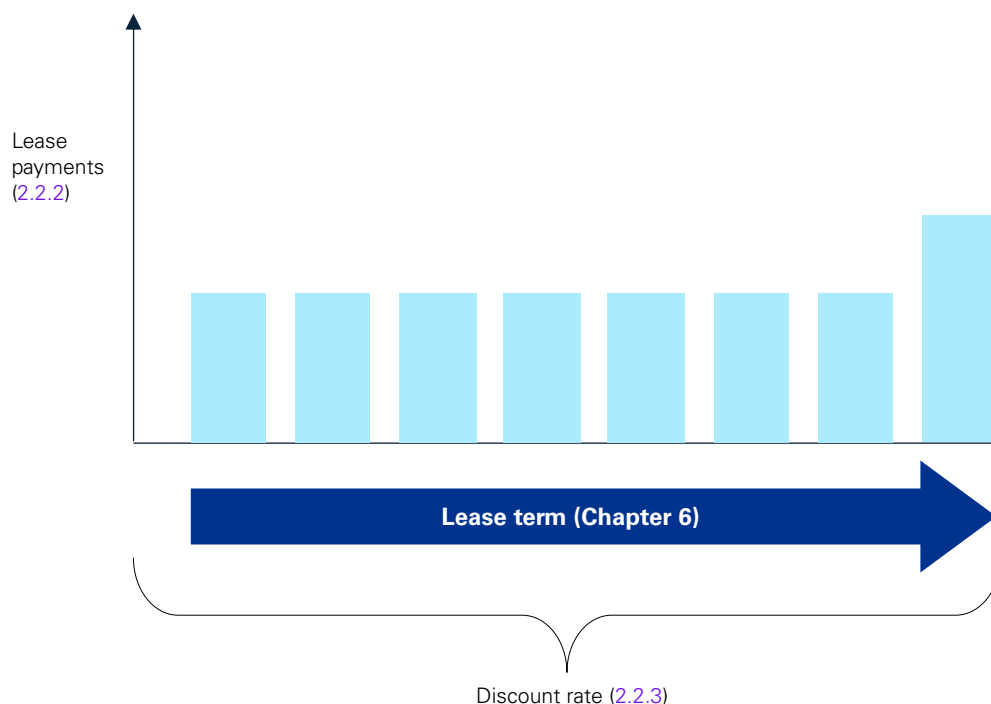
2.2.1 Overview

IFRS 16.26

A lessee initially measures the lease liability at the present value of the future lease payments.



The key inputs to this calculation are as follows.



When does a lessee first measure the lease liability?

A lessee initially measures the lease liability at the commencement date of the lease. This is the date on which a lessor makes an underlying asset available for use by a lessee.

The commencement date is distinct from the inception date of a lease, which is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease. An entity assesses whether a contract is, or contains, a lease at the inception date.

IFRS 16.9, 26,
Appendix A



Are lease liabilities financial liabilities?

Yes, lease liabilities are financial liabilities, measured in accordance with IFRS 16 – not IFRS 9 *Financial Instruments*. However, they are subject to the derecognition requirements of IFRS 9.

This represents a considerable simplification compared with financial instruments accounting in some cases. For example, common features of lease agreements – e.g. renewal and purchase options – are not accounted for separately, nor do they have the potential to result in the liability being measured at fair value.

IFRS 9.2.1(b)

2.2.2

Lease payments

IFRS 16.27

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.

IFRS 16.B42

‘In-substance fixed payments’ are payments that are structured as variable lease payments, but that – 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 of payments 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 16.27–28, BC166

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. Such payments include payments linked to a consumer price index (CPI), payments linked to a benchmark interest rate (such as IBOR) or payments that vary to reflect changes in market rental rates.

Variable lease payments that are highly probable to occur are not in-substance fixed payments if they are based on performance or use of the underlying asset and are therefore avoidable.

IFRS 16.27(c),
Appendix A

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. An unguaranteed residual value is always excluded from the determination of the lease payments by the lessee.

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 [Section 6.4](#)).



Example 1 – In-substance fixed payments: Minimum lease payment

IFRS 16.27, 38(b), B42

Lessee W leases a production line from Lessor L. 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 expected usage per year is 1,500 hours. If the usage is less than 1,000 hours, then W has to pay 1,000,000.

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 depend on usage and, therefore, are not included in the initial measurement of the lease liability but are expensed as the ‘over-use’ occurs.



Example 2 – Variable payments not depending on an index or rate

IFRS 16.27

Utility Company C enters into a 20-year contract with Power Company D to purchase electricity produced by a new solar farm. C and D assess that the contract contains a lease. There are no minimum purchase requirements, and no fixed payments that C is required to make to D. However, C is required to purchase all of the electricity produced by the solar plant at a price of 10 per unit.

C notes that it is highly probable that the solar plant will generate at least some electricity each year. However, the whole payment that C makes to D varies with the amount of electricity produced by the solar farm – i.e. the payments are fully variable. Therefore, C concludes that there are no in-substance fixed lease payments in this contract. C recognises the payments to D in profit or loss when they are incurred.



Example 3 – Variable payments depending on an index

IFRS 16.28

Lessee Y rents an office building. The initial annual rental payment is 2,500,000. Payments are made at the end of each year. The rent will be increased each year by the change in the CPI over the preceding 12 months.

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. an annual rental of 2,500,000 for each year of the lease. If during the first year of the lease the CPI increases from 100 to 105 (i.e. the rate of inflation over the preceding 12 months is 5%), then at the end of the first year the lease liability is recalculated assuming future annual rentals of 2,625,000 (i.e. $2,500,000 \times 105 / 100$).



Example 4 – Residual value guarantees

IFRS 16.27(c)

Lessee Z has entered into a lease contract with Lessor L to lease a car. The lease term is five years. In addition, Z and L agree on a residual value guarantee – if the fair value of the car at the end of the lease term is below 400, then Z will pay to L an amount equal to the difference between 400 and the fair value of the car.

At commencement of the lease, if Z expects the fair value of the car at the end of the lease term to be 380, then it includes 20 in the lease payments in respect of the residual value guarantee when calculating the lease liability.

IFRS 16.BC168–BC169

**Which variable lease payments are included in the initial measurement of the lease liability?**

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.

Variable lease payments that depend on sales or usage of the underlying asset are excluded from the lease liability. Instead, these payments are recognised in profit or loss in the period in which the performance or use occurs. This has a number of important consequences.

- A lessee's apparent indebtedness depends 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 recognises 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 is zero.

IFRS 16.18–19,
27(d)–(e), 70(d)–(e),
B37–B40,
Appendix A

**How does the lessee decide whether to include in the lease liability amounts payable on exercise of a renewal, purchase or termination option?**

The lessee determines whether it is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease early. This assessment is made by considering all relevant facts and circumstances that create an economic incentive to exercise an option or not to do so (see [Section 6.4](#)).

Each party determines the lease payments in a manner consistent with this assessment as follows.

- *Renewal option:* If it is determined that the lessee is reasonably certain to exercise a renewal option, then the lease payments include the relevant payments for the period covered by the renewal option.
- *Termination option:* If it is determined that the lessee is not reasonably certain not to terminate the lease early, then the lease payments include the termination penalty.
- *Purchase option:* If it is determined that the lessee is reasonably certain to exercise an option to purchase an underlying asset, then the lease payments include the exercise price of the purchase option.

IFRS 16.27(a),
Appendix A



What are lease incentives and how are they accounted for by lessees?

Lease incentives are payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of the costs of a lessee. Payments made by the lessor to the lessee are not lease incentives when they are associated with other obligations of the lessee to transfer distinct goods or services to the lessor.

Examples of lease incentives provided by lessors include up-front cash payments to the lessee or assumption of costs of the lessee such as leasehold improvements, relocation costs and costs associated with a pre-existing lease commitment. Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

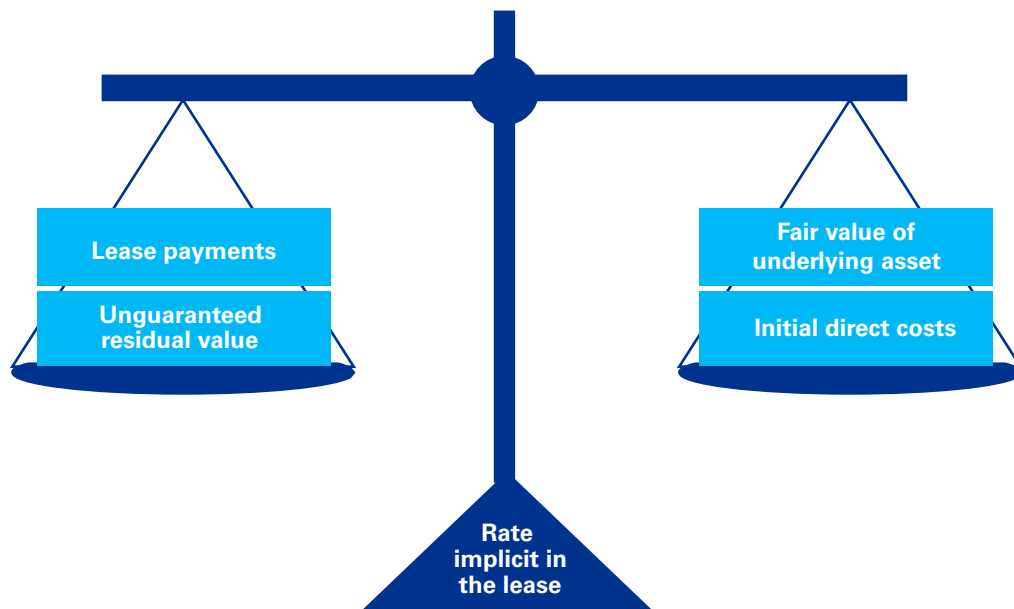
Irrespective of its form, a lease incentive is part of the lease payments – i.e. the net consideration for the lease.

2.2.3

IFRS 16.26,
Appendix A

Discount rate

At the commencement date, a lessee measures the lease liability at the present value of the lease payments using the interest rate implicit in the lease if this can be readily determined. 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 at 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.



Is the rate implicit in the lease readily determinable for a lessee?

IFRS 16.BC161

In most circumstances, a lessee is not able to determine the rate implicit in the lease. There is no separate definition of the interest rate implicit in the lease for the lessee. The lack of information available to the lessee (e.g. the lessor's initial direct costs, the initial fair value of the underlying asset and the lessor's expectations of the residual value of the asset at the end of the lease) typically makes it difficult for the lessee to determine the interest rate implicit in the lease. Therefore, it is likely to be difficult for lessees to readily determine the interest rate implicit for most leases. As a result, lessees often use their incremental borrowing rate.



Does a lessee's incremental borrowing rate reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments?

IFRS 16.BC162,
Appendix A,
IU 09–19

In some cases, a lessee seeking to determine its incremental borrowing rate may have readily observable evidence of the interest rate on a loan with the same term but a different payment profile from the lease. A question arises about whether a lessee's incremental borrowing rate is required to reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments.

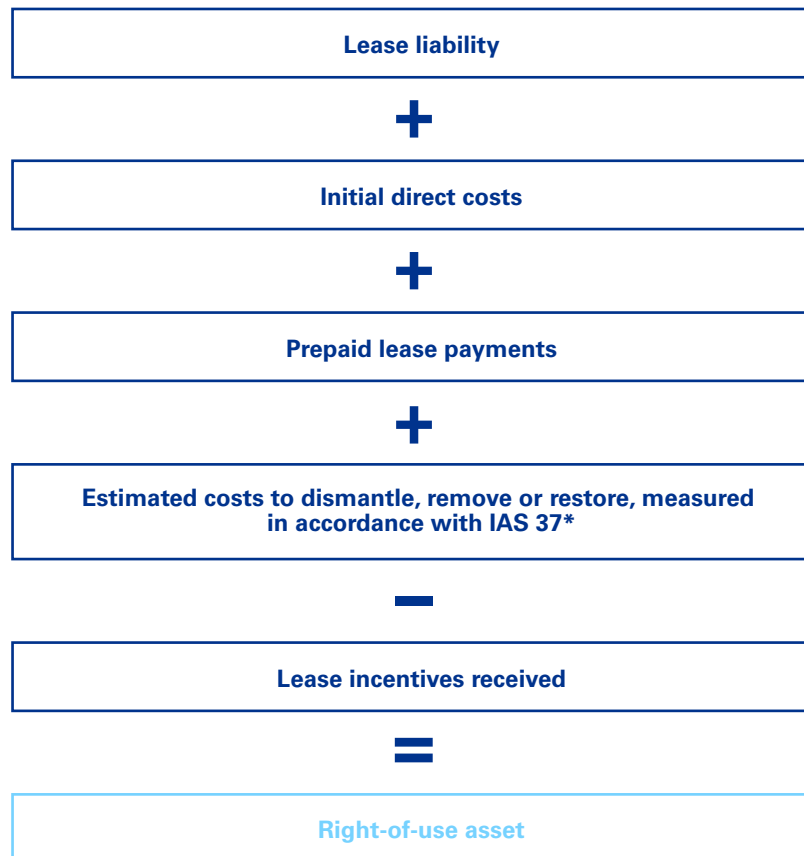
The IFRS Interpretations Committee discussed this matter and noted that the definition of a lessee's incremental borrowing rate requires the lessee to determine its incremental borrowing rate for a particular lease considering the terms and conditions of the lease. The Committee observed that it would be consistent with the International Accounting Standards Board (IASB)'s objective in developing the definition of incremental borrowing rate for a lessee to refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease, although IFRS 16 does not explicitly require this.

2.3

Initial measurement of the right-of-use asset

IFRS 16.23–24

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



* IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

IFRS 16 Appendix A

A lessee's 'initial direct costs' are the incremental costs of obtaining a lease that would not otherwise have been incurred. This definition is similar to the definition of the incremental costs of obtaining a contract under IFRS 15 *Revenue from Contracts with Customers*. That is, the focus is on costs that are contingent on actually obtaining the lease. Costs that are directly attributable to seeking to obtain a lease but are incurred irrespective of whether the lease is actually obtained are not initial direct costs.

Typical initial direct costs of a lessee	
Include	Exclude
• Commissions • Legal fees* • Costs that are incremental and directly attributable to negotiating lease terms and conditions* • Costs of arranging collateral • Payments made by a potential lessee to existing tenants to obtain the lease	• General overheads (e.g. costs incurred by a sales and marketing team or a purchase team) • Costs of investment appraisals, feasibility studies, due diligence and the like that are incurred regardless of whether the lease is entered into • Costs to obtain offers for potential leases

* If they are contingent on obtaining the lease.



Is IFRS 16 a pre-tax accounting model?

Yes. IFRS 16 addresses lessee (and lessor) accounting on a pre-tax basis, even if tax considerations are often a major factor when an entity is assessing whether to lease or buy an asset, and when a lessor is pricing a lease contract. The income tax accounting for lease contracts is in the scope of IAS 12 *Income Taxes*.



Does IAS 12's initial recognition exemption apply when equal taxable and deductible temporary differences arise on initial recognition of the right-of-use asset and lease liability?

No. IAS 12's initial recognition exemption does not apply to transactions that give rise to equal and offsetting temporary differences.

In many tax jurisdictions, a single tax deduction is available for a lease transaction, which needs to be allocated to the right-of-use asset or the lease liability.

Sometimes, determining how to allocate the tax deduction may be straightforward. For example, if a tax deduction is allowed for the depreciation of the leased asset, then it is allocated to the right-of-use asset; conversely, it may be allowed for the settlement of the lease liability, and in these cases, it would be allocated to the lease liability.

IAS 12.15, 22, 22A, 24

However, in some tax jurisdictions, it may be challenging to determine how to allocate the tax deduction. For example, if a deduction is allowed on a cash payment, then it may be unclear whether the tax law regards the payment as a settlement of the lease liability or as consideration for the right to use the asset. In our view, in these circumstances an entity should apply judgement, based on the terms of the local tax law, to determine whether to allocate a tax deduction related to a lease to the right-of-use asset or the lease liability.

Tax deduction allocated to:	Do temporary differences arise on initial recognition?	Is deferred tax recognised?
Right-of-use asset	No. The carrying amounts of both the right-of-use asset and the lease liability equal their respective tax bases.	Not applicable because there is no temporary difference.
Lease liability	Yes. - Right-of-use asset: taxable temporary difference arises (i.e. there is an asset for accounting purposes but no corresponding asset for tax purposes). - Lease liability: deductible temporary difference arises (i.e. the liability recognised for accounting purposes has a tax base of zero).	Yes. IAS 12's initial recognition exemption does not apply because the transaction gives rise to equal taxable and deductible temporary differences.

2.4 Subsequent measurement of the lease liability

2.4.1 Measurement basis

IFRS 16.36

After initial recognition, a lessee measures the lease liability by:

- increasing the carrying amount to reflect interest on the lease liability;
- reducing the carrying amount to reflect the lease payments made; and
- remeasuring the carrying amount to reflect:
 - any reassessment (see 2.4.2) or lease modifications (see Section 7.2); and
 - revised in-substance fixed lease payments (see 2.4.2).

IFRS 16.37

Interest on the lease liability in each period during the lease term is the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The 'periodic rate of interest' is the discount rate used in the initial measurement of the lease liability (see 2.2.3) or, if appropriate, the revised discount rate (see 2.4.2 and Section 7.2).

IFRS 16.BC183

Lessees cannot choose to measure lease liabilities subsequently at fair value.



Example 5 – Lease liability: Subsequent measurement

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 estimates that the incremental borrowing rate is 5.04% and uses it to measure the lease liability. The initial recognition of the obligation to make lease payments is 2,600.

X performs the following calculations at the end of Year 1.

	Amount	
Initial recognition of lease liability		2,600
Payment	(450)	
Repayment of interest	(131) ⁽¹⁾	
Repayment of principal		(319) ⁽²⁾
Carrying amount of liability at end of Year 1		2,281 ⁽³⁾

¹ Calculated as 2,600 × 5.04%.

² Calculated as 450 - 131.

³ Calculated as 2,600 - 319.

2.4.2

Remeasurement of the lease liability

IFRS 16.39

After the commencement date, a lessee remeasures the lease liability to reflect changes in the lease payments. This occurs when the lessee reassesses whether it is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease early. In addition, the lessee revises the lease term and remeasures the lease liability when there is a change in the non-cancellable period of a lease. See Section 6.6 for a detailed discussion.

The following table describes which discount rate to use for the remeasurement.

IFRS 16.36(c), 40–43, B42(a)(ii)

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 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 6 – Lease liability: 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 discounted at 5.9% to the commencement date.

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 ($655 \times 5.9\%$)	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).

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 [Section 2.5](#)). Y records the following entry.

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

2.5 Subsequent measurement of the right-of-use asset

2.5.1 Measurement basis

IFRS 16.29–30

Generally, a lessee measures right-of-use assets at cost less accumulated depreciation (see 2.5.2) and accumulated impairment losses (see 2.5.3).

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

The lessee adjusts the carrying amount of the right-of-use asset for the remeasurement of the lease liability – e.g. when there is a change in CPI (see 2.4.2). If the carrying amount of the right-of-use asset has already been reduced to zero and there is a further reduction in the measurement of the lease liability, then the lessee recognises any remaining amount of the remeasurement in profit or loss.

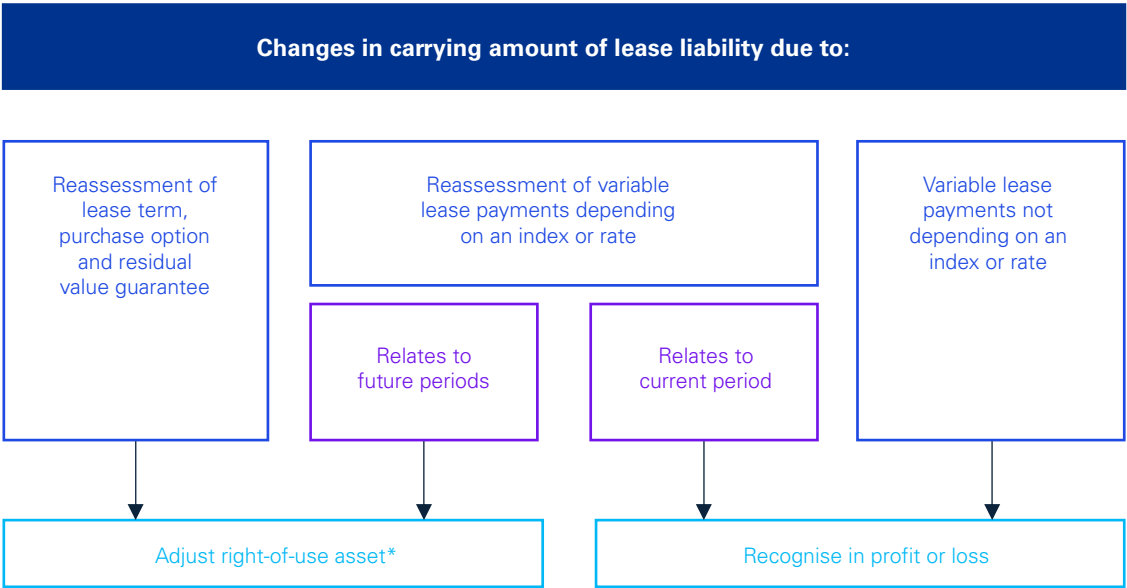
IFRS 16.34–35,
IAS 40.2

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 all of its investment property, which may be at fair value; and
- if a lessee applies the revaluation model to a class of property, plant and equipment, then it may elect to apply the revaluation model to all right-of-use assets that belong to the same class.

IFRS 16.38–39

The following diagram summarises the impact of changes in the carrying amount of the lease liability on the right-of-use asset.



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

2.5.2 Depreciation of the right-of-use asset

IFRS 16.31, IAS 16.60

A lessee depreciates right-of-use assets in accordance with the requirements of IAS 16 *Property, Plant and Equipment* – i.e. the depreciation method reflects the pattern in which the future economic benefits of the right-of-use asset are consumed. This will usually result in a straight-line depreciation charge.

IFRS 16.32

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 7 – Right-of-use asset: 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.

Ownership does not transfer to X; therefore, X depreciates the right-of-use asset from the commencement date over a period of five years (i.e. the end of the lease term).



Does IAS 16 *Property, Plant and Equipment* component accounting apply to depreciation of leases?

IFRS 16.31, IAS 16.43

Yes. IFRS 16 states that a lessee applies the depreciation requirements in IAS 16 and therefore identifies separate components for the purposes of depreciation. This can be an important practical consideration for lessees that lease big-ticket items under operating leases and adopt a component approach to maintenance accounting – e.g. major maintenance checks in some aircraft leases.

2.5.3 Impairment of the right-of-use asset

IFRS 16.33, IAS 36.63

A lessee applies 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 8 – Impairment of the 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.

2.6 Recognition exemptions for lessees

IFRS 16.5, Appendix A

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

- leases with a lease term of 12 months or less that do not contain a purchase option: i.e. short-term leases (see 2.6.1); and
- leases for which the underlying asset is of low value when it is new: even if the effect is material in aggregate (see 2.6.2).



**Short-term
leases**

≤ 12 months



**Leases of
low-value items**

≤ USD 5,000
for example

IFRS 16.6

If a lessee elects to apply 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.

2.6.1 Short-term leases

IFRS 16.8

The election for short-term leases is made by class of underlying asset. A 'class of underlying asset' is a grouping of underlying assets of a similar nature and use in the lessee's operations. When electing the short-term lease exemption for a particular class of underlying asset, only underlying assets from leases that meet the definition of a short-term lease are considered.

IFRS 16 Appendix A

The 'lease term' is determined in a manner consistent with that for all other leases (see Chapter 6). Consequently, the short-term lease exemption may be applied to renewable and cancellable leases (e.g. month-to-month, evergreen leases) if the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months.



Example 9 – Recognition exemption: Short-term lease

IFRS 16.18, B34–B35,
B37

Lessee L manufactures toys. L enters into a 10-year lease of a non-specialised machine to be used in manufacturing parts for Racing Car X1. It expects this model of toy to remain popular with customers until it completes development and testing of an improved model – Racing Car X2. The current machine can be easily replaced and the cost to install it in L's manufacturing facility is not significant. L, but not the lessor, has the right to terminate the lease without penalty on each anniversary of the lease commencement date.

The non-cancellable period is one year (see Section 6.2). In addition, because the machine is not specialised, it can easily be replaced and the cost to install the machine in L's manufacturing facility is not significant. L determines that it is not reasonably certain to continue the lease after the first year (see Section 6.4). As a result, the lease term is also one year and the lease qualifies for the short-term lease exemption.



What happens if the lessee applies the short-term lease exemption and there are changes in the lease term?

IFRS 16.7

If a lessee elects to apply 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 that it was not reasonably certain to exercise – or the lease is modified, then the lessee accounts for the lease as a new lease.

2.6.2 Low-value items

IFRS 16.5(b), 8, B3–B8

A lessee is permitted not to apply the recognition and measurement requirements to leases of assets that, when they are new, are of low value. This exemption, unlike the short-term lease exemption, can be applied on a lease-by-lease basis.

IFRS 16.B5

A lessee does not apply the low-value exemption to a lease of an individual asset in either of the following scenarios:

- if the underlying asset is highly dependent on, or highly inter-related with, other assets; or
- if the lessee cannot benefit from the underlying asset on its own or together with other readily available resources, irrespective of the value of that underlying asset.

IFRS 16.B7

The low-value exemption also does not apply to a head lease for an asset that is sub-leased or that is expected to be sub-leased. When a lessee neither enters into a sub-lease immediately nor expects to do so later, it may elect to apply the exemption.

IFRS 16.B6, B8, BC98–BC104

IFRS 16 does not specify a threshold for the low-value exemption, but the basis for conclusions states that the IASB ‘had in mind’ assets with a value of approximately USD 5,000 or less when they are new, such as small IT equipment (e.g. some laptops, desktops, tablets, mobile phones, individual printers) and some office furniture – i.e. ‘inexpensive’ assets. The exemption is not intended to capture underlying assets such as cars and most photocopiers.



Example 10 – Recognition exemption: Low-value items

IFRS 16.IE3

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

- real estate, both office building and warehouse;
- inexpensive office furniture;
- company cars, both for sales personnel and for senior management and of varying quality, specification and value;
- trucks and vans used for delivery; and
- inexpensive IT equipment – e.g. laptops.

B determines that the leases of inexpensive 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. Although the low-value exemption can be applied on a lease-by-lease basis, B elects to apply the exemption to all of these leases. In contrast, B applies the recognition and measurement requirements of IFRS 16 to its leases of real estate, company cars, trucks and vans.



What happens if the low-value exemption is applied and the underlying asset is subsequently sub-leased?

IFRS 16.7, B7

If a lessee sub-leases, or expects to sub-lease, an asset, then the head lease does not qualify as a lease of a low-value item. When a lessee neither enters into a sub-lease immediately nor expects to do so later, it may elect to apply the exemption.

However, if a lessee initially elects to use the low-value exemption – because it expects not to sub-lease the asset – but subsequently does enter into a sub-lease, then the lease would no longer qualify for the exemption. In our view, at the date of the change, the lessee should consider the lease to be a new lease. In these cases, the lessee also considers whether the reason for the change in intention provides evidence about whether other leases of low-value items do or do not qualify for the exemption.

2.7 Presentation and disclosure

2.7.1 Lessee presentation

IFRS 16.47–50

A lessee presents leases in its financial statements as follows.

Statement of financial position	Statement of profit or loss and other comprehensive income	Statement of cash flows
Right-of-use asset - Separate presentation in the statement of financial position* or disclosure in the notes to the financial statements Lease liability - Separate presentation in the statement of financial position or disclosure in the notes	Lease expenses Separate presentation of interest expense on the lease liability from depreciation of the right-of-use asset	Operating activities - Variable lease payments not included in the lease liability - Payments for short-term and low-value leases (subject to use of recognition exemption) Financing activities - Cash payments for principal portion of lease liability Depending on 'general' allocation - 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.

2.7.2

Lessee disclosure

IFRS 16.51

A lessee discloses information that provides a basis for users of financial statements to assess the effect that leases have on financial position, financial performance and cash flows.

IFRS 16.52

A lessee discloses information about leases for which it is a lessee in a single note or separate section in the financial statements. However, a lessee does not need to duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

IFRS 16.53–60,
IAS 16.77

Extensive disclosures are required by lessees. These are addressed in our [Guides to financial statements](#).

Normally, a lessee discloses at least the following information.

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 recognition exemption for short-term and/or low-value item leases

IFRS 16.47, 53, 58

IFRS 16.53–54

IFRS 16.53

IFRS 16.55

IFRS 16.58, 60,
IFRS 7.B11

*IFRS 16.56–57,
IAS 16.77*

Additional disclosures (when applicable)

- Disclosures required by IAS 40 *Investment Property* for right-of-use assets qualifying as investment property
- If the revaluation model of IAS 16 is applied for right-of-use assets, then:
 - 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

3 Lessor accounting

Lessors classify leases as finance or operating leases.

3.1 Lessor accounting model

IFRS 16.B53, BC289

The lessor follows a dual accounting approach for lease accounting. The accounting is based on whether significant risks and rewards incidental to ownership of an underlying asset are transferred to the lessee, in which case the lease is classified as a finance lease. This is similar to the previous lease accounting requirements that applied to lessors. The lessor accounting models are also essentially unchanged from IAS 17 *Leases*.



Are the lessee and lessor accounting models consistent?

No. A key consequence of the decision to retain a dual accounting model for lessors is a lack of consistency with IFRS 16's lessee accounting model. This can be seen in [Example 11](#), in which the lessor classifies the lease as an operating lease:

- 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 renewal and purchase options are reasonably certain to be exercised, and termination options not reasonably certain to be exercised. However, unlike lessees, lessors do not reassess their initial assessments of lease term and whether renewal and purchase options are reasonably certain to be exercised, and termination options not reasonably certain to be exercised (see [Section 6.6](#)).

Other differences are more subtle. For example, although the definition of lease payments is similar for lessors and lessees (see [2.2.2](#)), the difference is the amount of residual value guarantee included in the lease payments.

- The lessor includes the full amount (regardless of the likelihood that payment will be due) of any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.
- The lessee includes only any amounts expected to be payable to the lessor under a residual value guarantee.

3.2 Lease classification

IFRS 16.61–62, B53

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 the same as the one that previously existed in IAS 17.

IFRS 16.63

Generally, the presence of the following indicators, either individually or in combination, leads to a lease being classified as a finance lease:

- transfer of ownership to the lessee either during or at the end of the lease term;
- existence of a purchase option that is reasonably certain to be exercised;
- the lease term is for a major part of the economic life of the underlying asset;
- the present value of the lease payments amounts to substantially all of the fair value of the underlying asset at inception of the lease; and
- the underlying asset is specialised.

IFRS 16.66

Lease classification is made at the inception date and is reassessed only if there is a lease modification. Changes in estimates (e.g. changes in estimates of the economic life or of the residual value of the underlying asset), or changes in circumstances (e.g. default by the lessee), do not give rise to a new classification of a lease for accounting purposes.

IFRS 16.B54

However, if the contract includes terms and conditions to adjust the lease payments for particular changes occurring between the inception date and the commencement date, then, for the purpose of classifying the lease, the effect of any such changes is deemed to have taken place at the inception date.



Example 11 – 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.

IFRS 16.B55,
BCZ241–BCZ244



Are there special rules on the classification of leases of land?

No. The classification of a lease of land is assessed based on the general classification guidance. An important consideration is that land normally has an indefinite economic life. However, the fact that the lease term is normally shorter than the economic life of the land does not necessarily mean that a lease of land is always an operating lease; the other classification requirements are also considered.

For example, in a 99-year lease of land with fixed lease payments, the significant risks and rewards associated with the land are transferred to the lessee during the lease term, and on lease commencement the present value of the residual value of the land would be negligible. It follows that a long lease term may indicate that a lease of land is a finance lease.

There is no bright-line threshold for the lease term above which a lease of land would always be classified as a finance lease, and assessing classification can require the use of significant judgement in some cases.

IFRS 16.66–67, 70–71,
B54



Do changes between the inception and commencement dates impact lease classification?

Yes, in some cases. Generally, the classification of a lease is determined at inception of the lease and is not revised unless the lease agreement is modified. However, the classification is updated for certain changes between inception date and commencement date that are deemed to have taken place at the inception date.

A significant amount of time may pass between the inception date and the commencement date – e.g. when parties commit to leasing an underlying asset that has not yet been built. A lease contract may also include terms and conditions to adjust the lease payments for changes that occur between the inception date and the commencement date – e.g. a change in the lessor's cost of the underlying asset or a change in the lessor's cost of financing the lease.

In such cases, the calculation of the present value of lease payments used in determining the classification of the lease covers all lease payments made from the commencement of the lease term. However, if the lease payments are adjusted for contractual changes such as changes in the construction or acquisition cost of the underlying asset, general price levels or the lessor's costs of financing the lease between the inception and commencement dates, then the effect of these changes is deemed to have taken place at inception for the purpose of classifying the lease.

In our view, the lease payments for classification purposes should also be updated for changes between the inception and commencement dates in:

- the non-cancellable period of the lease (see [Section 6.2](#));
- lease payments that depend on an index or a rate; and
- variable payments that become in-substance fixed.

We believe that these changes are akin to contractual changes between the inception and commencement dates, and therefore the effect of these changes should be deemed to have taken place at inception for the purpose of classifying the lease. Consequently, a lessor should also update the rate implicit in the lease and its estimate of the unguaranteed residual value for classification purposes for such contractual changes.

However, for measurement purposes, in our view a lessor should update the lease payments, the rate implicit in the lease and the unguaranteed residual value for all changes between inception and commencement date. This is because a lessor measures the net investment in a finance lease, and the amount of operating lease income to be recognised, at the commencement date.

3.3 Operating lease model

IFRS 16.62

The lessor classifies a lease that is not a finance lease as an operating lease.

IFRS 16.81

If, before lease commencement, a lessor recognises an asset in its statement of financial position and leases that asset to a lessee under an operating lease, then the lessor does not derecognise the asset on lease commencement. Generally, future contractual rental payments from the lessee are recognised as receivables over the lease term as the payments become receivable.

IFRS 16.81, 83

Generally, lease income from operating leases is recognised by the lessor on a straight-line basis from the commencement date over the lease term. It may be possible for the lessor to recognise lease income using another systematic basis if that is more representative of the time pattern in which the benefit from the use of the underlying asset is diminished. Similarly, increases (or decreases) in rental payments over a period of time, other than variable lease payments, are reflected in the determination of the lease income, which is recognised on a straight-line basis.

IFRS 16.83

The initial direct costs incurred by the lessor in arranging an operating lease are added to the carrying amount of the underlying asset and cannot be recognised immediately as an expense. Initial direct costs are incremental costs of obtaining the lease that would otherwise not have been incurred. These costs are recognised as an expense on the same basis as the lease income. This will not necessarily be consistent with the basis on which the underlying asset is depreciated.

IFRS 16.81,
Appendix A

Incentives granted to the lessee in negotiating a new or renewed operating lease are recognised as an integral part of the lease payments relating to the use of the underlying asset. They are recognised as a reduction of rental income over the lease term using the same recognition basis as for the lease income.

IFRS 16.84

The lessor depreciates the underlying asset over the asset's useful life in a manner that is consistent with the depreciation policy that it applies to similar owned assets.

IFRS 16.85, 9.2.1(b)(i)

A lessor applies IAS 36 *Impairment of Assets* to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified. In addition, the lessor applies the impairment and derecognition requirements of IFRS 9 to operating lease receivables.



Does a lessor continue to recognise operating lease income on a straight-line basis if the lessee reduces actual usage of the underlying asset?

IFRS 16.81

Generally, yes.

In many leases, the benefit conveyed by the lessor to the lessee is the right to use the underlying asset over the lease term. For this reason, operating lease income from leases is typically recognised by the lessor on a straight-line basis from the commencement date over the lease term.

IFRS 16 states that it is possible to recognise operating lease income using another systematic basis if that is more representative of the time pattern in which the benefit of the underlying property is diminished. However, it is rare that a basis other than straight-line meets this test in a lease. For example, in a real estate lease, a retailer that leases a retail store from a landlord may expect its sales at the store to vary seasonally, and may project year-on-year increases in sales. However, the benefit that the retailer receives under the lease is the right to use the store. Therefore, if the lease payments are fixed then the landlord would recognise operating lease income on a straight-line basis in this fact pattern.

A question arises about whether this approach remains appropriate if the tenant significantly reduces sales at the store and/or the government imposes restrictions that reduce footfall at the store.

In the absence of a change in the lease agreement, the tenant's benefit under the lease agreement remains the right to use the store. As long as the landlord continues to convey the right to use the store to the retailer, the landlord will typically continue to recognise operating lease income on a straight-line basis.

3.4 Finance lease model

IFRS 16.67–69,
Appendix A

At commencement, the lessor derecognises the underlying asset and recognises a finance lease receivable at an amount equal to its net investment in the lease, which comprises the present value of the lease payments and any unguaranteed residual value accruing to the lessor. The present value is calculated by discounting the lease payments and any unguaranteed residual value, at the interest rate implicit in the lease (see 2.2.3). Initial direct costs are included in the measurement of the finance lease receivable, because the interest rate implicit in the lease takes initial direct costs incurred into consideration.

IFRS 16.70(a)

The lessor deducts any lease incentive payable from the lease payments included in the measurement of the net investment in the lease.

The lessor recognises the difference between the carrying amount of the underlying asset and the finance lease receivable in profit or loss when recognising the finance lease receivable. This gain or loss is presented in profit or loss in the same line item as that in which the lessor presents gains or losses from sales of similar assets.

IFRS 16.75–76

Over the lease term, the lessor accrues interest income on the net investment. The receipts under the lease are allocated between reducing the net investment and recognising finance income, to produce a constant rate of return on the net investment.

IFRS 16.77

A lessor applies the derecognition and impairment requirements of IFRS 9 to the net investment in the lease. A lessor recognises any loss allowance on the finance lease receivable, applying IFRS 9. A lessor regularly reviews estimated unguaranteed residual values used in computing the gross investment in the lease. If there is a reduction in the estimated unguaranteed residual value, then the lessor revises the income allocation over the lease term without changing the discount rate and immediately recognises any reduction in respect of amounts accrued. For a discussion on measuring the expected credit losses on lease receivables, see Chapter 7.8 of our publication [Insights® into IFRS](#).

3.5 Presentation and disclosure

3.5.1 Lessor presentation

A lessor presents leases in its statement of financial position as follows.

Finance lease	Operating lease
Statement of financial position	
Present assets held under a finance lease as a receivable at an amount equal to the net investment in the lease	Present the underlying assets subject to operating leases according to the nature of the underlying asset

IFRS 16.67, 88

3.5.2

Lessor disclosure

IFRS 16.89

A lessor discloses information that provides a basis for users of financial statements to assess the effect that leases have on financial position, financial performance and cash flows. Extensive disclosures are required by lessors for finance and operating leases. These are addressed in our [Guides to financial statements](#).

Normally, a lessor discloses at least the following information.

IFRS 16.90

IFRS 16.93–97

IFRS 16.93

IFRS 16.92

Finance lease	Operating lease
Quantitative information	
• 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	• Lease income relating to variable lease payments that do not depend on an index or rate • Other lease income
• Significant changes in the carrying amount of the net investment in the lease • Detailed maturity analysis of the lease payments receivable • A reconciliation between the undiscounted lease payments and the net investment in the lease, identifying the unearned finance income and any discounted unguaranteed residual value	• If applicable, disclosures in accordance with IAS 16 (separately from other assets), IAS 36, IAS 38 <i>Intangible Assets</i>, IAS 40 and IAS 41 <i>Agriculture</i> • Detailed maturity analysis of the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years
Qualitative information	
• Significant changes in the carrying amount of the net investment in the lease	• N/A

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.

4 Lease definition

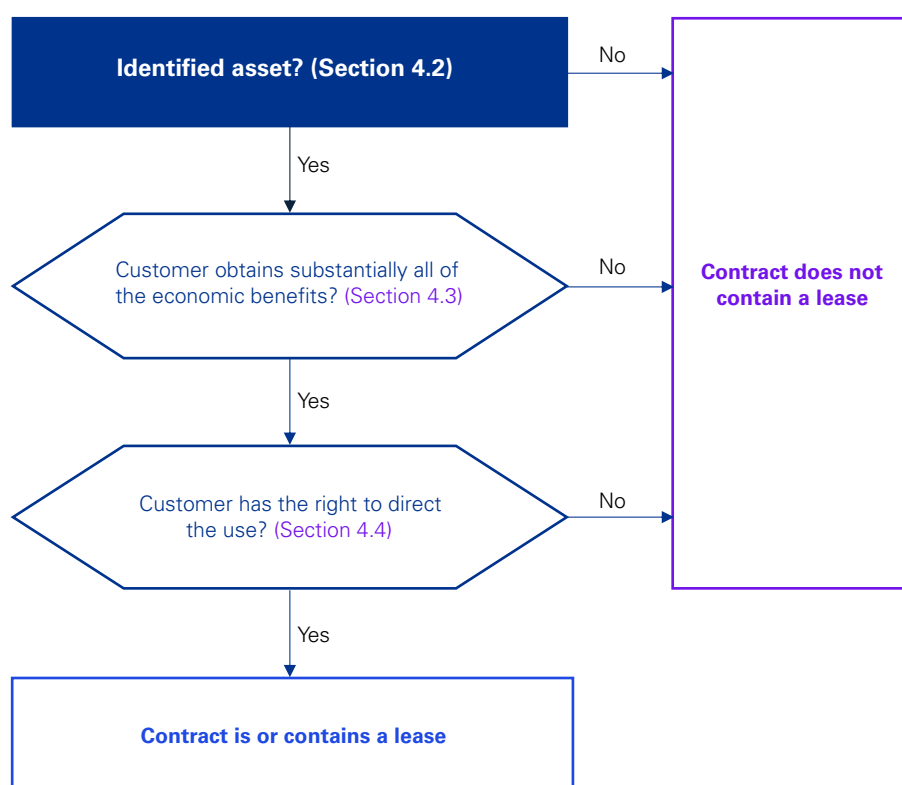
Lease definition is a key area of judgement in applying the standard – a de facto on/off-balance sheet test for lessees.

4.1 Overview

IFRS 16.9,
Appendix A

A contract is, or contains, a lease if it conveys the right to control the use of an identified asset (the underlying asset) for a period of time in exchange for consideration.

The key elements of the definition are therefore as follows.

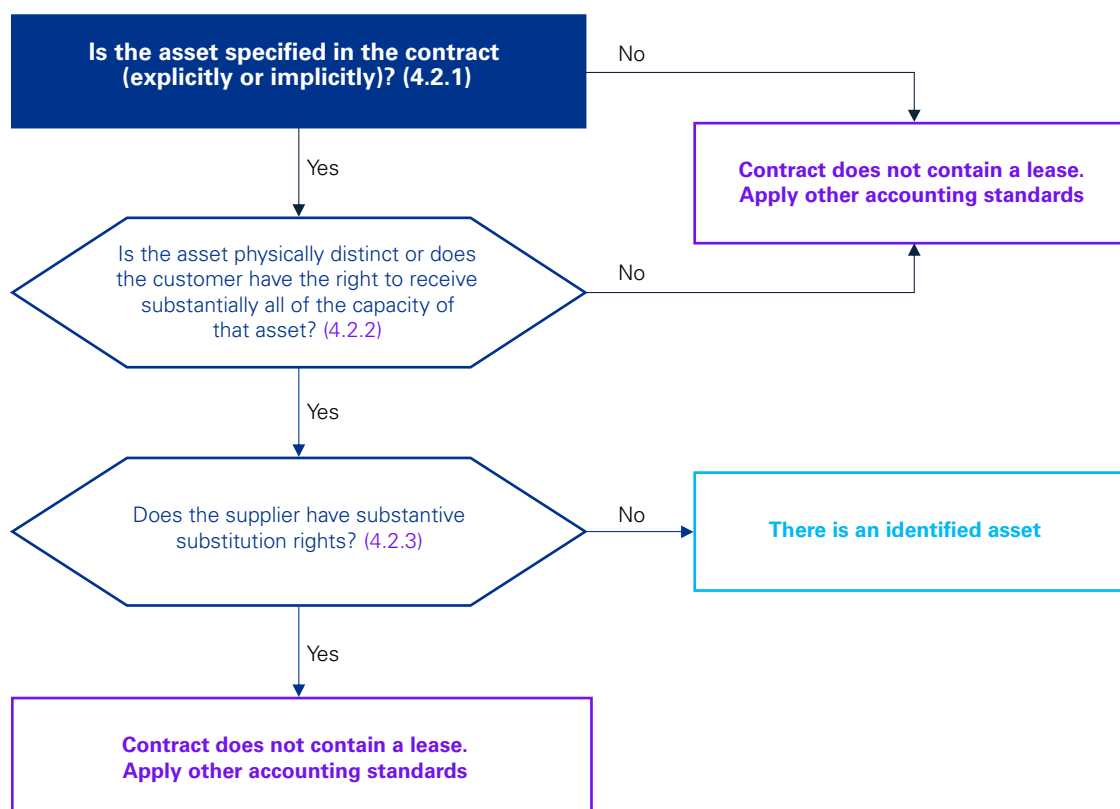


However, a lessee is not required to apply the lessee accounting model to leases that qualify for recognition exemptions (see [Section 2.6](#)).

4.2 Identified asset

IFRS 16.B13–B20

A contract contains a lease only if it relates to an identified asset.



4.2.1 Specified asset

IFRS 16.B13, BC111

An asset can be either explicitly specified in a contract (e.g. by a serial number or a specified floor of a building) or implicitly specified at the time it is made available for use by the customer.



What does 'implicitly specified' mean?

An asset is implicitly specified if the facts and circumstances indicate that the supplier can fulfil its obligations only by using a specific asset. This may be the case if the supplier has only one asset that can fulfil the contract. For example, a power plant may be an implicitly specified asset in a power purchase contract if the customer's facility is in a remote location with no access to the grid, such that the supplier cannot buy the required energy in the market or generate it from an alternative power plant.

In other cases, an asset may be implicitly specified if the supplier owns a number of assets with the required functionality, but only one of those assets can realistically be supplied to the customer within the contracted timeframe – i.e. the supplier does not have a substantive right to substitute an alternative asset to fulfil the contract – see 4.2.3. For example, a supplier may own a fleet of vessels but only one vessel that is in the required geographic area and not already being used by other customers.

4.2.2

IFRS 16.B20

Capacity portions

A capacity portion of an asset can be an identified asset if:

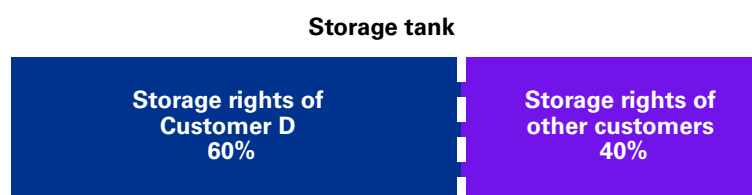
- it is physically distinct (e.g. a floor of a building, a specified strand of a fibre-optic cable or a distinct segment of a pipeline); or
- it is not physically distinct, but the customer has the right to receive substantially all of the capacity of the asset (e.g. a capacity portion of a fibre-optic cable that is not physically distinct but represents substantially all of the capacity of the cable).



Example 12 – Identified asset: Capacity portion is not an identified asset

Customer D enters into an arrangement with Supplier E for the right to store its gas in E's specified storage tank. The storage tank has no separate compartments. At inception of the contract, D has the right to use up to 60% of the capacity of the storage tank throughout the term of the contract. E can use the other 40% of the storage tank as it sees fit.

E has no substitution rights. However, the arrangement allows E to store gas from other customers in the same storage tank.

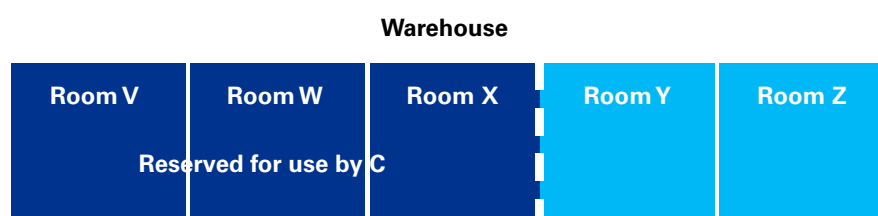


In this scenario, there is no identified asset. This is because D only has rights to 60% of the storage tank's capacity and that capacity portion is not physically distinct – i.e. is not physically separated – from the remainder of the tank, and does not represent substantially all of the capacity of the storage tank.



Example 13 – Identified asset: Capacity portion is an identified asset

Customer C enters into an arrangement with Supplier S for the right to store its products in a specified storage warehouse. Within this storage warehouse, rooms V, W and X are contractually allocated to C for its exclusive use. S has no substitution rights. Rooms V, W and X represent 60% of the warehouse's total storage capacity.



In this example, there is an identified asset. This is because:

- the rooms are explicitly specified in the contract;
- the rooms are physically distinct from the other storage locations within the warehouse; and
- S has no (substantive) substitution rights.



Does 'substantially all' of the capacity of an asset mean 90 percent?

Not necessarily. IFRS 16 does not define what is meant by 'substantially all' in the context of the definition of a lease.

IFRS 16 uses the same phrase in one of the criteria used by the lessor to determine lease classification: whether the present value of the lease payments (including the residual value guaranteed by the lessee or a third party) equals or exceeds substantially all of the fair value of the asset. US GAAP allows but does not require the use of a threshold of 90 percent for 'substantially all' when a lessor is determining classification. In our view, although the 90 percent threshold may provide a useful reference point, it does not represent a bright-line or automatic cut-off point under IFRS Accounting Standards.

For the purpose of applying the lease definition, an entity should develop an interpretation of 'substantially all' and apply it on a consistent basis.

4.2.3

Substantive supplier substitution rights

IFRS 16.B14

Even if an asset is specified in a contract, a customer does not control the use of an identified asset if the supplier has a substantive right to substitute the asset for an alternative asset. Such a right exists if the supplier:

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

IFRS 16.B18

A supplier's right or obligation to substitute the asset for repairs and maintenance, because the asset is not working properly – i.e. a 'warranty-type' obligation – or because a technical upgrade becomes available, is not a substantive substitution right.

IFRS 16.B14(a)

A supplier has the practical ability to substitute alternative assets when the customer cannot prevent it from substituting the asset and the supplier has alternative assets either readily available or available within a reasonable period of time.

IFRS 16.B15

However, there is no practical ability to substitute the asset *throughout* the period of use (and therefore there is no substantive substitution right) if the substitution right applies, for example, only:

- to a part of the period of use or at or after a specific date; or
- on the occurrence of a particular event.

IFRS 16 Appendix A

The 'period of use' is the total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).

IFRS 16.B14(b)

A supplier would benefit economically from the exercise of its right to substitute the asset when the economic benefits associated with substituting the asset are expected to exceed the related costs.

IFRS 16.B17

The costs associated with substitution are generally higher if the asset is not located at the supplier's premises – i.e. when it is at the customer's premises or elsewhere. In this situation, the costs are more likely to exceed the benefits associated with substituting the asset.

**Example 14 – Identified asset: Substantive substitution right**

Customer L enters into a five-year contract with Freight Carrier M for the use of rail cars from 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. The costs associated with substituting the rail cars are minimal for M.

Relevant experience demonstrates that:

- M benefits economically from being able to deploy alternative assets as necessary to fulfil its contracts with customers; and
- the conditions that make substitution economically beneficial are likely to continue throughout the period of use.

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, M has the practical ability to substitute the assets – i.e. the rail cars are not implicitly specified. In addition, the substitution is economically beneficial to M throughout the period of use. Therefore, M's substitution rights are substantive and the arrangement does not contain a lease.

**Example 15 – Identified asset: No substantive substitution right**

Customer L enters into an eight-year contract with Supplier K that requires K to install and maintain specific lighting equipment at L's stores. The equipment is designed and selected by K, subject to L's approval. K has an option to upgrade the equipment for future technological advancements and an obligation to replace any damaged or defective equipment. However, the equipment is large and costly to transport and install. Therefore, it is not economically feasible or practicable for K to substitute alternative assets once the equipment is installed – i.e. the costs of substitution would exceed the benefits.

Therefore, the substitution rights are not substantive and so fulfilment of the arrangement is dependent on the use of identified assets.

**Example 16 – Supplier's substitution right does not apply throughout the period of use****Scenario 1**

Customer S enters into a contract with Supplier T for the right to use a motor vehicle for five years. T has the right to substitute the asset at any time after three years from the commencement of the contract (i.e. no substitution right for the first three years).

Because the supplier's substitution right does not apply throughout the period of use, it is not substantive.

Scenario 2

The contract is the same as in Scenario 1 except that it gives T the right to substitute the identified asset on a single date, three years into the lease, but not at any other time.

The substitution right is not substantive because it does not apply throughout the period of use.

Scenario 3

The contract is the same as in Scenario 1 except that T has a right to substitute the identified asset on the occurrence of a particular event.

The substitution right is not substantive because it does not apply throughout the period of use but only on the occurrence of a particular event.

Scenario 4

The contract is the same as in Scenario 1 except that T has a right to substitute the identified asset throughout the period of use. However, T is only expected to benefit economically from the substitution once the asset has been used for three years or more.

The substitution right is not substantive because T is not expected to benefit economically from exercising its substitution rights for at least the first three years of the contract.



How do you evaluate whether the supplier would benefit economically from exercising its substitution rights and what should a customer do if it cannot assess whether a substitution right is substantive?

Judgement will be required to evaluate when the economic benefits associated with substituting the asset are expected to exceed the costs associated with doing so.

Examples of factors to consider include:

- the availability of other assets to fulfil the contract;
- the alternative use of the asset and additional benefits for the supplier;
- the costs that would be incurred to substitute the asset (e.g. costs of relocation, disruption of activity during a period of time); and
- the feasibility of substituting the asset (because of size and remote location).

Because the analysis is performed from the supplier's perspective, it is more difficult for the customer to determine whether the supplier's substitution right is substantive. Many of the factors that influence whether a substitution right is substantive are specific to the supplier – e.g. whether the supplier has access to alternative assets, the costs involved in substitution. The customer may not have access to this information.

If a customer cannot readily determine whether a supplier has a substantive substitution right, then the customer is to presume that any substitution right is not substantive.

IFRS 16.B19, BC115



When and how does an entity assess whether substitution rights are substantive?

IFRS 16.B16

An entity assesses whether substitution rights are substantive at inception of the contract. At that time, the entity considers all of the facts and circumstances, but not future events that are not likely to occur. For example, it excludes the following future events:

- an agreement by a future customer to pay an above-market rate for use of the asset;
- the introduction of new technology that is not substantially developed at inception of the contract;
- a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and
- a substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract.

4.3

Economic benefits from using the asset

IFRS 16.B9

To determine whether a contract conveys the right to control the use of an identified asset, an entity 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 throughout the period of use (see [Section 4.4](#)).

IFRS 16.B21, BC118

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). The benefits derived from ownership of the asset (e.g. income tax credits) are excluded from the analysis.

IFRS 16.B22

An entity considers the economic benefits that are in the defined scope of the right to use the asset – e.g. if a contract limits the use of a vehicle to only one particular territory during the period of use, then the entity considers only the economic benefits from use of the vehicle within that territory, and not beyond.



Example 17 – Economic benefits from use of a solar farm

IFRS 16.IE2, Ex9

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 the *use* of the solar farm and therefore are not considered in this assessment.

IFRS 16.B21,
IU 11–21



Example 18 – Economic benefits from use of a wind farm

Wind farm Operator E cannot supply electricity directly to customers and instead supplies electricity to the grid, from which the customers purchase electricity. E enters into a 20-year contract with Customer F that fixes the electricity unit price E will receive by swapping the spot price of electricity it supplies to the grid for a fixed price, with the difference settled in cash. The contract also transfers to F all renewable energy credits that accrue from use of the wind farm.

In assessing whether the customer receives substantially all of the economic benefits from use of the wind farm, there are two types of benefits to consider:

- the actual electricity generated by the wind farm; and
- the renewable energy credits.

Although F receives all of the renewable energy credits, it has no right to receive any of the electricity that the wind farm produces. Therefore, F does not receive substantially all of the economic benefits from use of the wind farm and, therefore, there is no lease.

IFRS 16.B21,
IU 03–26



Example 19 – Economic benefits from use of a battery under an offtake arrangement

Battery Owner G and Customer H enter into a battery offtake arrangement, under which G retains custody of the battery but is contractually obliged to operate it in accordance with H's instructions, which cover 100% of the battery's capacity. The battery cannot be substituted. H instructs G whether and when to charge and discharge the battery throughout the period of use.

Electricity stored in the battery is sold into a gross pool electricity market. In such a market, settlement of electricity transactions requires a single registered participant to transact with the market operator.

As G is the registered participant, it:

- buys and sells electricity to the market at the spot price by charging and discharging the battery according to H's instructions;
- pays (or receives) all resulting cash flows from the purchase and sale of electricity stored in the battery to (or from) H; and
- receives a fixed amount from H for the use of the battery regardless of whether the battery is charged or discharged.

Transactions between G and H are settled periodically, net in cash.

The economic benefits from use of the battery are derived from its storage capability and capacity; the battery is used to store, and then release, electricity.

H obtains the economic benefits derived from the battery storage because it has the exclusive right to use the entire capacity of the battery throughout the period of use, and to direct G as to whether, when and by how much to charge and discharge the battery. Therefore, H has the right to obtain substantially all of the economic benefits from use of the battery.



Example 20 – Sub-letting

IFRS 16.B21

Customer C enters into a contract to use an office. Because C does not need all of the space covered by the contract, it sub-lets 25%. C receives substantially all of the economic benefits through its own use and sub-letting (other benefits).



Example 21 – Sharing the economic benefits

IFRS 16.B22

Customer G enters into a two-year contract to use a business jet. G shares access and use of the business jet with another party. Both parties have the right to use the jet at any point in time, subject to a certain number of hours per month and the other party not using it at the same time. Neither party has the right to use substantially all of the hours for which the jet is available each month. G does not receive substantially all of the economic benefits because it shares the use of the asset with another party.



How does an entity evaluate whether a customer has the right to substantially all of the economic benefits from use of an asset?

Evaluating whether a customer has the right to obtain *substantially all* of the economic benefits from use of an asset throughout the period of use is straightforward in many situations, generally because the customer in a lease frequently has exclusive use of the asset.

However, in some situations a contract may provide a party other than the customer the right to more than a minor amount of the economic benefits from use of the same asset. In evaluating whether the customer has the right to obtain substantially all of the economic benefits from use of an asset, an entity considers the complete population of economic benefits that can be derived from the asset in the scope of the customer's right to use.



Are tax credits and similar items 'economic benefits' for the purpose of applying the lease definition?

IFRS 16.BC118

It depends on whether the benefits arise from ownership or use of the asset.

A lease conveys a right to *use* the underlying asset. Accordingly, the benefits derived from ownership of the asset (e.g. income tax credits) are excluded when considering whether a customer has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use.

Conversely, benefits such as renewable energy credits received from use of the asset are more akin to a by-product and so will be included in the analysis of economic benefits.

IFRS 16 includes specific guidance in this area and has the potential to bring consistency in assessing whether an arrangement contains a lease. However, given the variety of arrangements seen in practice, and the complex structures sometimes used to allocate specific forms of benefits to different parties, judgemental issues still remain in practice.

IFRS 16.B23



Can a customer obtain substantially all of the benefits from use even if lease payments are variable?

Yes. 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 these cases, although the customer passes on certain benefits to the supplier, the customer receives the cash flows arising from use of the asset.

For example, Customer D enters into a contract to use a retail store. The rent payments include a fixed amount per month plus 20 percent of the retail revenue generated from the store. D receives substantially all of the economic benefits: the gross proceeds accrue to D. Sharing a part of the revenues generated from the store (or, generally, usage-based rentals) does not prevent a contract from being a lease.

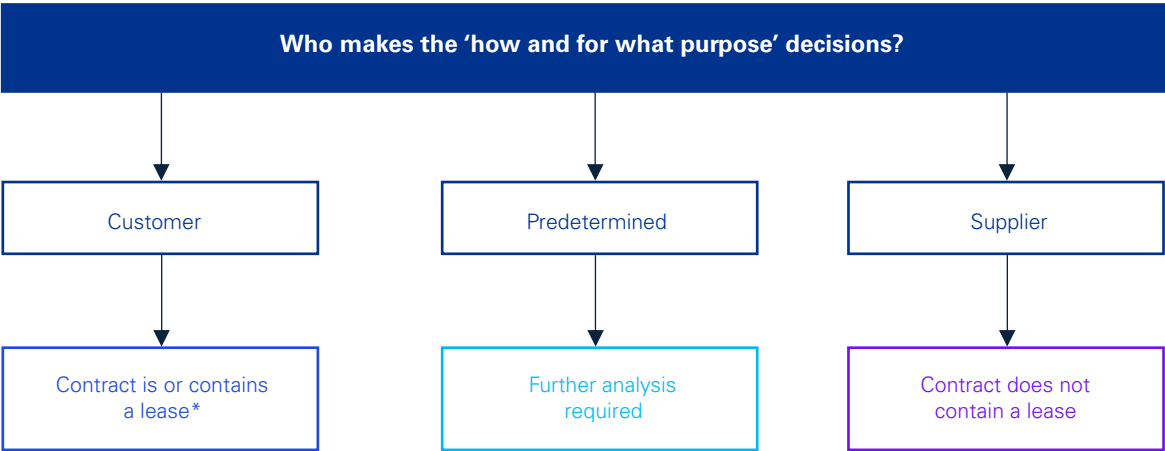
4.4 Right to direct the use

IFRS 16.B24

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

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use (see 4.4.2); or
- the relevant decisions about how and for what purpose the asset is used are predetermined and either:
 - the customer 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 supplier having the right to change those operating instructions; or
 - the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use (see 4.4.3).

The following diagram summarises the assessment of the right to direct the use.



* If other criteria are met (see Section 4.1).



How are decision-making rights evaluated?

IFRS 16 effectively requires a threefold classification of decision-making rights into the following categories, which feature in the analysis in different ways.

- **'How and for what purpose' (or relevant) decisions:** Unless they are predetermined, these determine whether the arrangement contains a lease (see 4.4.1–2).
- **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 and the other criteria for a lease are met (see 4.4.3).
- **Protective rights:** These typically define the scope of the customer's right to use an asset but do not, in isolation, preclude a conclusion that there is a lease. However, when protective rights are too restrictive for the customer to have any substantive decision-making authority over the use of the asset, this could indicate that the how and for what purpose decisions are predetermined (see 4.4.4).

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

4.4.1

IFRS 16.B25

How and for what purpose decisions

In assessing who has the right to direct how and for what purpose the asset is used, an entity considers the decision-making rights that are most *relevant* to changing how and for what purpose the asset is used. Decision-making rights are 'relevant' when they affect the economic benefits derived from use.

IFRS 16.B26

Examples of relevant decisions that, depending on the circumstances, grant the right to change how and for what purpose the asset is used include the following.

- **What:** 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.
- **When:** rights to change when the output is produced – e.g. deciding when a power plant will generate power.
- **Where:** rights to change where the output is produced – e.g. deciding on the destination of a truck or a ship.
- **Whether and how much:** 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.

IFRS 16.B27, B29

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, rights to maintain an asset or rights to take output that has already been produced. However, rights to operate an asset drive the analysis if the relevant decisions about how and for what purpose the asset is used are predetermined (see 4.4.3).

**Example 22 – Right to direct the use: Decision to take output**

Customer M enters into a 20-year contract with Supplier S, a solar developer, to install, operate and maintain a solar plant on M's facility. The solar plant has been designed by S to fulfil M's energy demand. M has the right to purchase any energy produced and S has the obligation to sell the energy to M whenever M wants to purchase it. Energy that is not purchased by M is sold into the grid – i.e. M has no obligation to purchase energy.

In this example, M's decision about whether to purchase the electricity from the solar plant affects only to whom the existing output is directed (to M or the grid). It does not affect when, where, whether or how much energy is produced. Therefore, it is not a how and for what purpose decision.

4.4.2*IFRS 16.B25***Determining who makes the how and for what purpose decisions**

An entity has the right to direct how and for what purpose the asset is used if, in the scope of its rights of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use (see 4.4.1).

IFRS 16.B29

In assessing whether an entity has the right to direct the use of an asset, only the rights to make decisions about the asset's use during the period of use are considered. Decisions that are predetermined before the period of use – i.e. commencement date – are not considered.

**Example 23 – Right to direct the use: How and for what purpose decisions***IFRS 16.IE2.Ex6B*

Customer T enters into a five-year contract with Supplier 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 4.4.4). 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 deciding the cargo that it will transport. T has the right to change these decisions throughout the period of use. Therefore, in this example the contract contains a lease.

**How is an arrangement analysed when the customer and the supplier each make some of the how and for what purpose decisions?**

An entity does not have to take all of the how and for what purpose decisions in order to have the right to direct the use of the asset – the decisions can be allocated between the parties. Judgement is required to assess the individual significance of the different how and for what purpose decisions – i.e. their impact on the economic benefits.

If some decisions have greater significance than others, then the party that makes the more significant decisions generally directs the right to use the asset.

IFRS 16.IE2.Ex4

For example, Retailer T enters into a contract with Landlord L to use a specific retail unit for a five-year period. The unit is part of a larger retail space with many retail units. The contract requires T to use the unit to operate its well-known store brand to sell its goods during the hours when the larger retail space is open. L can make reasonable changes to the opening hours of the larger retail space. T decides on the mix of goods sold from the unit, their pricing and the quantity of inventory held.

In this example, there are a number of how and for what purpose decisions that are not predetermined. L can make reasonable changes to the opening hours. However, by deciding the mix of goods, their pricing and available quantities, T makes the decisions that will have a more significant impact on the economic benefits derived from the unit. Therefore, it is T that directs the right to use the unit.

4.4.3

IFRS 16.B24, BC121

How and for what purpose decisions are predetermined

The decisions about how and for what purpose the asset is used can be predetermined in a number of different ways. They could, for example, be agreed between the customer and the supplier in negotiating the contract, with neither party being able to change them after the commencement date, or they could, in effect, be predetermined by the design of the asset. However, situations in which *all* how and for what purpose decisions are predetermined are likely to be rare.

As mentioned in [Section 4.4](#), when the relevant decisions about how and for what purpose the asset is used are predetermined, the customer has the right to control the use of an identified asset when either:

- the customer has the right to operate the asset; or
- the customer designed the asset.



Example 24 – Right to direct the use: Predetermined decisions

IFRS 16.IE2, Ex6A

Customer R enters into a contract with Supplier 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; these decisions are predetermined in the contract – i.e. the journey from A Coruña to Hartlepool transporting specified cargo within a specified timeframe. 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 over 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.Ex9A

**Example 25 – Right to direct the use: Predetermined decisions: Customer designed the asset**

Customer C enters into a 20-year contract with Energy Supplier E to install, operate and maintain a solar plant for C's energy supply. C designed the solar plant before it was constructed – C hired experts in solar energy to help in determining the location of the plant and the engineering of the equipment to be used. C has the exclusive right to receive and the obligation to take all energy produced.

In this example, the nature of the solar plant is such that all of the decisions about how and for what purpose the asset is used are predetermined because:

- the type of output (i.e. energy) and the production location are predetermined in the agreement; and
- when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because C designed the solar plant and thereby programmed into it any decisions about how and for what purpose it is used, C is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give E the right to direct how and for what purpose the solar plant is used.

IFRS 16.B24(a), B29, IU 01–20

**What happens if only some of the how and for what purpose decisions are predetermined?**

In some cases, many, but not all, of the decisions about how and for what purpose an asset is used are predetermined in the contract. However, the customer has the right to make the remaining relevant decisions. In these cases, a question arises over whether the customer has the right to direct how and for what purpose the asset is used throughout the period of use.

The IFRS Interpretations Committee discussed this question in the context of a shipping contract and observed that because not all of the relevant decisions about how and for what purpose the ship is used are predetermined, the customer applies paragraph B24(a) of IFRS 16 and assesses whether it has the right to direct how and for what purpose the asset is used. That is, when some but not all of the relevant decisions are predetermined, the assessment of whether the customer has the right to direct the use of the ship focuses on the relevant decisions that are not predetermined.

4.4.4

IFRS 16.B30

Supplier's protective rights

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

IFRS 16.B30

For example, a contract may:

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

IFRS 16.IE2.Ex7



Example 26 – Protective rights: Scope of right of use

Customer L enters into a two-year contract with Supplier M, an aircraft owner, for the use of an identified aircraft. The contract details the interior and exterior specifications for the aircraft. It also contains contractual and legal restrictions 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 it. 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 deciding 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 aircraft.

See our [Lease definition](#) publication for more guidance on identifying whether a contract contains a lease.

5 Separating components

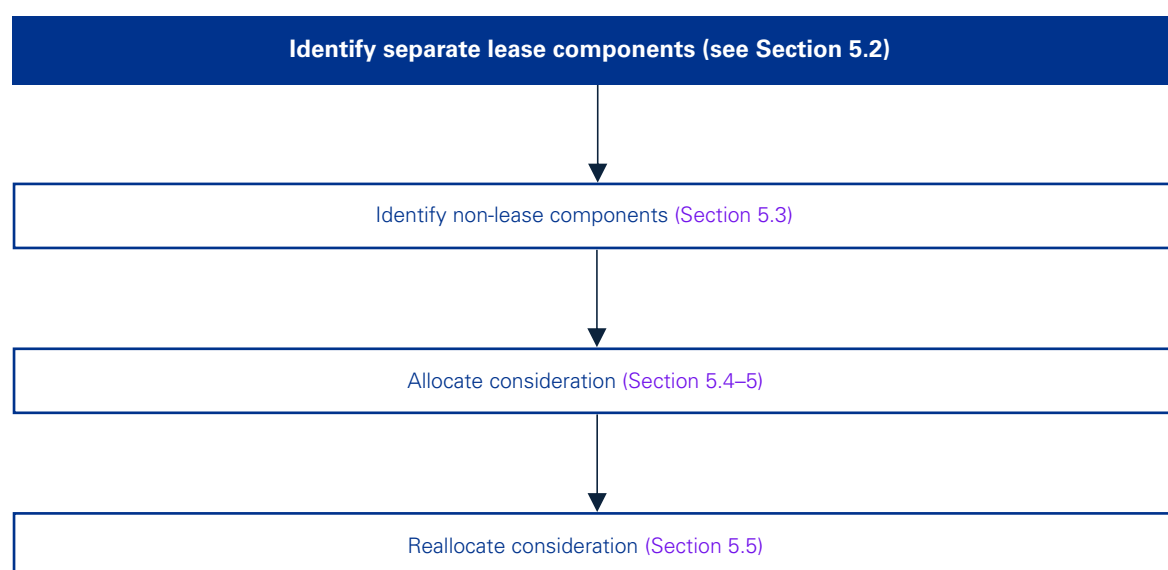
Many contracts contain multiple lease and non-lease components, which need to be identified and accounted for separately.

5.1 Overview

IFRS 16.12

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

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



5.2 Identify separate lease components

IFRS 16.B32(a)–(b)

An entity 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.

IFRS 16.B32(a)–(b),
BC134

Resources are considered to be readily available when they are sold or leased separately by the lessor or other suppliers, or when the lessee has already obtained them from the lessor or from other transactions or events. An asset is highly dependent on, or highly inter-related with, the other assets if the lessee could not lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract. The separation guidance is broadly similar to the identification of performance obligations in a revenue contract under IFRS 15.

IFRS 16.12, B53

The general guidance on identifying separate lease components is the same for lessees and lessors. A lessor then classifies each lease component as a finance or an operating lease, based on the extent to which the lease transfers the risks and rewards incidental to ownership of the underlying assets (this guidance is not relevant to lessees) (see [Section 3.2](#)).

IFRS 16.B1

IFRS 16 applies to individual leases. However, as a practical expedient an entity may apply the standard to a portfolio of lease contracts with similar characteristics if the entity reasonably expects that the effects of accounting for the contracts as a portfolio would not be materially different from those of accounting for the individual leases within that portfolio. Once the portfolio approach has been selected, the entity uses assumptions and estimates that reflect the size and composition of the portfolio.



Example 27 – Multiple lease components: Separation criteria met

IFRS 16.B32

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

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

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



Example 28 – Multiple lease components: Land and building: Separation criteria not met

IFRS 16.B32

Lessee T leases an entire office building from Lessor Q for 25 years. There are no non-lease components in the contract. T has exclusive use of the property, which includes a driveway. In addition to the explicit lease of the building, there is an implied lease of the underlying land.

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

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

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



If a lease of land and building is a single lease component, then does the lessor perform a single classification test?

IFRS 16.B55, B57

Not necessarily. When a lease includes both land and building elements, the lessor assesses the classification of each element separately, unless the value of the land at inception of the lease is deemed immaterial. In this case, the lessor may treat the land and building as a single unit to classify it as either a finance or an operating lease, applying the criteria in the standard.

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

IFRS 16.B56–B57

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

IFRS 16.B32, B55–B57

When a lease contract contains both land and building elements, a lessor considers the specific guidance described above, notwithstanding the fact that the land and building may not be separate components.

5.3

Identify separate non-lease components

IFRS 16.12

It is common for a lease contract to include non-lease components. For example, a real estate lease may include common area maintenance services provided by the lessor – e.g. cleaning services, maintenance of a central heating plant and common area repairs. IFRS 16 generally requires an entity to separate the lease and non-lease components of a contract. The lease component is accounted for under IFRS 16 and the non-lease components are accounted for in accordance with other applicable accounting standards.

IFRS 16.15, BC135

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

IFRS 16.17, BC135–BC136

The practical expedient is not available for a lessor. A lessor always accounts for non-lease components separately from the lease components.

IFRS 16.B33

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



Example 29 – Non-lease components: Common area maintenance

Lessee L enters into a three-year lease of an apartment. The apartment is in a multi-tenant building that includes shared facilities – e.g. a swimming pool and garden. In addition to the monthly lease payments, the contract includes an additional fee of 2,000 per quarter for the upkeep of the communal areas, maintenance and security – i.e. common area maintenance. This fee does not cover costs for non-routine and ‘major’ maintenance, which are billed to tenants separately.

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

L determines that the common area maintenance is a separate non-lease component because it transfers a good or service to L other than the right to use the apartment. That is, L receives a service that it would otherwise have to pay for separately (e.g. if its plumbing required repairs). L has not elected to apply the practical expedient to combine lease and non-lease components. Therefore, L allocates the contract consideration to the lease component and the non-lease component (see [Section 5.4](#)). L accounts for the lease component under IFRS 16, whereas common area maintenance charges are expensed when they are incurred.



Example 30 – Applying the practical expedient to combine lease and non-lease components

IFRS 16.15, 38(b)

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

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

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

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



What are the consequences for the lessee of applying the practical expedient?

IFRS 16.BC135(b)

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

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

For example, in a real estate lease the lessor may provide common area maintenance services to the tenants. If those services are accounted for as a non-lease component, then the tenant will typically recognise the consideration allocated to the common area maintenance as an operating expense as it is incurred. However, if the common area maintenance is fixed or varies depending on an index or rate and the tenant includes it in the lease payments, the entity will effectively recognise additional depreciation on the right-of-use asset and interest expense.

5.4 Allocate the consideration

5.4.1 General guidance

IFRS 16.13, 17, B33

IFRS 16 requires both the lessee and lessor to allocate consideration to the lease and non-lease components. Payments for activities and costs that do not transfer a good or service to the lessee do not give rise to a component and are included in the consideration that is allocated to the separate lease and non-lease components in the contract. Therefore, the consideration includes all payments in the contract – i.e. those that relate to lease and non-lease component(s), and other payments that relate to items such as taxes, which are not separate components.

IFRS 16.13, 17

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

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

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

IFRS 16.13–17, B33

The following table summarises the process for allocating consideration between 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 Section 5.3), allocate the consideration based on the relative stand-alone price of components.	Always allocate the consideration following the IFRS 15 approach – i.e. on a relative stand-alone selling price basis.
When there is no observable stand-alone price for some or all components	Estimate the stand-alone prices maximising use of observable information.	

IFRS 16.13–17, B33

	Lessee	Lessor
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 (see Section 5.3).	N/A

5.4.2

Lessee perspective

IFRS 16.13

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 on the basis of:

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

IFRS 16.14

The lessee determines the relative stand-alone prices of lease and non-lease components based on the price that a lessor would charge an entity for a similar component separately.

IFRS 16.14, 15.79

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.

Unless a lessee applies the practical expedient (see [Section 5.3](#)), it accounts for non-lease components in accordance with other applicable standards.



Example 31 – Accounting by lessee for lease and non-lease components

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

In this case:

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

Therefore, L allocates 68,182 ($(75,000^{(1)} / 110,000^{(2)}) \times 100,000^{(3)}$) to the lease component.

Notes

¹ Total stand-alone price of lease component calculated as $15,000 \times 5$ years.

² Total stand-alone prices of lease and non-lease components calculated as $(2,000 + 5,000 + 15,000) \times 5$ years.

³ Total consideration for the contract $20,000 \times 5$ years.

5.4.3 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.

IFRS 15.78

If a stand-alone selling price is not directly observable, then the lessor estimates the price considering all information that is reasonably available to the lessor. IFRS 15 includes examples of acceptable approaches to estimating stand-alone selling prices.



Example 32 – Lessor allocation of consideration: Observable and estimated stand-alone selling prices

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

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

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

R estimates the stand-alone selling prices as follows.

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

On this basis, R allocates the consideration as follows.

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



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

IFRS 16.90, 15.114, B87–B89

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

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

5.5 Allocate the variable consideration

It is common for a lease contract to include variable payments. If the contract contains more than one component and includes both variable and fixed payments, then a question arises about how to allocate the variable payments – e.g. whether the variable payments can be allocated to one or more, but not all, of the components.

IFRS 15.84–86

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

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

IFRS 16.14, Ex12

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

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



Example 33 – Lessee's allocation: Variable payments allocated to all components

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

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

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

- observable stand-alone price for the lease: 500; and
- estimated stand-alone price for the maintenance, based on the expected costs plus an appropriate margin: 200.

L allocates the total consideration of 600 (fixed payments of 500 and variable payments of 100) to the components as follows.

Component	Stand-alone price	%	Allocation of fixed payments	Allocation of variable consideration
Lease of property	500	71.43%	357	71
Maintenance	200	28.57%	143	29
	700		500	100

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

In contrast, if the payments of both components were at stand-alone prices, then the fixed consideration would be allocated to the lease component and the variable consideration would be allocated to the non-lease component.



Does an entity need to reallocate the consideration during the lease term?

IFRS 16.17, 39, 45

Yes, in some cases. For example, when an entity allocates the consideration, both fixed and variable, to multiple lease and non-lease components:

- on remeasurement of the lease liability, the lessee reallocates the revised consideration to the components;
- on the revision of the lease term, the lessor reallocates the revised consideration to the components; and
- for a modification that is not a separate lease, a lessee reallocates the consideration to the components of the modified contract.

See our [Lease components](#) publication for more guidance on identifying lease and non-lease components and allocating consideration.

6 Lease term

The lease term is a critical estimate. For lessees, the lease term affects the size of the lease liability. For lessors, it may impact the lease classification.

6.1 Overview

IFRS 16.18

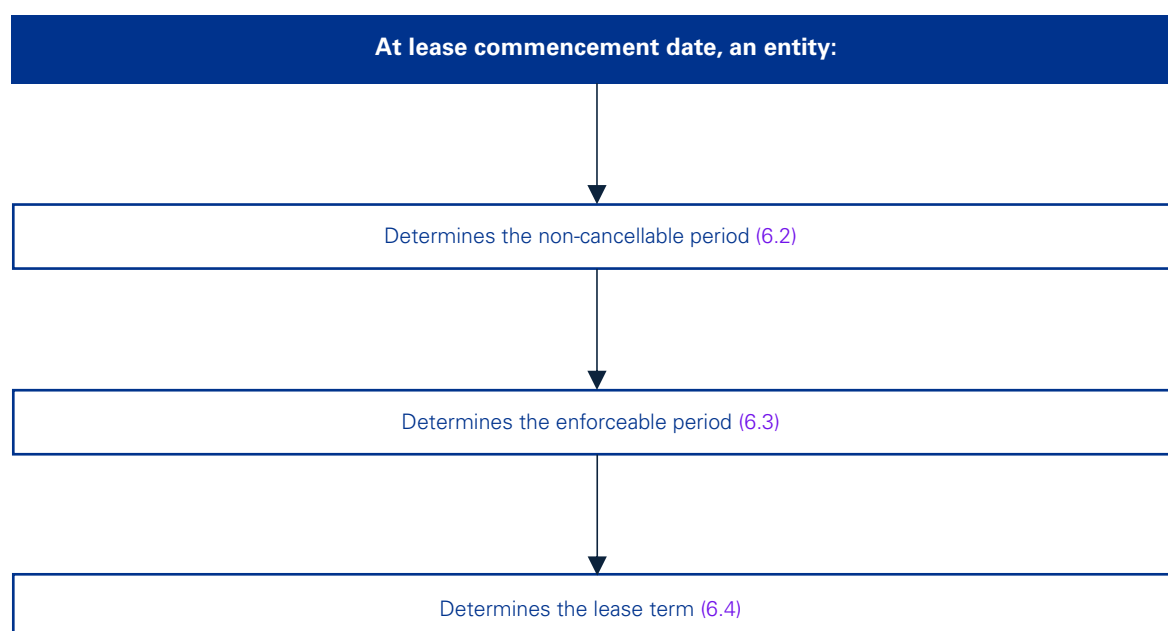
The lease term is the non-cancellable period of the lease, together with:

- 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.

IFRS 16.B35

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

To determine the lease term, an entity first determines the length of the non-cancellable period of a lease and the period for which the contract is enforceable. It can then determine – between those two limits – the length of the lease term. In lease contracts that have no options, the non-cancellable period, the period for which the contract is enforceable and the lease term will all be the same.



6.2 The non-cancellable period

IFRS 16.B35,
BC127–BC128

The ‘non-cancellable period’ is the period during which the lessee cannot terminate the contract. The lease term cannot be shorter than the non-cancellable period.



If a lessor can cancel the lease, does this affect the non-cancellable period?

IFRS 16.B35, BC128

No. If only the lessor has the right to terminate a lease, then the non-cancellable period of the lease includes the period covered by the lessor’s option to terminate the lease. In this situation, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease.

Any non-cancellable period or notice period in a lease meets the definition of a contract and is part of the lease term.

6.3 The enforceable period

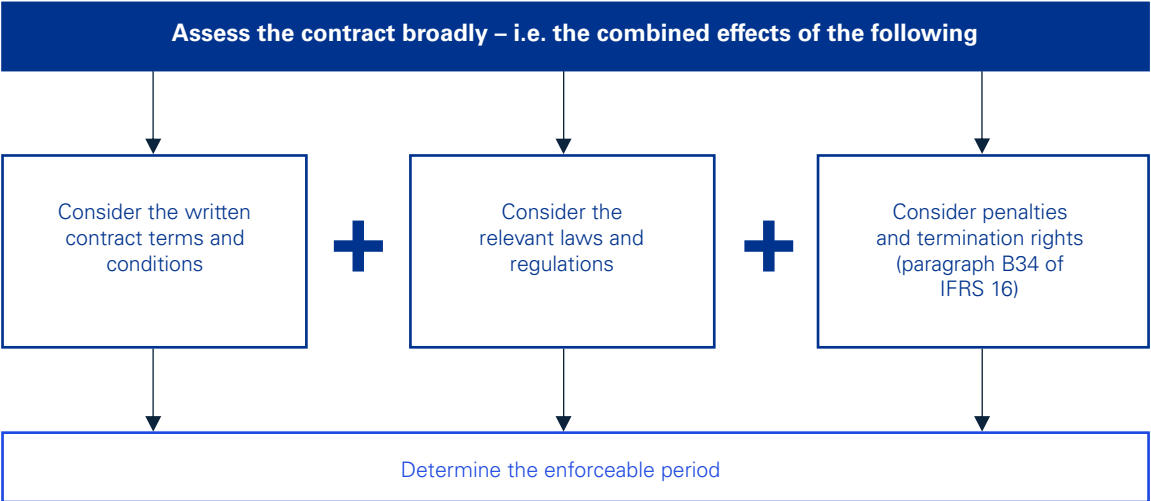
IFRS 16.B34, BC127

The ‘enforceable period’ is the period for which enforceable rights and obligations exist between the lessee and lessor. This is the maximum potential length of the lease term.

IFRS 16.2, B34, BC127

To determine the enforceable period of the lease, an entity applies the definition of a contract. For this purpose, the contract comprises the written agreement and applicable laws and regulations in the local jurisdiction that stipulate and govern the parties’ rights and obligations. Enforceability is a matter of law in the relevant jurisdiction and each contract will need to be evaluated based on its terms and conditions. This includes considering the guidance on enforceability in paragraph B34 of IFRS 16, including the role of penalties in assessing the enforceable period.

The key steps to determining the enforceable period are as follows.



IFRS 16.B34, BC127

Renewal and termination options are considered in the assessment of the lease term if they are enforceable.

IFRS 16.B34, BC127,
IU 11-19

A lease is no longer enforceable beyond the point at which both the lessee and the lessor have the unilateral right to terminate the lease without permission from the other party, and with no more than an insignificant penalty.

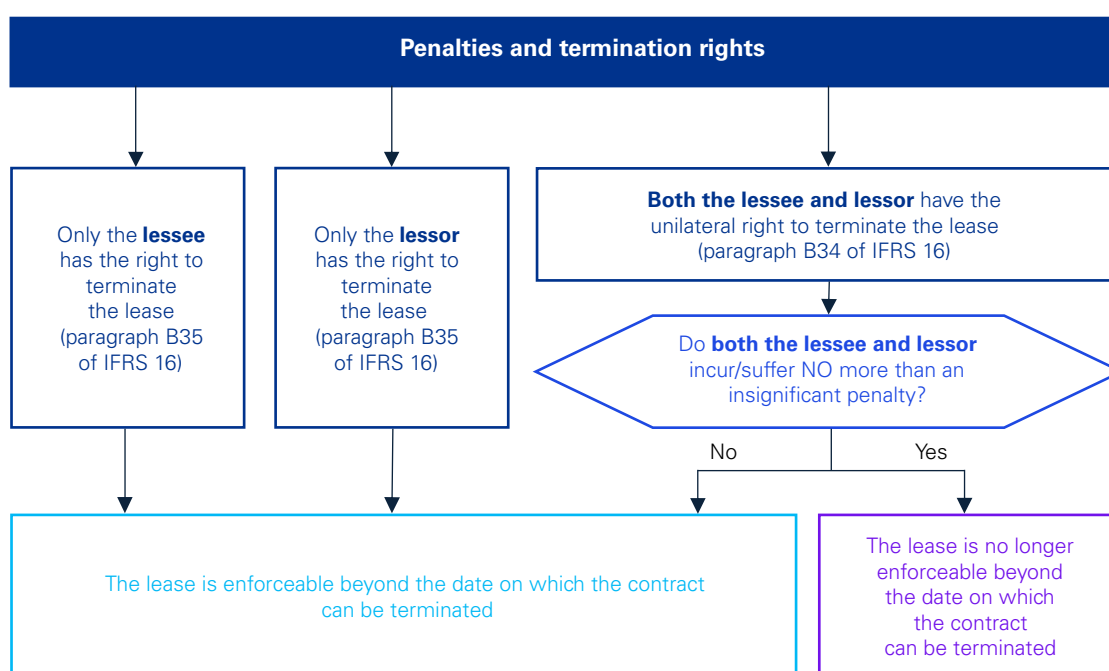
Consequently, a contract is enforceable beyond the date on which it can be terminated if:

- both parties have the right to terminate but one party, or both, would incur a penalty on termination that is more than insignificant; or
- only one party has the right to terminate the lease without the permission of the other party.

IFRS 16.B34–B35,
BC127, IU 11-19

A lease is no longer 'enforceable' when both the lessee and lessor have the right to terminate it without agreement from the other party with no more than an insignificant penalty. If only the lessee has the right to terminate a lease, then that right is considered to be an option available to the lessee to terminate the lease that an entity considers when determining the lease term. Termination options held by the lessor only are not considered when determining the lease term because, in this situation, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless the lessor decides to terminate the lease.

The following summarises the impact of penalties and termination rights on the determination of the enforceable period.



IFRS 16.B34, IU 11-19

IFRS 16 does not define the term 'penalty'. Therefore, questions have arisen in practice about whether an entity considers the broader economics of the contract or only contractual termination payments when applying paragraph B34 of the standard. The IFRS Interpretations Committee discussed this issue and noted that when determining the effect of termination rights under paragraph B34, an entity considers the broader economics of the contract and not only contractual termination payments.



Example 34 – Impact of termination rights on enforceable period

Scenario 1

Lessee B leases a retail store from Lessor C under the following terms.

- The written contract is for a stated maximum term of five years.
- B and C each have the unilateral right to terminate the lease at the end of Year 2 with no more than an insignificant penalty.
- Relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

On lease commencement, the enforceable period is two years, regardless of how likely it is that both parties will decide to extend the lease beyond the end of Year 2.

Scenario 2

Lessee D leases a warehouse from Lessor E under the following terms.

- The written contract is for a stated maximum term of five years.
- After Year 1, D and E each have the unilateral right to terminate the lease, but a one-month notice period is required – i.e. the lease terminates one month after the termination notice is given. Notice cannot be given before the end of Year 1. If the lease is terminated in this way, then neither party will suffer a more-than-insignificant penalty.
- Relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

On lease commencement, the enforceable period is 13 months.



What is the enforceable period when both the lessee and lessor have termination rights, but only one party would suffer a more-than-insignificant penalty?

The existence of a penalty affects the enforceable period in different ways, depending on which party would suffer a more-than-insignificant penalty.

In the following scenarios, relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

Scenario 1 – Both parties have termination rights without the permission of the other, but only the lessor's right gives rise to a more-than-insignificant penalty

In this case, the enforceable period ends when the lessor's exercise of its termination option no longer gives rise to a more-than-insignificant penalty – i.e. when both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty.

IFRS 16.B34–B35,
BC127, IU 11–19

In contrast, if the lessor's termination right will no longer result in a more-than-insignificant penalty before the lessee's termination option becomes exercisable, then the lessor's termination option is disregarded for accounting purposes until the lessee's termination option becomes exercisable. When the lessee's termination option becomes exercisable, both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty, and the enforceable period does not extend beyond that point.

Scenario 2 – Both parties have termination rights without the permission of the other, but only the lessee's right gives rise to a more-than-insignificant penalty

In this case, the enforceable period ends when the lessee's exercise of its termination option no longer gives rise to a more-than-insignificant penalty.

6.4

The reasonably certain threshold

IFRS 16.19, B37,
B40, BC157

IFRS 16 does not define 'reasonably certain' and there is no bright line when making the assessment. When determining the lease term, an entity considers all relevant facts and circumstances that create an economic incentive for the lessee to exercise an option to renew or purchase, or not to exercise an option to terminate early. When assessing whether a lessee is reasonably certain to exercise an option to extend or purchase, or not to exercise an option to terminate early, the economic reasons underlying the lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned) may provide useful information.

IFRS 16.B37–B40

IFRS 16 provides examples of factors to consider when assessing whether it is 'reasonably certain' that a lessee would exercise an option to renew or not exercise an option to terminate the lease. The assessment of the degree of certainty is based on the facts and circumstances at commencement of the lease, rather than on the lessee's intentions. The following table provides examples of factors that create an economic incentive to exercise or not to exercise options to renew or 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
- Costs to return the underlying asset

Asset

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

**Example 35 – Lessee renewal option: Reasonably certain to renew**

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

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 enforceable period. At commencement of the lease, rentals under the contract reflect current market rates.
- 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 undertakes non-removable significant leasehold improvements with an estimated useful life of eight years.

X concludes that it has a significant economic incentive to extend the lease and therefore is reasonably certain to exercise its four-year extension option. Consequently, X determines that the lease term is eight years.

**Example 36 – Lessee renewal option: Not reasonably certain to renew**

Lessee Y enters into a lease of a three-year-old machine. The non-cancellable period 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 aircraft 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.
- Y does not expect to be able to use the machine in its manufacturing process for other types of aircraft without significant modifications.
- The total remaining economic 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. Y does not expect to have a business purpose for using the machine after the non-cancellable lease period.

Y therefore concludes that it is not reasonably certain to exercise its renewal options. Consequently, the lease term consists of the 10-year non-cancellable period only.



Does the existence of non-removable significant leasehold improvements impact the lease term?

IFRS 16.B37, IU 11–19

Yes. The IFRS Interpretations Committee considered the interaction between the determination of the lease term and the useful life of non-removable significant leasehold improvements.

The Committee noted that an entity considers all relevant facts and circumstances that create an economic incentive for the lessee when assessing whether it is reasonably certain to extend (or not to terminate) a lease. This includes significant leasehold improvements (made or planned to be made) over the term of the contract that are expected to have significant economic benefit when the option to extend (or terminate) becomes exercisable.



Can lessees and lessors reach different conclusions about whether it is reasonably certain that an option will be exercised?

Yes. Lessees and lessors may reach different conclusions about lease term because of information asymmetry and the judgemental nature of the assessment. The assessment of reasonably certain is based on judgements (e.g. about the importance of an underlying asset to the lessee) and estimates (e.g. of the fair value of the underlying asset in the future). Lessees and lessors may reach different conclusions about whether the lessee is reasonably certain to exercise an option to renew, or not to exercise an option to terminate early.

6.5 Renewable and cancellable leases

IFRS 16.B34, IU 11–19

In some cases, a lease contract may continue indefinitely until either party gives notice to terminate it (i.e. cancellable lease), or may renew indefinitely unless it is terminated by either party (i.e. renewable lease). For example, evergreen leases are leases that automatically renew on a day-to-day, week-to-week or month-to-month basis – i.e. they are cancellable leases. A question arises over how to determine the non-cancellable and enforceable period of such leases. The IFRS Interpretations Committee discussed this issue and noted that in doing so an entity considers the broader economics of the contract and not only contractual termination payments. If only one party has the right to terminate the lease without permission from the other party and with no more than an insignificant penalty, then the contract is enforceable beyond the date on which the contract can be terminated by that party.

IFRS 16.19, B37–B40, IU 11–19

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), then it applies the reasonably certain threshold assessment to determine the lease term (see [Section 6.4](#)).

A penalty may expire or, over a period of time, the effect of a penalty that is initially more than insignificant may become insignificant. For example, a termination penalty that is more than insignificant if it is incurred after only one year of a lease may be insignificant if it is incurred after four or five years when considered in the context of the broader economics of the contract.

IFRS 16.B34, IU 11–19

**Example 37 – Termination rights: No more than an insignificant penalty**

Lessee L enters into a five-year lease of a warehouse with Lessor M. L designs and sells furniture internationally online and is testing the use of the warehouse as a showroom. The cost to fit out the space is not significant. If the showroom is unsuccessful, then L does not plan to use the space as a warehouse.

Under the lease agreement, L and M each have the right to terminate the lease without a contractual penalty on each anniversary of the lease commencement date.

In applying the broad definition of penalty, L considers the following.

- The leasehold improvements are minor. Therefore, L's loss of economic value if the contract is terminated before the end of their economic life is not significant.
- The cost to dismantle the leasehold improvements is not significant.
- The cost to restore the warehouse to its original condition is not significant.
- The potential impact of early termination on customer relationships is low. L mostly interacts with its customers through its website, with a small number expected to visit the showroom in person.

Based on its analysis of the facts and circumstances, L determines that it can terminate the lease with no more than an insignificant penalty after one year. Assuming that M can also terminate with no more than an insignificant penalty after one year, the lease term consists of the one-year non-cancellable period because there are no enforceable rights and obligations beyond this point. This is because – after both parties' termination rights become exercisable – neither party has enforceable rights (i.e. L to use the warehouse or M to receive lease payments) or obligations (i.e. L to make lease payments or M to permit continued use of the warehouse).

IFRS 16.B37, B39

**Example 38 – No stated terms**

Lessor R leases equipment to Lessee E. There is no stated duration for the lease in the contract. E can terminate the lease at any time by returning the underlying asset to R's location. For each day that the asset remains in E's possession, E will pay a fixed fee to R for the right to use that asset.

The non-cancellable period of the lease is one day because E could elect to return the asset to R's location before the start of Day 2. If E has an ongoing need to use an asset similar to the underlying asset in its business, then the costs to E of terminating the lease (e.g. returning the underlying asset to R's location) and entering into a new lease (e.g. identifying another asset, entering into a different contract and training employees to use a different asset) may provide a compelling economic reason for E to continue to use the same asset for a period that is longer than the non-cancellable period – i.e. the lease term may be more than one day.

IFRS 16. B37, B39
Appendix A



Does the assessment of reasonably certain differ for evergreen leases?

No. For evergreen leases, once the enforceable period is established, the lease term is determined in the same manner as for all other leases. This involves considering whether the lessee is reasonably certain to exercise one or more of the renewal options. The assessment is based on all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to renew.

Determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgement. In general, the shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher for a shorter non-cancellable period.

For example, if a lessee leases a retail or warehouse space on a monthly basis and expects to need a substantially similar space for the next 18–24 months, then there may be a significant economic incentive (e.g. to avoid moving costs or customers having to find the lessee's new location) to renew the lease rather than continually move to a similar space throughout the period.

6.6 Changes in the lease term

IFRS 16.20, 36(c), 40

After the commencement date, a lessee reassesses whether it is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease early. The lessee revises the lease term consequently. The lessee does this when there has been a significant event or a significant change in circumstances that:

- is within its control; and
- affects whether it is reasonably certain to exercise those options.

IFRS 16.B41

IFRS 16 provides the following examples of significant events or changes in circumstances:

- significant leasehold improvements that the lessee did not anticipate at the commencement date, if it expects them to have a significant economic benefit when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;
- a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;
- the inception of a sub-lease of the underlying asset for a period beyond the end of the previously determined lease term; and
- a business decision of the lessee that is directly relevant to exercising, or not exercising, an option – e.g. a decision to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use asset is used.

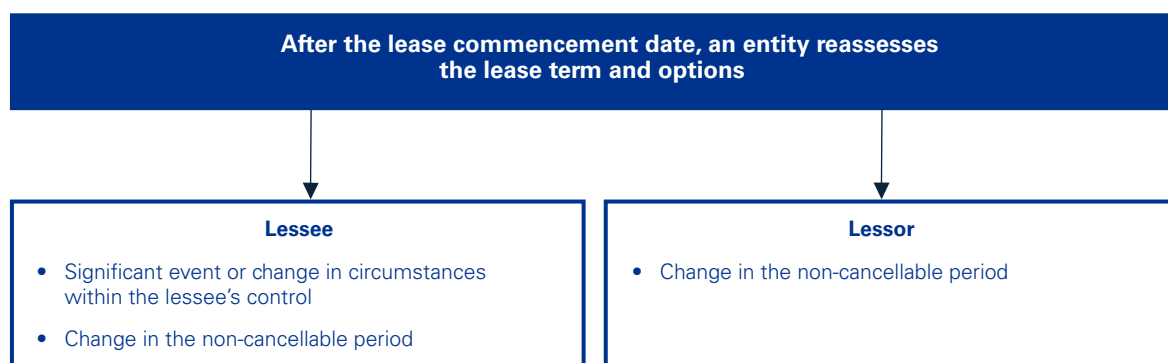
If a lessee reassesses the lease term due to changes in its assessment of whether it is reasonably certain to exercise a renewal option, then it remeasures its lease liability using a revised discount rate. The lessee adjusts the carrying amount of the right-of-use asset for the remeasurement of the lease liability. If the carrying amount of the right-of-use asset is reduced to zero, then any further reductions are recognised in profit or loss.

IFRS 16.21

In addition, both the lessee and the lessor revise the lease term when there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:

- the lessee exercises an option that was not previously included in the entity's determination of the lease term;
- the lessee does not exercise an option previously included in the entity's determination of the lease term;
- an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term; or
- an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term.

For example, a lessee and a lessor determined at commencement that the lease term was the non-cancellable period of five years, considering that it was not reasonably certain that the lessee would exercise a renewal option for an additional five years. However, if at the end of Year 4 the lessee exercises the renewal option for the additional five years by giving formal notification to the lessor, then the lessee and the lessor revise the remaining lease term to six years to reflect the new non-cancellable period.

*IFRS 16.40*

When there is a change in the lease term, a lessee remeasures its lease liability using a revised discount rate and, generally, makes a corresponding adjustment to the right-of-use asset.

IFRS 16.21

IFRS 16 is silent on how a lessor accounts for the remeasurement of the net investment in the lease when it revises the lease term. In our view, the lessor should choose an accounting policy, to be applied consistently, to remeasure the net investment in the lease by applying by analogy the guidance in:

- IFRS 9 on accounting for a change in expected cash flows; or
- IFRS 16 on remeasurement of a lease liability by the lessee.

**Example 39 – Lessee renewal option: Reassessing if reasonably certain to be exercised**

Lessee W leases a shop from Lessor L.

The lease has a non-cancellable term of five years, and W can renew the lease for a further five years – i.e. the lease has a potential maximum term of 10 years.

Initial assessment at commencement

At lease commencement, W assesses that it is not reasonably certain to exercise the renewal option and therefore determines that the lease term is five years.

Subsequent reassessment of certainty that option will be exercised

During Year 3, W undergoes significant rebranding – changing its logo, colour scheme and target market. At this time, W installs significant leasehold improvements, which include a store fascia, shelving and other branded material. Based on its experience at other stores, W believes that these materials have a useful life of 10 years once they are installed; they cannot be repurposed to other stores because they would be damaged in being removed.

W notes that it was its decision to install the leasehold improvements and the improvements are evidence that it has an economic incentive to renew the lease. W updates its overall assessment and notes that it is now reasonably certain to extend the lease.

Accordingly, W reassesses the lease term and determines that the remaining lease term is seven years. W remeasures the lease liability using a revised discount rate and makes an equal adjustment to the right-of-use asset.

IFRS 16.B37(b)

**Example 40 – Date of the change in the non-cancellable period**

Lessee L leases a retail store from Lessor R. The lease is non-cancellable for 10 years and includes a five-year renewal option. L is required to notify R if it intends to exercise the renewal option by the end of Year 9. At lease commencement, R concludes that L is not reasonably certain to exercise the renewal option and, therefore, the lease term is 10 years.

The retail location performs better than expected for reasons not anticipated at lease commencement. In Year 7, L decides that it will exercise the renewal option. However, L decides not to notify R until it is required to do so – i.e. at the end of Year 9.

In this case, the better-than-expected trading performance is a market-based factor, which does not in isolation trigger a reassessment of the lease term. Therefore, both R and L reassess the lease term only when L formally notifies R that it will renew the lease – i.e. at the end of Year 9. This is the date when there is a change in the non-cancellable period.

IFRS 16.21



What are the major impacts for lessees of reassessing the lease term and remeasuring the lease liability?

Companies need to reassess key judgements – e.g. the lease term – and consider the need to remeasure lease balances each time they report. Significant judgement is 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 may be difficult for an entity to ignore changes in market-based factors (e.g. market rates) when performing a reassessment of the lease term.

A lessee'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.

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



Is a lessor allowed to reassess the lease term when the lessee reassesses whether it is reasonably certain to exercise an option?

No. Unlike a lessee, in our view a lessor should revise the lease term only when there is a change in the non-cancellable period of the lease, as described in paragraph 21 of IFRS 16. In contrast, paragraph 20 requires reassessment in additional circumstances, but this applies only to lessees.

IFRS 16.20–21

See our [Lease term](#) publication for more guidance on determining the lease term.

7 Lease modifications

IFRS 16 provides detailed guidance for accounting for lease modifications for both the lessee and the lessor.

7.1 Definition

IFRS 16 provides detailed guidance for the accounting for lease modifications by lessees and lessors.

IFRS 16 Appendix A

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of its original terms and conditions. Common examples are:

- increasing the scope of the lease by adding the right to use one or more underlying assets or extending the contractual term;
- decreasing the scope of the lease by removing the right to use one or more underlying assets or shortening the contractual lease term; and
- changing the consideration in the lease by increasing or decreasing the lease payments.

IFRS 16.18–20,
39–40(a)–(b)

Changes that result from renegotiations of the contract are lease modifications. Adjusting the lease payments (cash flows) by contractual rent adjustment mechanisms, and reassessing whether a lessee is reasonably certain to exercise (or not to exercise) an option included in the contract, are not lease modifications because these are part of the original terms and conditions (see [Section 6.6](#)).

IFRS 16.BC202

IFRS 16 distinguishes between lease modifications that represent, in substance, the creation of a new lease that is separate from the original lease and those that represent, in substance, a change in the scope of, or consideration paid for, the existing lease.

IFRS 16 Appendix A

Lease modifications that are not accounted for as separate leases are accounted for at the effective date of the lease modification. This is the date on which both parties agree to the lease modification and is usually the date on which the modified contract is signed.



What is the difference between remeasurement of lease assets and liabilities and lease modifications?

IFRS 16.BC201

There is a difference between scenarios that result in the remeasurement of existing lease assets and lease liabilities due to:

- reassessment of estimates used in lease accounting; and
- lease modifications (see [Section 7.2](#)).

After the commencement date, lease reassessments take place, for example, when there are changes in the lease payments (cash flows) based on contractual clauses included in the original contract. The accounting for remeasurement is addressed in [2.4.2](#) and [Section 6.6](#).

Changes that result from renegotiations and changes to the terms of the original contract are lease modifications. The accounting for a lessee lease modification is addressed in [Section 7.2](#).

IFRS 16.38, 76, 81,
Appendix A, 9.3.3.1



What are the accounting implications for the lessee and the lessor if a lessee does not make rent payments when they are due?

If the lessee fails to pay amounts due under the lease contract with no agreement with the lessor, then this is not a lease modification. However, there may be other accounting implications, as follows.

Lessee

The lessee continues to recognise the lease liability and assesses whether it is liable for additional interest or penalties for late payment under the lease contract.

Lessor

The lessor continues to account for the lease under its original terms and conditions unless and until the lessor agrees to modify the contract.

However, if the lessee fails to pay amounts due under the lease contract, or the lessor is otherwise concerned that the lessee may be unable to pay amounts falling due in future periods, then there are a range of other issues that the lessor needs to consider.

For **operating leases**, these issues include but are not limited to the following.

- *Income recognition:* Operating lease income reflects the rental payments to which the lessor is entitled under the enforceable terms and conditions of the lease. In addition, the lessor will need to assess whether it remains appropriate to recognise income from non-lease components – e.g. maintenance income under IFRS 15.
- *Carrying amount of the underlying asset:* Lessors will need to ensure that the underlying asset is appropriately measured. For investment property measured at fair value, this will include ensuring that the fair value reflects current market participant expectations about in-place leases and residual values. For other underlying assets, this will include considering whether there is a trigger for impairment testing.
- *Lease receivables:* Operating lease receivables are subject to impairment testing under IFRS 9.

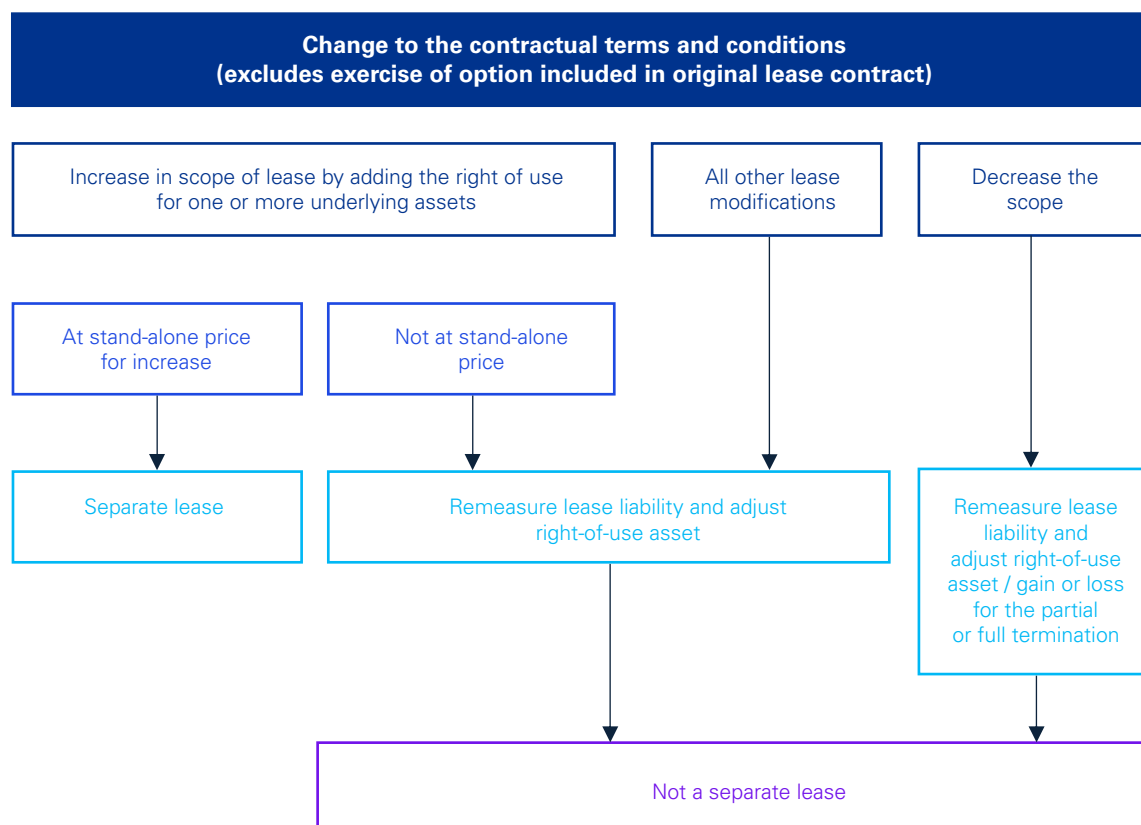
In a **finance lease**, although the lessor will continue to account for the lease under its original terms and conditions, the carrying amount of the net investment in the lease and related interest income may be impacted. The lessor applies IFRS 9's impairment requirements to the net investment in the lease and regularly reviews the estimated, unguaranteed residual values used in computing the gross investment in the lease. The lessor applies IFRS 16 to recognise reductions in the unguaranteed residual value of the underlying asset.

7.2 Lessee modification accounting

7.2.1 Lessee modifications – General

IFRS 16.44–46

The following diagram summarises the accounting for lease modifications by a lessee.



7.2.2 Separate lease

IFRS 16.44

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 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.

IFRS 16.44

In this case, the lessee accounts for the separate lease in the same way as any new lease and makes no adjustment to the accounting for the initial lease. The lessee uses a revised discount rate to account for the separate lease. The new rate is determined at the effective date of the modification. The lessee uses the interest rate implicit in the lease if it is readily determinable; otherwise the lessee uses its incremental borrowing rate.

**Example 41 – Lease modification: Separate lease***IFRS 16.44, Ex15*

Lessee Z entered into a lease contract with Lessor L to lease one floor in an office building for 10 years. At the beginning of Year 7, Z and L amend the contract to grant Z the right to use an additional floor of office space in the same building for four years. The new office space is the same size as the original office space and similar in all significant respects.

The lease payments for the new office space are commensurate with market rentals for office space of that size and characteristic. However, Z receives a 5% discount for the new office rentals because its existing relationship with L enabled L to forego costs that it would have incurred if the additional floor had been leased to a new tenant – e.g. marketing costs, rental agent's commission and costs for undertaking credit checks.

The lease of the additional office space was not part of the original terms and conditions of the contract. Therefore, this is a lease modification.

Z accounts for this modification as a separate lease at the effective date of the lease modification because:

- the modification increases the scope of the lease by adding the right to use an additional underlying asset – i.e. an additional floor of office space; and
- the lease payments for the additional floor are commensurate with market rentals for a similar office space, as adjusted for the circumstances of the contract. Even though the lease payments for the new office space are 5% below market rentals, the discount reflects L's sharing with Z of the benefit of not having to market the property or pay a broker's commission and not having to incur other common origination fees.

Z does not modify the accounting for the original office space lease.

7.2.3**Not a separate lease***IFRS 16.45–46*

A lessee accounts for a lease modification that is *not a separate lease*, at the effective date of the modification by remeasuring the lease liability. To do so, the lessee discounts the revised lease payments using a revised discount rate determined at that date and:

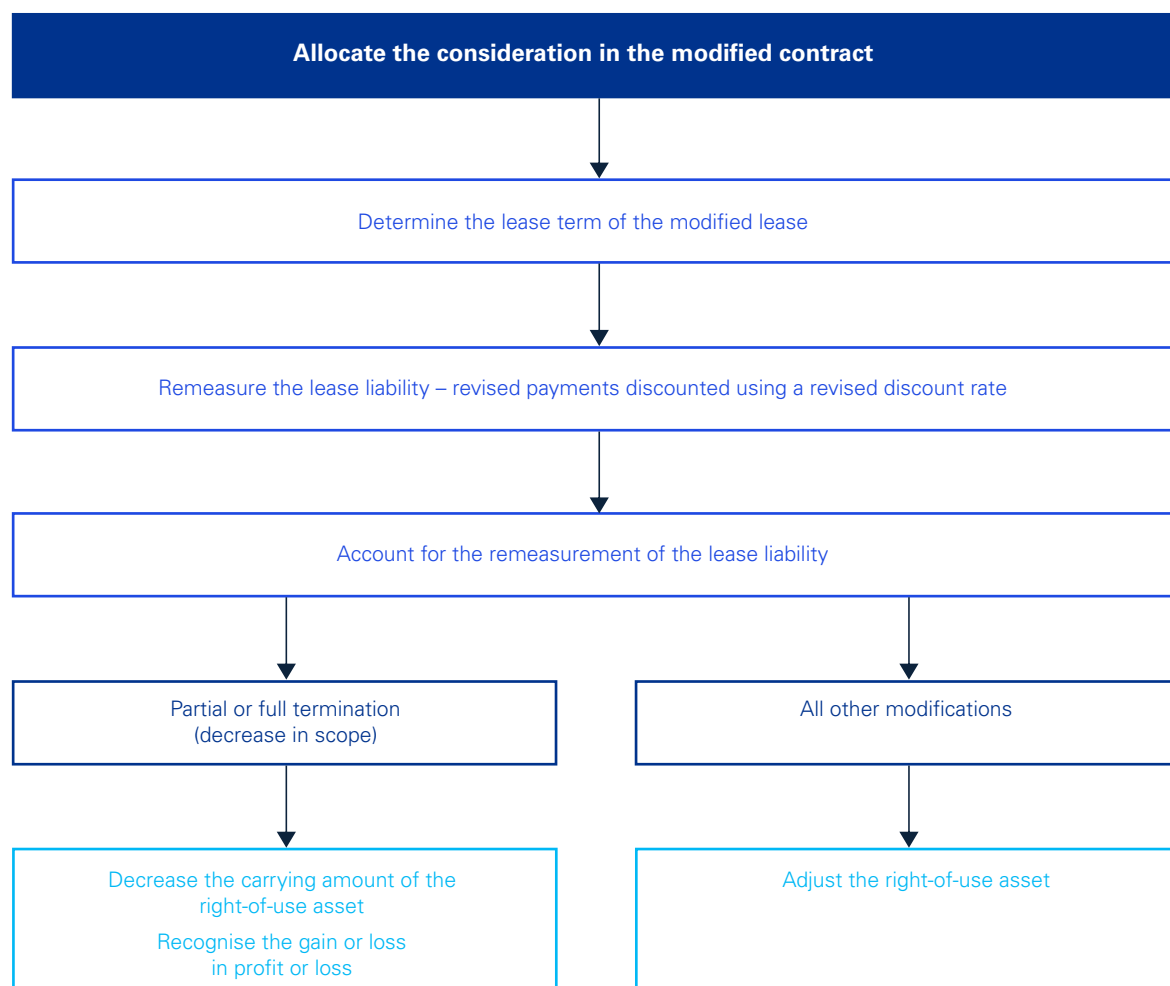
- for lease modifications that decrease the scope of the lease, the lessee decreases the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, and recognises a gain or loss that reflects the proportionate decrease in scope; and
- for all other lease modifications,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

IFRS 16.45–46

For a lease modification that is not accounted for as a separate lease, the lessee allocates consideration in the modified contract, determines the lease term and remeasures the lease liability *at the effective date of the modification*.

IFRS 16.45–46

The following diagram summarises the steps for accounting for a modification that is not a separate lease at the effective date of the modification.



IFRS 16.45–46, IE7,
Ex16,
Appendix A



Example 42 – Lease modification: Not a separate lease: Increase in lease term

Lessee X enters into a 20-year lease of a manufacturing plant with Lessor Y. The annual lease payments are 150,000 payable in arrears. The interest rate implicit in the lease cannot be readily determined and X uses its incremental borrowing rate. The incremental borrowing rate at commencement of the lease is 5%. There are no initial direct costs, lease incentives or other payments between X and Y. Accordingly, X initially recognises a lease liability and right-of-use asset of 1,869,332.

At the end of Year 18 (i.e. two years before the end of the original lease term), X and Y agree to modify the lease by extending the lease term for an additional 10 years – i.e. the lease term will be 30 years in total. Because there were no renewal options in the original lease, this is not a reassessment of the lease term. This is a lease modification that increases the lease term only – i.e. it does not grant X the right to use an additional underlying asset. Therefore, it does not result in a separate lease.

The annual lease payments remain unchanged and X's incremental borrowing rate at that date is 8%. There are no initial direct costs, lease incentives or other payments between X and Y as a result of the modification. The pre-modification carrying amount of the lease liability and right-of-use asset are 278,912 and 186,933, respectively.

X remeasures the lease liability at 1,130,412⁽¹⁾ and recognises the difference between the carrying amount of the lease liability before the modification and the carrying amount of the modified lease liability of 851,500⁽²⁾ as an adjustment to the right-of-use asset.

Notes

¹ The lease liability after the modification is determined based on:

- annual lease payments payable in arrears of 150,000;
- a remaining lease term of 12 years; and
- a revised incremental borrowing rate of 8%.

² Calculated as 1,130,412 - 278,912.

**Example 43 – Lease modification: Not a separate lease: Decrease in scope and consideration**

Lessee E entered into a 10-year lease for 10,000m² of office space with Lessor F. The rental payments are 100,000 per annum payable in arrears. The interest rate implicit in the lease cannot be readily determined and E uses its incremental borrowing rate. The incremental borrowing rate at commencement of the lease is 7%. There are no initial direct costs, lease incentives or costs to restore the leased asset to its original condition. Accordingly, E recorded a right-of-use asset and a lease liability of 702,358 at the commencement date.

At the beginning of Year 7, E and F agree to modify the lease by reducing the space to 7,500m² (i.e. a reduction of 2,500m²) and the lease payments to 75,000 per annum, payable in arrears for the remaining four years. The incremental borrowing rate at this date is 8%, the pre-modification carrying amount of the right-of-use asset is 280,943 and the lease liability is 338,721.

At the effective date of the modification – i.e. the beginning of Year 7 – E remeasures the lease liability at 248,410 based on:

- annual lease payments payable in arrears of 75,000;
- a remaining lease term of four years; and
- a revised incremental borrowing rate of 8%.

E accounts separately for the reduction of space and change in consideration as follows.

As a first step, at the effective date of the modification E accounts for the partial termination of the lease – i.e. reduction by 2,500m² – and proportionally reduces the pre-modification carrying amount of the right-of-use asset by 70,236⁽¹⁾ and lease liability by 84,680⁽²⁾. The resulting gain is 14,444⁽³⁾.

As a second step, at the effective date of the modification E recognises the difference between the remaining carrying amount of the lease liability determined in Step 1 of 254,041 and the modified lease liability of 248,410 (i.e. 5,631) as an adjustment to the right-of-use asset. This reflects the change in the consideration paid for the lease and the revised discount rate.

Notes

¹ Calculated as $280,943 \times (2,500\text{m}^2 / 10,000\text{m}^2)$, the remaining carrying amount of the right-of-use asset is 210,707.

² Calculated as $338,721 \times (2,500\text{m}^2 / 10,000\text{m}^2)$, the remaining carrying amount of the lease liability is 254,041.

³ Calculated as $84,680 - 70,236$.

7.2.4 Rent concessions

Rent concessions often meet the definition of a lease modification, unless they were envisaged in the original lease agreement. Rent concessions may occur in various forms – e.g. one-off rent reductions, rent waivers or deferrals of lease payments.

Practical expedient for COVID-19-related rent concessions

IFRS 16.46A–46B

During the COVID-19 pandemic, lessees were permitted to choose a practical expedient not to apply lease modification accounting to rent concessions granted as a direct consequence of the pandemic. A lessee was permitted to apply the practical expedient only if:

- the revised consideration was substantially the same as or less than the original consideration;
- any reduction in lease payments was related to payments originally due on or before 30 June 2022; and
- no other substantive changes had been made to the terms of the lease.

IFRS 16.46A–60A(a)

A lessee accounted for rent concessions that met all of the conditions described above in the same way as it would have applied IFRS 16 if the change were not a lease modification. Additional disclosure requirements applied when a lessee used this practical expedient.

Extinguishment of lease liabilities

IFRS 9.2.1(b)(ii), 3.3.3

A lessee is required to recognise gains or losses on the extinguishment of lease liabilities in the scope of IFRS 9 in profit or loss by applying paragraph 3.3.3 of IFRS 9.



How should a lessee distinguish between a lease modification and an extinguishment of a lease liability for the purpose of applying IFRS 16 vs IFRS 9?

IFRS 9.2.1(b)(ii), 3.3.1, 3.3.3, IFRS 16.46(b)

A lease contract may be modified to forgive specifically identified lease payments. If this is the only change to the lease contract, then it is unclear how the lessee distinguishes between a lease modification and an extinguishment (or partial extinguishment) of a lease liability. As a result, it is also unclear whether the lessee should apply the requirements of IFRS 16 or IFRS 9.

In our view, the lessee should choose an accounting policy, to be applied consistently, to account for these modifications by applying one of the following approaches.

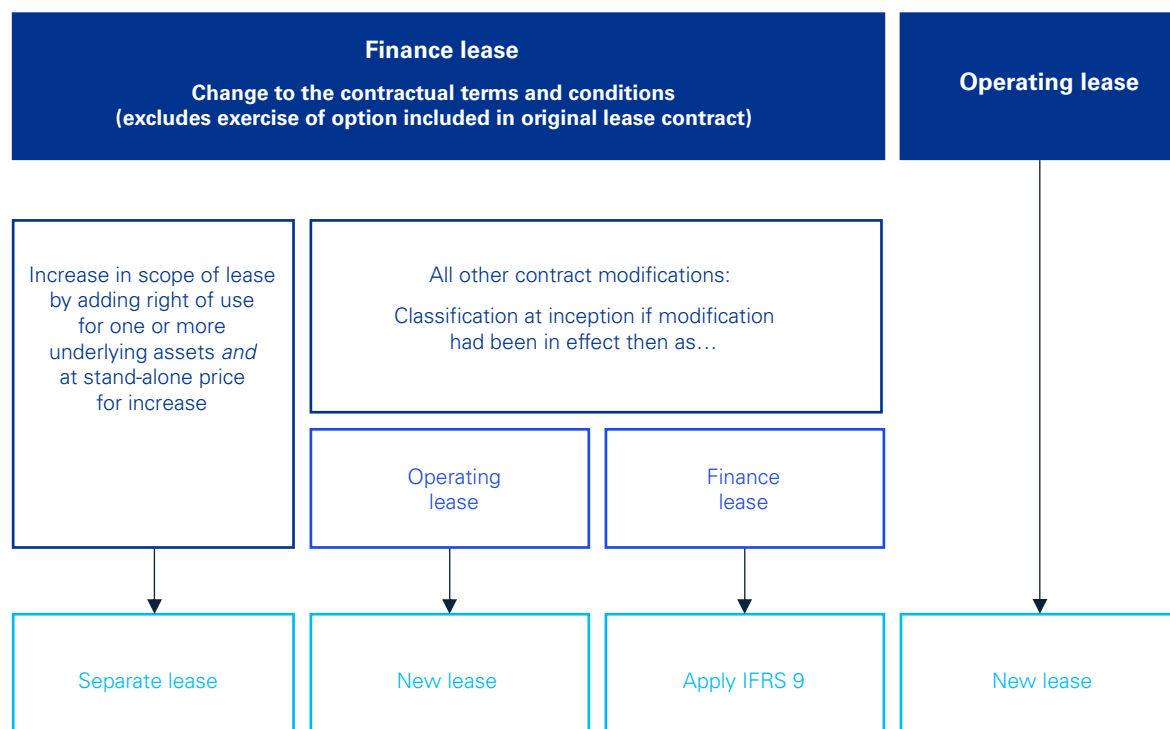
- **Full IFRS 16 approach:** Under this approach, the lessee remeasures the lease liability using a revised discount rate and makes a corresponding adjustment to the carrying amount of the right-of-use asset.
- **Partial IFRS 9 approach:** Under this approach, the lessee derecognises the lease liability for the lease payments forgiven and makes a corresponding adjustment to profit or loss in accordance with IFRS 9. The lessee then remeasures the lease liability for the remaining lease payments using a revised discount rate and adjusts the carrying amount of the right-of-use asset in accordance with IFRS 16.
- **Full IFRS 9 approach:** Under this approach, the lessee derecognises the lease liability for the present value of the lease payments forgiven and makes a corresponding adjustment to profit or loss. The lease liability is not remeasured.

7.3 Lessor modification accounting

7.3.1 Lessor modifications – General

IFRS 16.79–80, 87

The following diagram summarises the accounting for lease modifications by a lessor.



7.3.2 Lessor – Modifications to an operating lease

IFRS 16.87

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

IFRS 16.87,
Appendix A

It does not derecognise any unamortised lease incentives relating to the original lease on modification, because they are akin to prepaid lease payments.



Example 44 – Lease modification: Operating leases

IFRS 16.87

Lessor Y enters into a 10-year lease of office space with Lessee X. Y classifies this lease as an operating lease because it does not transfer substantially all of the risks and rewards incidental to ownership of the office space.

The lease agreement specifies a starting rent of 100,000 payable in arrears and requires the lease payments to be increased by 2% per annum – i.e. 1,094,972 for the whole 10-year period. X does not provide any residual value guarantee. There are no initial direct costs, lease incentives or other payments between X and Y.

The accounting for the lease payments on a straight-line basis is performed by first determining the annual rental income of 109,497 (1,094,972 / 10), which takes into account the annual indexation. Therefore, Y accounts for the lease payments over the first half of the lease term (i.e. Years 1–5) as follows.

Date	Lease payment (A)	Annual rental income (B)	Accrual period end balance (C)*
Year 1	100,000	109,497	9,497
Year 2	102,000	109,497	16,994
Year 3	104,040	109,497	22,451
Year 4	106,121	109,497	25,827
Year 5	108,243	109,497	27,081
* Calculated as C prior year + (B - A).			

At the beginning of Year 6, the real estate market deteriorates and Y would like to encourage X to commit to staying in the office space for longer. Y and X enter into negotiations and agree to:

- extend the original lease of the floor of office space by an additional five years after Year 10; and
- fix the annual payments for the original lease at 110,000 payable in arrears for the remaining 10 years (i.e. five remaining years of the original lease term plus a five-year extension).

The change in consideration and the extension of the lease term were not part of the original terms and conditions of the lease and are therefore a lease modification. Y accounts for this modification as a new operating lease from the effective date of the modification. This takes into account accrued lease payments relating to the original lease as follows.

Date	Lease payment (A)	Annual rental income (B)	Accrual period end balance (C)*
Year 6	110,000	107,292	24,373
Year 7	110,000	107,292	21,665
Year 8	110,000	107,292	18,957
Year 9	110,000	107,292	16,249
Year 10	110,000	107,292	13,541
Year 11	110,000	107,292	10,833
Year 12	110,000	107,292	8,125
Year 13	110,000	107,292	5,417
Year 14	110,000	107,292	2,709
Year 15	110,000	107,292	–

* Calculated as $((110,000 \times 10) - 27,081) / 10$ – i.e. (sum of A [lease payments] - (C at end of Year 5)) / 10 [remaining lease term].



Is there guidance on how a lessor applies the expected credit loss model and derecognition requirements in IFRS 9 to an operating lease receivable when there is a rent concession?

IFRS 16.87, IU 09–22

Yes. In some rent concession scenarios, the only change to the lease contract is the lessor's forgiveness of lease payments due from the lessee under that contract. The IFRS Interpretations Committee discussed such a scenario in which the lessor in an operating lease legally releases the lessee from its obligation to make specifically identified lease payments, which include:

- amounts contractually due but not paid, which the lessor had recognised as operating lease income and an operating lease receivable; and
- amounts that are not yet contractually due.

For the rent concession in this scenario, the Committee noted that the lessor:

- measures expected credit losses on the operating lease receivable in the period before the rent concession was granted. In doing so, it considers a range of possible outcomes and reasonable and supportable information that is available without undue cost or effort, including its expectations of forgiving lease payments recognised as part of that receivable;
- applies the derecognition requirements in IFRS 9 to lease payments that the lessor had forgiven and included in an operating lease receivable on the date the rent concession was granted; and
- applies the lease modification requirements in IFRS 16 to lease payments that the lessor had forgiven but not included in an operating lease receivable at that date.

7.3.3

IFRS 16.79–80,
BC238–BC239

Lessor – Modifications to a finance lease

A lessor's accounting for a modification to a finance lease depends on whether the modification, in substance, represents the creation of a new lease that is separate from the original lease. Like the lessee (see 7.2.2), the lessor accounts for such a modification as a separate lease. Accounting for a modification to a finance lease that does not result in a separate lease depends on whether the lease classification would have been different had the modified terms been in effect at the inception date.

Separate lease

IFRS 16.79

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.

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

Not a separate lease

IFRS 16.80

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 the termination of the original lease and the creation of a new operating 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.
- Otherwise, it applies the requirements of IFRS 9.



Example 45 – Lease modification: Separate lease

IFRS 16.63–66, 79

Lessor L enters into an eight-year lease of 40 lorries with Lessee M. The lease term approximates the lorries' economic life and no other features indicate that the lease does not transfer substantially all of the risks and rewards incidental to ownership of the lorries. Therefore, L classifies the lease as a finance lease.

M's business has expanded and M now requires additional lorries. At the beginning of Year 5, L and M amend the contract to grant M the right to use 20 additional lorries of the same type for the remaining contractual period – i.e. for four years. The lease payments for these additional lorries are 5% higher than originally, reflecting an increase in their purchase price.

The lease of the additional lorries was not part of the original terms and conditions of the contract. Therefore, this is a lease modification. L accounts for this modification as a separate lease at the effective date of the lease modification because:

- the modification increases the scope of the lease by adding the right to use additional underlying assets – i.e. 20 additional lorries; and
- the lease payments for the additional lorries are commensurate with their stand-alone rentals. Even though the lease payments for the new lorries are 5% higher than the prices in the original lease, this change reflects the increase in purchase prices.

L does not modify the accounting for the original lease of 40 lorries. L classifies the lease of 20 additional lorries as an operating lease because the lease term for those additional lorries is not for the major part of their economic life and no other features indicate that the lease transfers substantially all of the risks and rewards incidental to ownership of the lorries.



Example 46 – Lease modification: Not a separate lease: Lease would have been classified as an operating lease

Modifying [Example 45](#), at the end of Year 2 Lessee M decides to cease one of its activities in two years and therefore needs to terminate the lease of 40 lorries early. At the beginning of Year 3, L and M amend the contract so that it now terminates after Year 4.

Early termination was not part of the original terms and conditions of the lease and is therefore a lease modification. The modification does not grant M an additional right to use an underlying asset and therefore cannot be accounted for as a separate lease.

L determines that had the modified terms been in effect at the inception date, the lease term would not have been for the major part of the lorries' economic life. In addition, there are no other indicators that the lease would have transferred substantially all of the risks and rewards incidental to ownership of the lorries. Consequently, the lease would have been classified as an operating lease.

At the beginning of Year 3, L accounts for the modified lease as a new operating lease. Consequently, L:

- derecognises the finance lease receivable and recognises the underlying assets in its statement of financial position according to the nature of the underlying asset – i.e. as property, plant and equipment in this case; and
- measures the aggregate carrying amount of the underlying assets as the amount of the net investment in the lease immediately before the effective date of the lease modification.

IFRS 16.63–66,
79–80(a), 81, 88

See our [Lease modifications](#) publication for more guidance.

8 Sub-leases

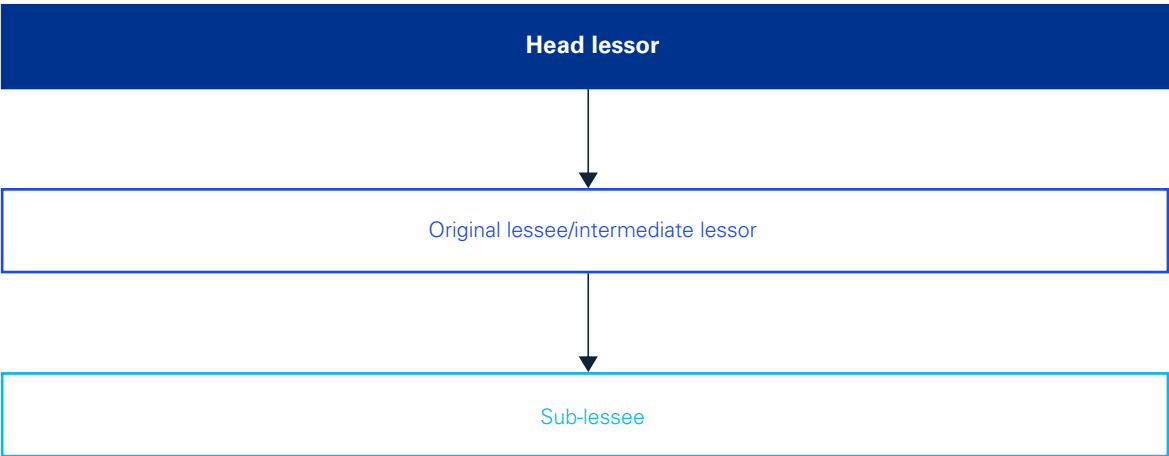
The classification guidance in IFRS 16 means that many sub-leases are finance leases, impacting the financial position and financial performance of intermediate lessors.

IFRS 16 Appendix A

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.

IFRS 16.3

An entity 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, applying both the lessee and lessor accounting requirements.



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, adjusted for any initial direct costs associated with the sub-lease, to account for the sub-lease.

IFRS 16.B58

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

IFRS 16.IE8, Ex20

**Example 47 – Sub-lease classified as a finance lease**

Head lease: Company 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 Company 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.

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.

**Does entering into a sub-lease with a longer term than the remaining head lease term trigger a remeasurement of the head lease?**

IFRS 16.B41(c)

Yes. Two parties may enter into a sub-lease in which the non-cancellable period of the sub-lease or the sub-lease term – i.e. including one or more optional periods – exceeds the lease term for the head lease. Because the act of entering into the sub-lease is a significant event within the intermediate lessor's control, it reassesses the head lease term. This results in the term of the head lease being equal to or longer than the term of the sub-lease. If this represents a change in the term of the head lease, then this will trigger a remeasurement of the intermediate lessor's liability under the head lease.

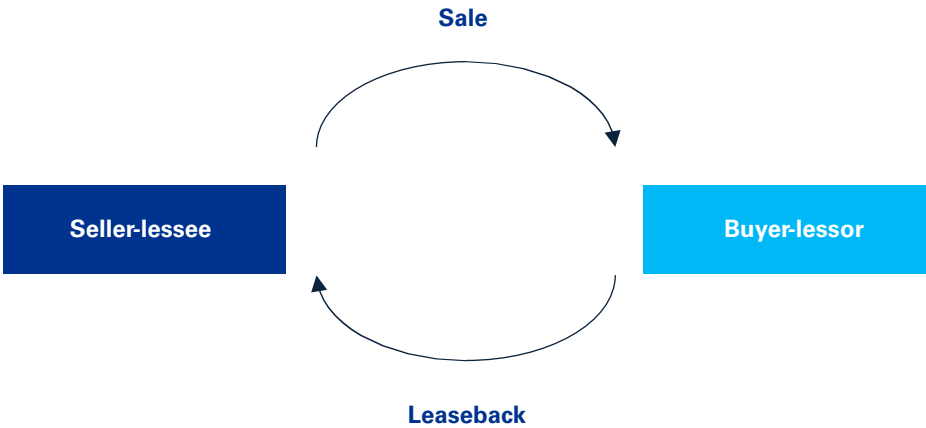
9 Sale-and-leaseback

The IFRS 16 guidance on ‘failed sales’ means that some sale-and-leaseback transactions are accounted for as pure financing transactions by both lessors and lessees.

9.1 Overview

IFRS 16.98–103

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



To determine how to account for a sale-and-leaseback transaction, an entity first considers whether the initial transfer of the underlying asset from the seller-lessee to the buyer-lessor is a sale. The entity 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	• Derecognise the underlying asset and apply the lessee accounting model to the leaseback.* • Measure the right-of-use asset at the retained portion of the previous carrying amount (i.e. at cost).* • Recognise only the amount of any gain or loss related to the rights transferred to the lessor.*	• Recognise the underlying asset and apply the lessor accounting model to the leaseback.*

	Lessee (seller)	Lessor (buyer)
Transfer to buyer-lessor is not a sale	- Continue to recognise the underlying asset. - Recognise a financial liability under IFRS 9 for amounts received from the buyer-lessor.	- Do not recognise the underlying asset. - Recognise a financial asset under IFRS 9 for amounts transferred to the seller-lessee.

* Adjustments are required if the sale is not at fair value or lease payments are off-market. However, an entity is not required to assess both – only whichever one is more ‘readily determinable’.



Example 48 – Sale-and-leaseback transaction when transfer is a sale

IFRS 16.IE11, Ex24

Company C sells an office building to Company D for cash of 1,000,000. Immediately before the transaction, the building is carried at a cost of 500,000. At the same time, C enters into a contract with D for the right to use the building for 15 years with annual payments of 80,000 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 900,000. 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 100,000 (1,000,000 – 900,000) is recognised as additional financing provided by D to C. The incremental borrowing rate of the lessee is 5.0% per annum. The present value of the annual payments is 830,400, of which 100,000 relates to the additional financing and 730,400 relates to the lease – corresponding to 15 annual payments of 9,634 and 70,366, respectively, when discounting at 5.0% per annum.

Seller-lessee perspective

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 405,778 ($730,400 / 900,000 \times 500,000$).
- The total gain on the sale of the building amounts to 400,000 ($900,000 - 500,000$), of which:
 - 324,622 ($730,400 / 900,000 \times 400,000$) relates to the right to use the office building retained by C; and
 - 75,378 ($((900,000 - 730,400) / 900,000 \times 400,000)$) relates to the rights transferred to D.
- C recognises only the portion of the gain on sale that relates to the rights transferred to D, which is 75,378.

At the commencement date, C makes the following entries.

	Debit	Credit
Cash	1,000,000	
Right-of-use asset	405,778	
Building		500,000
Financial liability		830,400
Gain on sale-and-leaseback		75,378
<i>To recognise sale-and-leaseback</i>		

Buyer-lessor perspective

At the commencement date, D makes the following entries.

	Debit	Credit
Building	900,000	
Financial asset	100,000	
Cash		1,000,000
<i>To recognise acquisition</i>		



How does a buyer-lessor assess whether a transaction qualifies for sale-and-leaseback accounting?

The buyer-lessor assesses whether the transfer leg meets the requirements for determining when a performance obligation is satisfied under IFRS 15. Put another way, the buyer-lessor assesses whether the seller-lessee has transferred control of the property. This assessment is made from the perspective of the seller-lessee.

There is no specific or additional guidance in IFRS 16 about how to make this assessment. Instead, the parties apply the guidance in IFRS 15.

Cases in which the assessment is clear – Repurchase options

In some cases, it will be clear that the transfer leg does *not* meet this test, and therefore the transaction is accounted for as a financing transaction.

For example, some transactions contain a call option under which the seller-lessee can, at its option, repurchase the property. Such an option generally precludes sale accounting under IFRS 15, because the existence of the call option means that the seller-lessee retains control of the property. Therefore, sale-and-leaseback accounting does not apply and both parties account for the transaction as a financing transaction.

Cases in which the assessment is less clear

In the absence of a substantive call option or other feature that generally precludes the transfer leg being a sale, judgement is required to assess the appropriate accounting.

For example, whether the leaseback would be classified as a finance or operating lease by the buyer-lessor would not in itself determine whether the transfer leg qualifies as a sale. The standard does not preclude the possibility that the transfer leg is a sale when the classification of the leaseback is a finance lease – i.e. sale-and-finance-leaseback accounting is not prohibited under IFRS 16. However, in our experience, only in rare circumstances would the transfer qualify as a sale in this case.

IFRS 16.99

IFRS 16.99,
IAS 16.58, 69



Are land and buildings separate units of account when determining whether a sale has taken place?

It depends. A key consideration is how the seller-lessee accounted for the land and buildings before the transaction.

If a sale-and-leaseback transaction involves a piece of real estate (comprising land and buildings) that was previously accounted for by the seller-lessee under IAS 16, then in our view the land and buildings should be assessed separately when applying IFRS 15 to determine whether a sale has taken place. This is because land and buildings are recognised as separate assets under IAS 16 and the IAS 16 disposal requirements apply separately to each item of property, plant and equipment. This is potentially significant because it may result in different conclusions for the land and buildings in a sale-and-leaseback scenario – i.e. the transfer of the land, which typically has an indefinite economic life, may qualify as a sale but the transfer of the building may not.

However, if the piece of real estate was previously recognised as a single asset by the seller-lessee, then the unit of account for the assessment would differ. For example, the piece of real estate may previously have been classified as investment property with no own-use element and measured under IAS 40's fair value model as a single asset. In this scenario, if the land and buildings were transferred to another party and leased back, then they would be treated as a single unit of account when assessing whether a sale has taken place.

IAS 40.10



Does IFRS 16 contain guidance on the unit of account for assessing whether a sale has taken place if an entity sells a building and leases part of it back?

No. A seller-lessee may transfer a building and lease back only some floors. There is no guidance in IFRS 16 on what the unit of account is in such cases.

In our view, one acceptable approach may be to consider the requirements in paragraph 10 of IAS 40 by analogy. If each floor could be sold or leased out separately under a finance lease, then a seller-lessee would determine whether a sale has occurred for each floor. We believe another acceptable approach would be to consider *only* whether the floors could be sold separately.



Example 49 – Sale-and-leaseback accounting when an entity sells a building and leases part of it back

Company B transfers a 10-storey building to Company C and immediately leases five floors back.

Applying the requirements in paragraph 10 of IAS 40 by analogy, if each floor could be sold or leased out separately under a finance lease, then B would determine whether a sale has occurred for each floor. This would lead to B accounting for a sale of the five floors that have not been leased back provided that there is no other factor preventing a sale. B would account for the other five floors that have been leased back as being subject to either a sale-and-leaseback transaction or as a financing transaction.

If each floor could not be sold or leased separately under a finance lease then, under this approach, B would determine whether a sale has occurred for the whole building. Accordingly, either the transfer of the whole building would qualify as a sale, and sale-and-leaseback accounting would apply, or the transfer of the whole building would be a failed sale and accounted for as a financing transaction.

An alternative approach would be to consider *only* whether the floors could be sold separately. If this were the case, then B would determine whether a sale has occurred for each floor. If not, it would determine whether a sale has occurred for the whole building.

9.2 Variable lease payments in a sale-and-leaseback transaction

IFRS 16.100

The payments for the lease in a sale-and-leaseback transaction may be fully or partially variable. In these cases, a seller-lessee:

- measures the right-of-use asset at the proportion of the previous carrying amount of the asset that relates to the right of use retained; and
- determines the amount of any gain or loss to be recognised at the date of the transaction by applying paragraph 100 of IFRS 16.

IFRS 16.102A, IE12

The seller-lessee also recognises a lease liability. To determine the amount of the lease liability on initial recognition, the seller-lessee develops an accounting policy. It does this based on an acceptable approach under which measuring the lease liability would not result in it:

- measuring the right-of-use asset at an amount that inappropriately reflects the rights retained in the underlying asset; or
- recognising any portion of the total gain or loss that relates to the rights retained in the underlying asset.



Can the right-of-use asset be zero in a leaseback with variable payments?

IFRS 16.100, 102A

No. In a sale-and-leaseback transaction with fully variable payments (e.g. depending on sales or usage), the right-of-use asset is not measured at zero at the date of the transaction. This is because that measurement would not reflect the retained portion of the previous carrying amount.

IFRS 16.102A, IE12

IFRS 16 includes an example illustrating the following two approaches for the subsequent measurement of a right-of-use asset and lease liability in a sale-and-leaseback transaction with variable lease payments that do not depend on an index or rate:

- **Approach 1:** expected lease payments at the commencement date; and
- **Approach 2:** equal lease payments over the lease term.

Both approaches ensure that the seller-lessee will not recognise any amount of the gain or loss relating to the right of use retained.

IFRS 16.38(b), IE12

The seller-lessee recognises in profit or loss for that period the difference between the actual lease payments made and the lease payments determined under the selected approach that reduce the carrying amount of the lease liability each period.



Do IFRS 16's requirements apply to a sale-and-leaseback in which lease payments vary depending on an index or a rate?

IFRS 16.100, 102A

Yes. IFRS 16's requirements do not distinguish between different types of variable payments. Instead, they set out a general requirement that when a seller-lessee applies the subsequent measurement requirements for the lease liability, it does not recognise a gain or loss relating to the right-of-use asset it retains under the leaseback.

Therefore, in our view IFRS 16's requirements apply to all sale-and-leaseback transactions in which the lease payments are fully or partially variable, including those in which lease payments vary depending on an index or a rate.



Are the two approaches illustrated in IFRS 16 the only acceptable approaches?

No. In our view different approaches may be acceptable on subsequent measurement, subject to the overriding requirement that the seller-lessee does not recognise any portion of the gain or loss that relates to the rights retained.



Does IFRS 16 contain specific requirements on how a buyer-lessor accounts for a sale-and-leaseback transaction with variable payments?

No. IFRS 16 does not specifically address the accounting for the buyer-lessor in a sale-and-leaseback transaction with variable payments. The buyer-lessor applies the general guidance in IFRS 16, recognising the purchase of the asset applying relevant accounting standards and accounting for the lease under the lessor accounting requirements in IFRS 16.

If the leaseback is an operating lease, then the lessor recognises lease payments on either a straight-line or another systematic basis. Variable lease payments are recognised as income in profit or loss. They are recognised in the period in which a change occurs and according to the facts and circumstances on which the variable payments are based.

If the leaseback is a finance lease, then the lessor recognises a net investment in the lease according to the guidance provided in IFRS 16.

IFRS 16.100, 102A

See our [Sale and leaseback](#) publication for more guidance.

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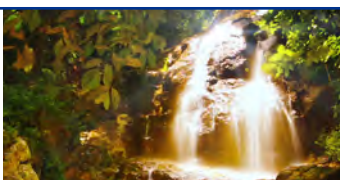
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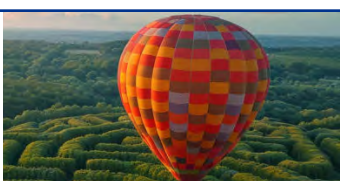
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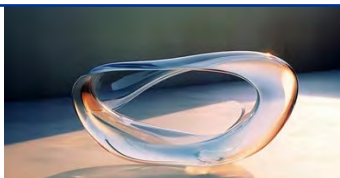
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