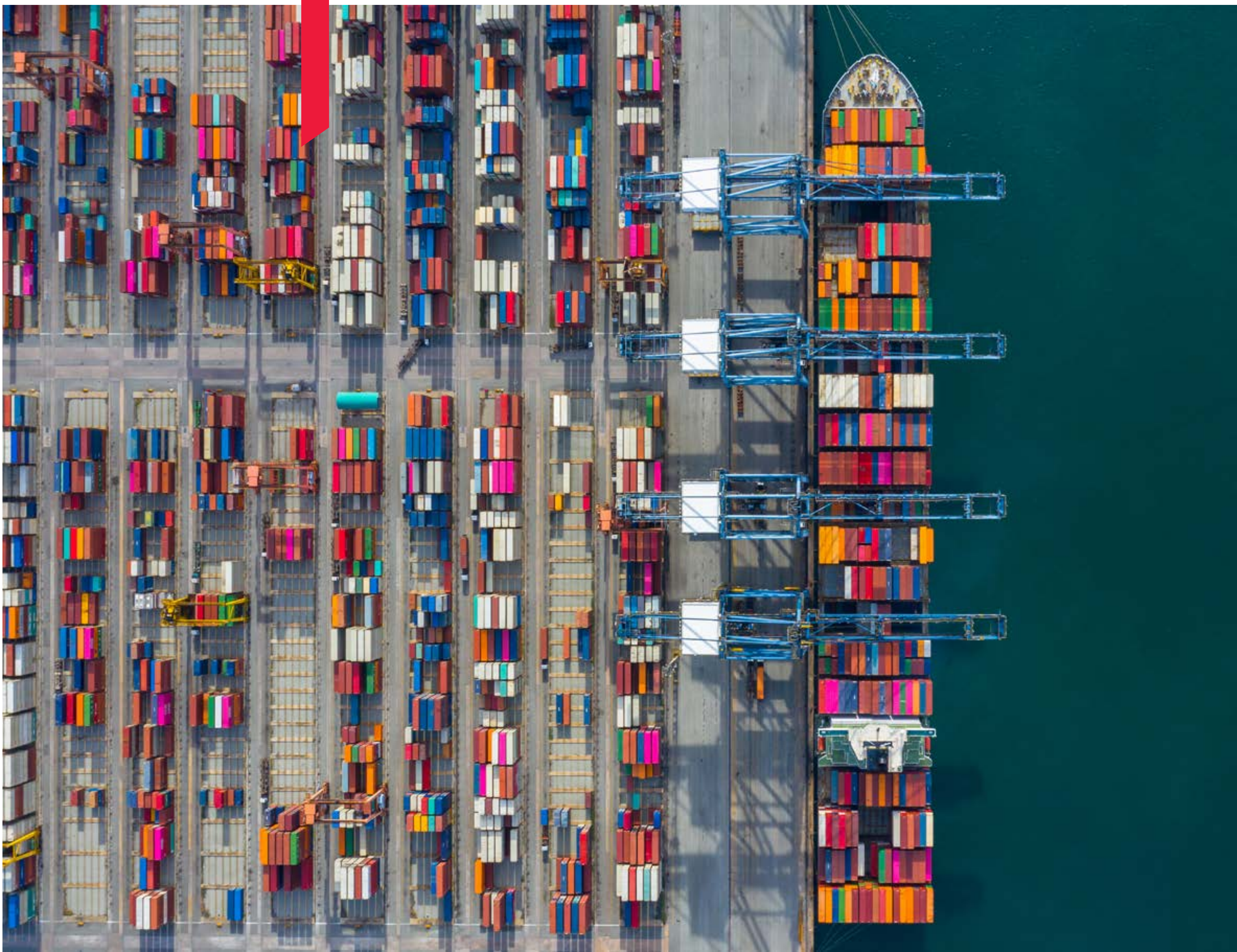

IFRS IN PRACTICE 2019/2020

IFRS 16 *Leases*

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1. INTRODUCTION

IFRS 16 *Leases* brings significant changes in accounting requirements for lease accounting, primarily for lessees. IFRS 16 replaces the existing suite of standards and interpretations on leases:

– IAS 17 *Leases* (IAS 17);
– IFRIC 4 *Determining whether an Arrangement contains a Lease* (IFRIC 4);
– SIC 15 *Operating Leases – Incentives* (SIC 15);
– SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (SIC 27).

This BDO *In Practice* sets out the requirements of IFRS 16 in relation to the classification and measurement of leases from the perspective of lessees and lessors and compares those requirements to the previous standards, primarily IAS 17. It should be noted that the guidance relating to lessor accounting remains largely unchanged from IAS 17, so the focus of this publication is on the requirements for lessees.

Those requirements are summarised as:

Lessees

Almost all leases are recognised in the statement of financial position as a 'right-of-use' asset and a lease liability. There are narrow exceptions to this recognition principle for leases where the underlying asset is of low-value and for short-term leases (i.e. those with a lease term of twelve months or less). The asset is subsequently accounted for in accordance with the cost or revaluation model in IAS 16 *Property, Plant and Equipment* (IAS 16) or, if the right-of-use asset meets the definition of investment property, in accordance with the requirements of IAS 40 *Investment Property* (the fair value model is required if the lessee measures investment property at fair value). The liability and right-of-use asset are unwound over the term of the lease giving rise to an interest expense and depreciation charge, respectively.

Lessors

As noted above the guidance relating to lessors remains substantially unchanged from IAS 17. Lessors continue to account for leases as either operating or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee. An exception is intermediate lessors, where the classification of the sublease is determined with reference to the intermediate lessor's right-of-use asset, and not the entire underlying asset.

Operating leases continue to be recorded as assets in the statement of financial position and lease income is recognised on a straight line basis over the lease term. For finance leases, a lessor is required to derecognise the underlying asset and record a receivable equal to the net investment in the lease, with a gain or loss on sale. Finance income is subsequently recognised at the interest rate implicit in the lease over the lease term.

Effective date

The effective date of IFRS 16 is for annual reporting periods beginning on or after 1 January 2019. For lessees there is a choice of full retrospective application (i.e. restating comparatives as if IFRS 16 had always been in force), or retrospective application without restatement of prior year comparatives. This results in the cumulative impact of adoption being recorded as an adjustment to equity at the beginning of the accounting period in which the standard is first applied (the date of initial application).

Early adoption of IFRS 16 is permitted, but entities electing to do so must also apply IFRS 15 *Revenue from Contracts with Customers* (IFRS 15) at the same time. Entities that do elect to early adopt IFRS 16 and apply IFRS 15 at the same time can choose different transition methods for each standard. For example, an entity that chooses the modified retrospective approach under IFRS 15 can use the fully retrospective approach under IFRS 16. The transition choices need not be the same under both standards.

Comparison with US GAAP

IFRS 16 began as a joint project between the International Accounting Standards Board (IASB) and its US counterpart, the Financial Accounting Standards Board (FASB). However, the Boards did not agree on some points and, ultimately, the FASB's standard differs from the IASB's in that the FASB's standard retains distinct categories of leases for lessees with different accounting requirements.

2. SCOPE

The scope of IFRS 16 is broadly similar to IAS 17 in that it applies to contracts meeting the definition of a lease (see Section 3.), except for:

(a) Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

(b) Leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee;

(c) Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*;

(d) Licences of intellectual property granted by a lessor within the scope of IFRS 15; and

(e) Rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* (IAS 38) for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

BDO comment – Leases to explore for Non-regenerative Resources (e.g. minerals, oil, etc.)

As noted above, IFRS 16 excludes from its scope 'leases to explore for or use mineral, oil, natural gas and similar non-regenerative resources'. Interpreting precisely how this scope exclusion should be applied may be challenging in practice. For example:

1. *Does the exemption only apply to projects still in the scope of IFRS 6, Exploration for and Evaluation of Mineral Resources?*
2. *Does the exemption apply to 'surface rights' (i.e. amounts paid to private owners of land to access the surface of the land that contains non-regenerative resources) in addition to amounts paid to government authorities to obtain the right to explore for those non-regenerative resources?*
3. *Does the exemption apply to leases for equipment necessary for the exploration and/or extraction process?*
4. *Does the exemption apply to leases to access land necessary for the extraction of resources (e.g. a lease of land to place equipment necessary in the extraction process or to place roads needed to access sites)?*

Regarding issue #1, as the scope exclusion applies to '…leases to explore…', it is unclear whether the scope exclusion is limited to only those projects that are within the scope of IFRS 6. As IFRS 6 is not explicitly noted in IFRS 16's scope exclusion, it would appear that the scope exclusion applies in a more broad sense than only projects still within the scope of IFRS 6 (i.e. projects still in the exploration and evaluation phase of their development).

Item #2 above appears to satisfy the scope exclusion in both cases as they relate to a right to explore land for non-regenerative resources.

For item #3, while this relates to a project for the exploration of non-regenerative resources, the rights relate to items necessary to explore for the resources, not the right to explore directly. Leases of equipment do not fall within the scope exclusion in IFRS 16 (i.e. they are not excluded from the requirements of the standard).

For item #4, it is necessary to understand which portion of land is being leased. For example, a lease of land which contains an oil field, where the lessee is granted permission to access the land for the purposes of oil exploration and/or extraction would fall within the scope exclusion in IFRS 16. However, leases of other areas of land would be within the scope of IFRS 16. For example, in addition to entering into the lease above over land which contains an oil field, the lessee might also enter into leases of adjacent land (for example, to place pipes for the transporting of oil away from the extraction area). These leases would fall within the scope of IFRS 16 (the scope exclusion would not apply).

BDO comment – Leases to explore for Non-regenerative Resources (e.g. minerals, oil, etc.) (continued)

It may be complex to determine the point in which the lease of land ceases to be within the scope exclusion to IFRS 16. In our view, a principle that may be applied is that the scope exclusion ceases when significant inputs and processing are no longer being applied to the applicable natural resource. For example, an oil field may be placed on leased property, where the land lease would be excluded from the scope of IFRS 16. The entity would also have to place an oil battery on land that is also leased, immediately adjacent to the oil field. An oil battery is a group of tanks that receive crude oil, where the volume is measured and tested for being pumped into a pipeline system for transport. Cleaning and treating of the oil also typically occur in the battery. In our view, the scope exclusion would apply to the land lease where the battery is placed, since at that point, the land lease still relates to 'leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources'. Once the oil passes beyond the battery into pipelines for transportation, the scope exclusion would cease, as the land over which the pipelines are placed do not relate to 'exploration'. The entity would apply the criteria for determining whether the land on which pipelines are placed meet the definition of a lease since the scope exclusion from IFRS 16 would not apply.

Determining the boundary of the scope exclusion will depend on the precise facts and circumstances, and this analysis would not apply in all cases. For example, the conclusion may differ if the oil battery were placed at a significant distance from the oil field from which the oil is extracted.

2.1. Recognition Exemptions

In addition to the above scope exclusions, a lessee can elect not to apply IFRS 16's recognition and measurement requirements to:

(a) Short-term leases; and

(b) Leases for which the underlying asset is of low value ('low-value leases').

The short-term lease exemption must be applied consistently to all underlying assets in the same class. The low-value lease exemption, in contrast, may be applied on a lease-by-lease basis.

If an entity applies either exemption, it must disclose that fact and certain information to make the effect of the exemption known to users of its financial statements (see Section 7. – Disclosure).

Short-term Leases

Short-term leases are defined as 'leases that, at the commencement date, have a lease term of twelve months or less. A lease that contains a purchase option is not a short-term lease.'

BDO comment

This exemption simplifies the application of the standard for short-term leases significantly.

It is important to note that the IFRS 16's definition of 'lease term' must be considered carefully before concluding that a lease is a short-term lease. In particular the lease term must include the effect of options to extend or terminate a lease. This means that it will be unlikely to be possible to keep a lease off balance sheet by, say, structuring the contract with an initial term of 11 months and 29 days, with extension options for further periods of 11 months and 29 days, or by including periodic lessor termination options. This is because the 'lease term' as defined includes periods covered by extension options that are reasonably certain to be exercised by the lessee and the existence of termination options exercisable only by the lessor are disregarded.

However, where the lease is not enforceable by either party (i.e. they both have an option to terminate the lease without permission from the other with no more than an insignificant penalty) then the lease term would take into account those termination options.

Determining the lease term is discussed in more detail in Section 4. below.

Leases of Low-Value Assets

The assessment of 'low value' for a leased asset is to be made on the basis of the value of an asset when it is (or was) new, regardless of whether the actual asset being leased is new. Additionally, the assessment is made regardless of whether the leased asset is material to the lessee. This guidance is meant to achieve the goal that different lessees should reach the same conclusions relating to underlying assets, regardless of their size, nature or circumstances.

An underlying asset in a lease can be of low value only if:

(a) The lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and

(b) The underlying asset is not highly dependent on, or highly interrelated with, other assets.

This means that a lessee cannot claim that, for example, an aircraft or a vehicle are comprised of a large number of low-value items (individual components) because, in the context of the overall operating asset, these components are highly dependent on and interrelated with each other.

IFRS 16 provides examples of low-value leases, which include tablets and personal computers, small items of office furniture and telephones.

BDO comment

The standard does not provide very much guidance to assist in assessing what 'low value' means. Examples are provided to allow preparers to analogise the comparative cost of assets, but this may become problematic in the future as assets become more or less expensive due to technological advancement, which may increase the functionality of equipment and/or decrease its cost. The Basis for Conclusions to the standard notes the value of USD 5,000 as being an amount the IASB had in mind when finalising IFRS 16 towards the end of 2015, but this was not included in the standard itself.

The assessment of low value should be applied consistently, regardless of the lessee's size and nature. This is illustrated in the following two examples.

Example 1 – Low-Value Lease Assessment

Entity A is a large, multi-national technology company with approximately CU 10 billion in its annual operating budget. It enters into a contract to lease one floor of an office building in a major city in Central America for total lease cost of CU 50,000 per annum for five years. The operations of the facility and the lease cost are immaterial to Entity A.

Assessment

Despite the fact that the lease is clearly immaterial to Entity A (it represents 0.0005% of the annual operating budget), a floor of an office building is not generally considered to be of 'low value' on an absolute basis. Additionally, analogising its cost to those items provided in IFRS 16 as examples of items meeting 'low value' criteria such as telephones and laptops, shows that the cost is clearly much more significant. Therefore, the lease does not meet the low-value lease exemption.

Example 2 – Low-Value Lease Assessment

A lessee in the pharmaceutical manufacturing and distribution industry has the following leases:

(a) Leases of real estate (both office buildings and warehouses);

(b) Leases of manufacturing equipment;

(c) Leases of company cars, both for sales personnel and senior management and of varying quality, specification and value;

(d) Leases of trucks and vans used for delivery purposes, of varying size and value;

(e) Leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones);

(f) Leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as the lessee has needed to increase the storage capacity of the servers;

(g) Leases of office equipment:

  (i) Office furniture (such as chairs, desks and office partitions);

  (ii) Water dispensers; and

  (iii) High-capacity multifunction photocopier devices.

Assessment

The lessee determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are (or were) individually of low value:

(a) Leases of IT equipment for use by individual employees; and

(b) Leases of office furniture and water dispensers.

The lessee elects to account for these leases using the low value exemption.

Although each module within the servers, if considered individually, might be an asset of low value, the leases of modules within the servers do not qualify as leases of low-value assets. This is because each module is highly interrelated with other parts of the servers. The lessee would not lease the modules without also leasing the servers.

The other items of equipment (including the high-capacity multifunction photocopier devices) all have a cost when new which exceeds USD 5,000.

3. IDENTIFYING A LEASE

As all leases (except for the limited exceptions described in Section 2.) will be recorded 'on balance sheet', a key consideration is whether a contract meets the definition of a lease in IFRS 16:

> **'A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time* in exchange for consideration.'**

* *Note: a period of time may also be described in terms of an amount of use of an asset (e.g. Number of production units that a piece of machinery will produce).*

An entity only reassesses whether a contract is, or contains, a lease subsequent to initial recognition if the terms and conditions of the contract are changed.

Separation of Lease Components

For a contract that contains a lease component, an entity accounts for each lease component within the contract separately from non-lease components. However, a lessee may apply a practical expedient by class of underlying asset, and ignore the requirement to separate non-lease components (such as services) from the lease components. Instead it may account for the entire contract as a single lease contract. For example, a contract for the lease of an asset together with its maintenance during the lease term can be accounted for in its entirety as a lease contract rather than accounting for the lease of the asset separately from the maintenance service. This practical expedient is only available to lessees; it does not apply to lessors.

If this practical expedient is not used, a lessee must allocate the total contract consideration to the lease and non-lease component on the basis of their relative stand-alone prices. If standalone prices are not available, then they must be estimated. This can be quite complex and judgemental and so applying the practical expedient simplifies the accounting. A consequence of using the practical expedient is that the amounts recognised on balance sheet are greater than would be the case from identifying the payments related to, and separately accounting for, the non-lease components.

BDO comment

Non-lease components exist in numerous types of lease agreements. For example, they may arise from maintenance included in the lease payments for vehicles, or common area maintenance costs for multi-unit real estate leases to cover shared costs such as security, cleaning, etc. In determining whether an entity will elect to include non-lease components in the measurement of the lease contract, entities should consider the cost vs. benefit of determining stand-alone prices for the individual components.

Additionally, for non-lease components such as common area maintenance costs, entities should consider whether such costs are variable in nature and not dependent on an index or rate, and therefore would not be included in the lease measurement regardless of the accounting policy choice (see Section 5.1. for discussion of common area maintenance and variable lease payments).

Combining Contracts

It may be necessary to combine two or more contracts to assess whether the combined transaction constitutes a lease. For example, the substance of multiple legal agreements entered into at or near the same time with the same counterparty (or parties related to the counterparty) might only be understood when viewed as a single, composite contract. Combination of contracts is required when:

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

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

(c) The rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component.

Unit of Account

IFRS 16 is written in the context of accounting for the lease of a single asset. This means that the low-value asset exemption described in Section 2.1. above applies even if there is only a single lease contract for, say, 1,000 low-value computers.

However, as a practical expedient to treating the unit of account as the lease of a single asset, an entity may apply IFRS 16 to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the standard to the portfolio would not differ materiality from applying the standard to the individual lease contracts within the portfolio.

If it accounts for the leases on a portfolio basis, an entity is then able to make estimates and assumptions that reflect the size and composition of the portfolio. Therefore, if an entity leases 1,000 vehicles under 1,000 separate contracts (i.e. each contract is for a single vehicle) it may be possible to consider the portfolio of leases as a single right to use 1,000 vehicles, rather than 1,000 rights to use a single vehicle. It will depend on how similar the features of each contract are (such as the specification of the vehicles) and the extent to which they were entered into at or around the same time time (i.e. how similar or dissimilar the lease term is). As IFRS 16 requires that an entity must demonstrate that the application of this practical expedient would not result in a materially different result, entities may be required to perform some level of calculations to support this assertion. The more disparate the characteristics of lease contracts that are grouped into a portfolio, the more difficult it will be for entities to satisfy the requirements to use this practical expedient.

BDO comment

Judgement must be applied in determining whether the underlying asset is within the scope of IAS 16, IAS 38, or is a service arrangement. The facts and circumstances related to the right to use the underlying asset must be analysed to determine the appropriate accounting treatment. For example, if it is determined that the underlying asset is in the scope of IAS 16, a right-of-use asset and corresponding lease liability would be recognised as per Section 5. below. In contrast, for a right to use an intangible asset in the scope of IAS 38, an accounting policy choice exists. A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights (which are excluded from the scope of IFRS 16).

IFRS Interpretations Committee agenda decision — Interaction between IFRS 11 and IFRS 16

At its March 2019 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of a question it had received about the recognition of liabilities by a joint operator in relation to its interest in a joint operation (as defined in IFRS 11). In the fact pattern described in the request, the joint operation is not structured through a separate vehicle. One of the joint operators, as the sole signatory, enters into a lease contract with a third-party lessor for an item of property, plant and equipment that will be operated jointly as part of the joint operation's activities. The joint operator that signed the lease contract (hereafter, the operator) has the right to recover a share of the lease costs from the other joint operators in accordance with the contractual arrangement to the joint operation.

The Committee noted that identifying the liabilities that a joint operator incurs and those incurred jointly requires an assessment of the terms and conditions in all contractual agreements that relate to the joint operation, including consideration of the laws pertaining to those agreements.

The Committee observed that the liabilities a joint operator recognises include those for which it has primary responsibility. Therefore, the joint operator that entered into the lease contract must recognise the lease liability as it is primarily responsible for lease payments.

The IFRS IC concluded that the principles and requirements in IFRS Standards provide an adequate basis for the operator to identify and recognise its liabilities in relation to its interest in a joint operation. Consequently, the IFRS IC decided not to add this matter to its agenda.

BDO comment

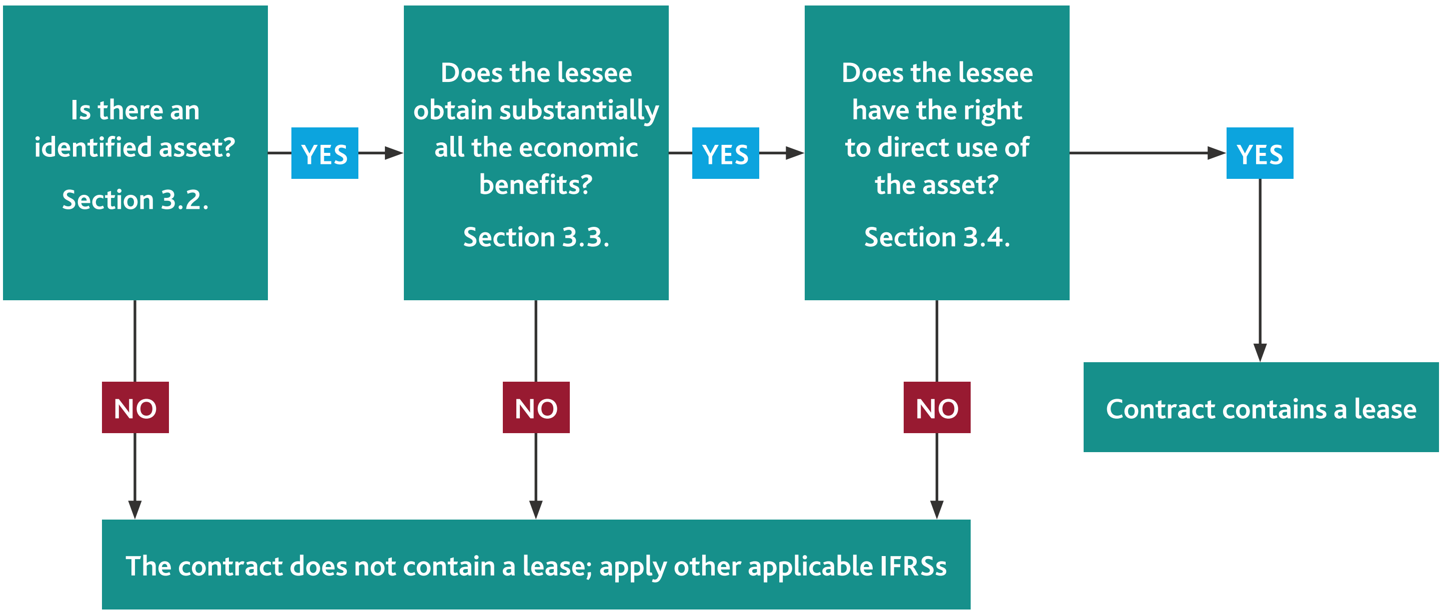
Previously, some joint operators may have accounted only for their share of the lease liability (e.g. a percentage of the total lease liability based on the agreement giving rise to the joint operation). Consequently, the clarification provided by this agenda decision may result in a significant change in practice.

To illustrate the effect of the agenda decision, consider three non-related entities (A, B and C) that enter into a joint operation that is not structured through a separate vehicle. Entity A enters into a lease agreement with a lessor for equipment that will be used for the purposes of the joint operation. The lease has a term of 10 years with CU 1,000 in payments due each year. Entity A has a contractual agreement to be compensated 1/3 from both Entity B and Entity C. In Entity A's financial statements, the full amount of the lease liability (i.e. CU 10,000, ignoring the effect of discounting) must be presented, as Entity A is the party to the lease agreement with the lessor. Regardless of the right of reimbursement that Entity A holds, the agenda decision makes it clear that since Entity A is the lessee in the arrangement and is primarily responsible for the payments to the lessor, it must present the full lease liability in its financial statements.

3.1. Applying the Definition of a Lease

IFRS 16 provides new guidance on the evaluation of a contract to determine whether it contains a lease. This replaces guidance previously found in IAS 17, IFRIC 4 and SIC 27. In most cases, the determination of whether contracts give rise to a lease will remain consistent upon adoption of IFRS 16, but entities must perform an analysis of the relevant facts and circumstances as IFRS 16 contains more guidance than the previous standards and has a different recognition threshold. This is most likely to be relevant for contracts previously accounted for in accordance with IFRIC 4. In addition, where contracts were identified as containing a lease by applying IFRIC 4, the conclusion may have been that those lease contracts were operating leases and so remained off balance sheet. In contrast, if (as is likely to be the case) those arrangements meet IFRS 16's definition of a lease they will be recorded on balance sheet.

In applying the definition of a lease, there are several criteria that must be met, as illustrated below:



3.2. Identified Asset

The first criterion to be assessed in determining whether a contract between a customer and a supplier contains a lease is whether there is an identified asset. This is consistent with the requirement that for a lease to exist, the customer must control the asset. Typically, an asset will be explicitly identified in a contract (for example, by specifying the registration or chassis number of a car as well as a description of the manufacturer and model). Alternatively, a contract can involve the use of an identified asset if that asset is implicitly identified at the point at which it is made available for use by the customer.

However, even if a contract specifies a particular asset, a customer does not have the right to use that asset if the supplier has a substantive right to substitute the asset throughout the period of use.

Substitution Rights

A supplier's right to substitute an asset would be substantive, and therefore the customer would not account for a lease of that asset, if both of the following conditions are met:

- The supplier has the practical ability to substitute alternative assets throughout the period of use; and
- The supplier would benefit economically from the exercise of its right to substitute the asset.

BDO comment

It is important to note that both of the above criteria must be satisfied for a supplier's substitution right to be substantive. Some contracts contain clauses where a lessor has the right to substitute an asset. However, unless the lessor has a compelling reason to exercise this right, it is not substantive. In such a case, the substitution right may be protective (rather than substantive) to ensure the supplier's interest in the asset is maintained.

In addition, IFRS 16 requires that this substitution right must exist 'throughout the period of use'. If a substitution right were to only be exercisable upon the occurrence of a specific event, after a period of time has elapsed or on a specific date, than the substitution rights would not be substantive for the purposes of IFRS 16 as they are not present 'throughout the period of use'.

In situations where the asset is located at the lessee's premises or elsewhere away from the lessor, the cost to substitute the asset may outweigh any perceived benefit to the lessor. In addition, a supplier's right to substitute an asset for the purposes of repairs or maintenance (if the asset is not operating properly) or to be upgraded when a technical update becomes available, does not mean the lessor has a substantive right of substitution.

In situations where it is not readily determinable whether a supplier has substantive substitution rights, a lessee must presume that any substitution right is not substantive.

BDO comment

That the standard requires lessees to conclude substitution rights are non-substantive where it is unclear means that in situations of doubt lessees should assume that the contract contains a lease. Consequently, notwithstanding the existence of the substitution rights, if an asset is identified in the contract (by being explicitly or implicitly specified), further analysis of the contract is needed to see if the other two conditions of the definition of a lease are met (see Sections 3.3. and 3.4. below).

IFRS Interpretations Committee agenda decision – Sub-surface Rights

In June 2019, The IFRS Interpretations Committee (the Committee) issued an agenda decision relating to sub-surface rights, which addressed whether a specific fact pattern satisfied the 'identified asset' criteria in determining whether a contract is, or contains a lease, or alternatively was within the scope of IAS 38, *Intangible Assets*.

In the fact pattern described in the submission to the Committee, a pipeline operator (customer) obtains the right to place an oil pipeline in underground space for 20 years in exchange for consideration. The contract specifies the exact location and dimensions (path, width and depth) of the underground space within which the pipeline will be placed. The landowner retains the right to use the surface of the land above the pipeline, but it has no right to access or otherwise change the use of the specified underground space throughout the 20-year period of use. The customer has the right to perform inspection, repairs and maintenance work (including replacing damaged sections of the pipeline when necessary).

The Committee noted that this fact pattern was not subject to any of the scope exclusions in IFRS 16, and that IAS 38 first requires an entity to determine if the contract is or contains a lease. Consequently, it was necessary to apply the applicable identification criteria in IFRS 16.

The Committee observed that IFRS 16.B20 states that a 'capacity portion of an asset is an identified asset if it is physically distinct', subject to the lessor not having substantive substitution rights.

In the fact pattern described, the specified underground space is physically distinct as the contract specifies the path, width and depth of the pipeline. The fact that the space is underground and therefore does not include the surface area of the land is not relevant. This space is physically distinct in the same way that a portion of land on the surface may be physically distinct. Therefore, as no substitution rights exist, the Committee concluded that an identified asset does exist.

The Committee also concluded through separate analysis that the customer has the right to obtain substantially all the economic benefits from use of the land, and the customer also has the right to direct the use of the land. Consequently, the Committee concluded that the contract contains a lease.

Example 3 – Lease of Rail Cars

A contract between Customer and Supplier requires Supplier to transport a quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of 5 years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for 5 years. Supplier provides the rail cars, driver and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods). Supplier has a large pool of similar rail cars that can be used to fulfil the requirements of the contract. Similarly, Supplier can choose to use any one of a number of rail cars to fulfil each of Customer's requests, and a rail car could be used to transport not only Customer's goods, but also the goods of other customers. The cars are stored at Supplier's premises when not being used to transport goods.

Assessment

Supplier's substitution rights in this example are substantive because it:

(a) Has the practical ability to substitute the rail cars throughout the period of use; and

(b) It would benefit economically from substituting the rail cars because there is a large pool of them available and they are stored at its premises. Potential benefits to Supplier are deploying the rail cars to a nearby location for use in other contracts or to use any of the 10 rail cars that are sitting idle for other purposes because they are not currently being used by Customer.

Therefore, although the contract makes use of identified assets (the rail cars), the contract does not contain a lease of those rail cars because Supplier has substantive substitution rights.

Portions of Assets

A capacity portion of an asset may be an identified asset if it is physically distinct (e.g. a floor of a building). A capacity portion of an asset that is not distinct (e.g. a specified capacity of fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset.

Example 4a – Fibre Optic Cable

A customer enters into a 15-year contract with a supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong and Tokyo. The specified amount is equivalent to the customer having the full capacity of 3 fibre strands within a 15 strand cable. The supplier makes decisions about the transmission of data (i.e. which fibres are used to transmit the lessee's data).

Assessment

The contract does not contain a lease as the capacity specified is not physically distinct and it does not represent substantially all of the underlying asset as the capacity is only 20% of the total capacity of the cable. If the contract specified an amount of capacity equivalent to, say, 14 fibre strands of the total cable, the contract would contain a lease because this represents substantially all (approximately 94%) of the cable's capacity.

Example 4b – Fibre Optic Cable (specific strands)

A customer enters into a 15-year contract with a supplier for the right to use 3 of 10 specific strands of fibre optic cable connecting Paris and London. The customer has the exclusive right to use these strands to transfer their data.

Assessment

The contract does contain an identified asset as the strands of fibre optic cable are distinct from one another and the vendor does not have the right to substitute the strands for others in the same cable. Despite the number of strands not being substantially all of the cable's total capacity, the strands are identified, therefore the contract provides a specified asset to the customer.

BDO comment

The requirement that a portion of an asset can meet the identifiability criterion can be seen as a potential 'anti-avoidance' provision of the standard. Without this provision, a contract could exclude an insignificant portion of an asset's capability, and not meet the identifiability criterion.

Although IFRS 16 makes reference to a capacity portion that is 'physically distinct', in our view this approach also applies when a capacity portion is technologically distinct. For example, a lease could be of all of the light blue colour capacity of a fibre optic cable. In that case, the light blue component would be an identified asset for the purposes of IFRS 16.

3.3. Obtaining Economic Benefits

The next criterion to analyse in determining if a customer controls the use of an identified asset is whether the customer has the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use, for example by having exclusive use of the asset throughout the period of the contract or by having a right to sub-lease the asset.

Simply because lease payments include a portion of the cash flows derived from an asset (e.g. a percentage of sales from the operations of a property) does not mean that the customer does not obtain substantially all of the economic benefits associated with the asset. Such requirements are common in retail lease contracts.

Example 5 – Obtaining Economic Benefits with Outputs Flowing to Supplier

A retailer enters into a contract for the lease of a store in a shopping centre for 5 years. The rental terms include payments equal to 10% of the gross sales revenue generated from the store. The retailer has the right to determine which products are to be sold, the interior design of the store, etc.

Assessment

It is the customer's control and use of the property which generates all of the sales revenue. The fact that a portion of the cash flows generated from use of the property are passed to the lessor is not relevant. The lessee has a right to 100% of the sales revenue generated from the store (i.e. all of the economic benefits generated by the store), albeit that it has negotiated a contract which results in rent being determined by reference to that gross sales revenue.

In assessing whether a customer has a right to substantially all the economic benefits from the use of an identified asset, the assessment should be made based on the asset's use within the defined scope of the contract. For example:

- If a contract limits the use of a vehicle to only a particular geographic area, an entity assesses only the economic benefits from use of the motor vehicle within that territory. It does not consider what economic benefits could be obtained had there not been any geographical restriction in the contract.
- If a contract specifies a machine can only be utilised during specific times of the day, an entity assesses only the economic benefits from use of the machinery during that time of the day. It does not consider what economic benefits could be obtained from using the machine 24 hours a day.

Economic benefits from use of the asset include its primary outputs (e.g. finished goods for a manufacturer to sell) and by-products, including potential cash flows that are derived from these items. When considering economic benefits, emphasis should be placed on the benefits derived from using the asset rather than on other incidental benefits.

Example 6 – Obtaining Economic Benefits from use versus ownership of an asset

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. The contract specifies that the energy must be produced from this particular facility (and so the supplier does not have substantive substitution rights). The supplier receives tax incentives from various levels of government for building the bio-mass facility, as it produces clean, renewable energy.

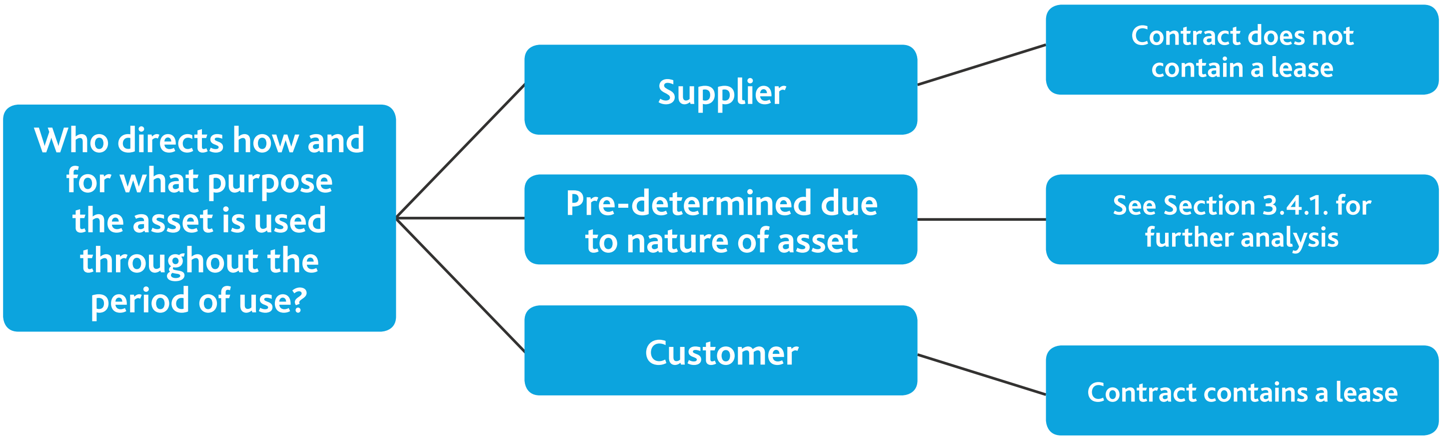
Assessment

The contract transfers to the customer the right to obtain substantially all of the economic benefit from use of the underlying asset (the power plant) because the customer has exclusive use of the primary product of the facility (i.e. the electricity).

Although the supplier obtains economic benefits in the form of tax incentives, these derive from legal ownership of the asset, and not from its use. Therefore, the value of these tax incentives should be disregarded in assessing who obtains substantially all the economic benefits of the bio-mass facility.

3.4. Right to Direct the Use of the Asset

In determining whether a customer has the right to direct the use of an asset, an analysis of who directs ***how and for what purpose*** the asset is used throughout the period of use needs to be carried out:



A customer has the right to direct how and for what purpose an asset is used if, within the scope of its right-of-use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. Certain decision making rights are clearly more relevant than others. Those that affect the economic benefits derived from use of the asset (as outlined in Section 3.3.) are the most relevant.

Examples of decision-making rights that may grant a customer the right to change how and for what purpose an asset is used (depending on the circumstances), include rights to change:

- The type of output that is produced by the asset (e.g. what type of food certain food processing equipment produces);
- When the output is produced (e.g. the regular operating hours for equipment);
- Where the output is produced (e.g. the physical location of machinery or destinations and routes for transport equipment); and
- Whether the output is produced, and the quantity of the output (e.g. to decide whether to produce energy from a power plant and how much energy to produce).

Decision-making rights relating to operating or maintaining an asset do not grant the right to change how and for what purpose the asset is used. However, the rights to operate an asset may grant a customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used is predetermined.

BDO comment

The guidance on determining who has the right to direct the use of the asset focuses on control. This is consistent with the IASB's focus on control being a primary element in determining whether transactions qualify for recognition in other recently issued standards, such as IFRS 10 Consolidated Financial Statements and IFRS 15 Revenue from Transactions with Customers. However, it is slightly different from the current focus in IAS 17 on which party has the risks and rewards of the leased asset.

Example 7 – Customer Directs Use

A customer enters into a 5-year contract with a supplier where the customer will purchase up to 100% of the energy produced by a bio-mass facility. The energy must be produced from this particular facility and the supplier does not have substantive substitution rights to provide energy from a separate facility. Alternative arrangements can only be made in extraordinary circumstances (for example, emergency situations rendering the facility inoperative). Under the contract the customer tells the supplier how much energy to produce and when to produce it and the supplier must stand ready to operate the facility to meet the customer's needs. To the extent there is spare capacity, the supplier is not allowed to generate energy for sale to other customers. The supplier must therefore stand ready to provide all of the power output to the customer if needed. The supplier designed the facility when it was constructed some years before entering into the contract with the customer, who had no involvement in that original design.

Assessment

It is clear that the bio-mass facility is identified in the contract and the customer obtains substantially all of the economic output (it can take any amount up to 100% of the production capacity without anyone else being able to benefit from any spare capacity). The contract contains a lease for the bio mass facility because the customer also has the right to direct its use. That is, the customer makes the relevant decisions as to how and for what purpose the facility is used because it decides when and how much power is produced. The supplier's staff simply follow the directions of the customer. The fact that the customer had no involvement in the design of the underlying asset is only relevant when decisions about how and for what purpose the asset will be used are predetermined, as illustrated in Example 8 below.

The customer therefore needs to determine how much of the total contractual payments to the supplier are for the leased asset as distinct from fees that may be charged for other services (such as operation and maintenance of the facility) and capitalise those lease payments on balance sheet. Alternatively, as a practical expedient, the customer can treat the entire contract as a lease, recognising an asset and liability for the present value of all payments to be made under the contract.

IFRS Interpretations Committee agenda decision – Cloud Computing

At its March 2019 meeting, the IFRS Interpretations Committee (the Committee) published an Agenda Decision in respect of a customer's right to access a supplier's application software hosted on the cloud, for a specified term. The request asked whether a customer receives a software asset at the contract commencement date or a service over the contract term (i.e. no asset or liability recognised)?

The Committee observed that part of the definition of IFRS 16 is that the contract must convey the 'right to use' an asset. For a contract to convey the right to use an asset, the customer would need to have the right to obtain substantially all of the economic benefit from use of the asset and the right to direct use of the asset.

Based on the fact pattern presented, the Committee observed that a right to receive future access to the supplier's software on cloud infrastructure does not in itself give the customer any decision-making rights about how and for what purpose the software is used; it conveys a 'right to access', as opposed to a 'right to use'. The Committee therefore concluded that if a contract conveys only the right to receive access to a software application over the contract term, the contract does not contain a lease.

BDO comment

'Right to access' type cloud computing software arrangements are common since they typically do not require a large up-front investment and the software is maintained on hardware owned by the supplier (in the case of 'public' cloud structures). The Committee's agenda decision means that many 'software as a service' (SaaS) arrangements will not be accounted for as leases in the scope of IFRS 16, however, entities must carefully analyse their facts and circumstances in light of the Committee's decision.

In cases where an entity accesses software hosted on the cloud using its own IT infrastructure, then these conclusions would not apply, as no customer-supplier relationship exists.

3.4.1. Relevant Decisions are Pre-Determined

The nature of an asset or contractual restrictions may indicate that relevant decisions about how and for what purpose an asset will be used are pre-determined.

For an asset where the relevant decisions are pre-determined, the contract contains a lease if:

(a) 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

(b) 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.

BDO comment

Assets that may fall into this category include those that are:

- *Technologically advanced such that they are designed for highly specific purposes;*
- *Costly to modify or repurpose for other uses; and/or*
- *Whose use is restricted based on regulation or law.*

An entity is only permitted to include in its analysis decision-making ability that will occur during the term of the lease, except in the situation described in (b) above where the customer designed the asset. In such a situation, an entity would identify which elements were pre-determined by the decisions made prior to the asset being completed.

Example 8 – Pre-determined Functionality

A customer enters into a contract with a supplier where the customer will purchase 100% of the energy produced by a bio-mass facility. The customer designed the bio-mass facility before it was constructed by hiring experts in the field to assist in determining the location of the facility and the engineering of the equipment to be used. The supplier is responsible for building the facility to the customer's specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions.

Assessment

In assessing the 'right to direct use of asset' criterion, the functionality of the facility is predetermined based on its design, and those predeterminations were made by the customer. Therefore, the customer has the right to direct its use.

4. DETERMINING THE LEASE TERM

If a contract is, or contains, a lease, the lease term needs to be determined. The lease term begins on the commencement date (i.e. the date on which the lessor makes the underlying asset(s) available for use by the lessee) and includes any rent-free or reduced rent periods. It comprises:

(a) The non-cancellable period of the lease (Section 4.1.);

(b) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option (Section 4.2.); and

(c) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option (Section 4.2.).

See Appendix C for a flowchart that may assist entities in applying the requirements of IFRS 16 in determining the lease term. The flowchart summarises the guidance noted below, including assessing the period of time over which a lease remains enforceable.

4.1. Non-cancellable Period

The non-cancellable period of a lease is as defined in the contract. It is the period under which the terms of the contract are enforceable until both the lessee and lessor each have the right to terminate the contract or the term ceases.

During the non-cancellable period only extension and termination options held by the lessee are considered when determining the lease term. If only a lessor has termination rights, the non-cancellable period of the lease includes the period of time covered by these lessor termination options (i.e. a lessee is not required to make estimates of whether a lessor is likely to exercise a termination option that the lessor possesses alone).

BDO comment

Requiring a lessee to estimate the likelihood of the lessor exercising termination options (or not exercising extension options) would have necessitated making significant judgements about the intentions and economic conditions of lessors, for which the lessee will often have only limited information. A lessee also has an unconditional obligation to pay for the right-of-use asset during periods covered by lessor extension and termination options, unless and until the lessor decides to terminate the lease. Therefore, the standard requires a lessee to assume that a lessor will continue to enforce a contract over the period of time during which the lessor has the sole, unilateral right to terminate the contract.

4.2. Lessee Extension and Termination Options

Options to extend or terminate a lease contract are common in many types of leases. For leases where only the lessee has a termination option the analysis is entirely about the duration the lessee will choose and the likelihood of the lessee exercising its options. However, if both the lessee and the lessor have termination options IFRS 16 Paragraph B34 is considered. Paragraph B34 states that a lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an 'insignificant penalty'. It is important to note that Paragraph B34 means that it is only required for one of the lessee and the lessor to have more than an insignificant penalty for the lease to remain enforceable (i.e. Paragraph B34 does not establish an 'and' test requiring both parties to satisfy the threshold for a more than insignificant penalty). Refer to Appendix C of this publication for a flowchart that helps apply the requirements of Paragraph B34 to the definition of lease term.

IFRS Interpretations Committee tentative agenda decision – Lease Term

At its June 2019 meeting, the IFRS Interpretations Committee (the Committee) considered a request about how to determine the lease term of a cancellable or renewable lease. The request to the Committee defined these as follows:

Cancellable lease — The contract includes a notice period of, for example, less than 12 months and the contract does not oblige either party to make a payment on termination.

Renewable lease — A lease that specifies an initial period, and renews indefinitely at the end of the initial period unless terminated by either of the parties to the contract.

The request asked whether Paragraph B34 should be interpreted to mean broader economics in a contract (e.g. the significance of installed leasehold improvements, the importance of the leased asset itself, etc.) or only contractual termination penalties (e.g. a payment specified in the lease contract that a lessee must make to the lessor if the lessee chooses to terminate the lease).

The Committee noted that the Board's view is that the lease term is meant to 'reflect an entity's reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information' (see IFRS 16.BC156). The Committee tentatively concluded that IFRS 16.B34 should be interpreted to consider broader economics of a lease contract and not only contractual termination payments.

At the date of this publication, this issue will be brought back to the Interpretation Committee at a later date.

Therefore, to assess whether there is no more than an insignificant penalty, the analysis needs to include both what is explicitly specified in the lease contract as well as other kinds of economic penalties that may not be included in the contract. In other words, the definition of ‘penalty’ is meant to be interpreted more broadly than simply a contractual penalty, and should also include other economic factors such as those discussed below (items (b) through (e)). Termination clauses must have economic substance to be considered.

In circumstances in which only the lessee has a termination option, to estimate the lease term a lessee must assess the likelihood of it either exercising or failing to exercise that option. Factors that would be considered in this assessment include, but are not limited to:

(a) Contractual terms and conditions for the optional periods compared with market rates, such as:
   i. The amount of payments for the lease in any optional period;
   ii. The amount of any variable payments for the lease or other contingent payments;
   iii. The terms and conditions of any options that are exercisable after periods covered by another option (or other options), e.g. a purchase option that is exercisable at the end of one or more extension periods at a rate that is currently below market rates;

(b) Significant leasehold improvements or other improvements made to underlying assets that are expected to have a significant residual benefit to the lessee when options become exercisable;

(c) Costs relating to the termination of the lease (e.g. negotiation, relocation, and search costs, installation and setup costs for new assets, termination penalties or costs to return an underlying asset at the end of the lease term);

(d) The importance of an underlying asset to the lessee’s operations (e.g. whether the underlying asset is highly specialised, the location of the asset and the availability of suitable alternatives); and

(e) Conditionality associated with the exercise option (i.e. if an option can be exercised only if one or more conditions are met) and the likelihood that those conditions will be met.

A lessee’s past practice with leases, particularly leases of similar assets, should also be considered in determining the likelihood of options being exercised. The reason for exercising such options may not be apparent from any single criterion, but may relate to synergies and a weighting of several reasons that must be considered in aggregate. Therefore two lessees may determine different lease terms on identical lease contracts because the facts and circumstances under which they operate may mean that one lessee concludes it is reasonably certain to exercise one or more options, whereas the other might conclude it is not reasonably certain any of them will be exercised.

Example 9 – Assessment of Lease Term (only lessee has termination option)

A customer is considering entering into a lease for equipment to manufacture widgets.

The lease has a 5 year term, with an option exercisable by the lessee only to extend the lease for an additional 2 years. This means that there is effectively a termination option for the lessee at the end ofYear 5, but not the lessor. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional 2 year period if the lessee exercises its extension option.

The customer operates in a remote location where the cost of shipping and installation for pieces of equipment are significant.

Assessment

Paragraph B34 does not apply, since only the lessee can terminate the lease. The customer lacks a direct, contract-specific economic incentive to extend the lease given that lease payments are at a market rate throughout the period of the lease. However, all relevant facts and circumstances that create an economic incentive for the customer to exercise, or not exercise, options must be considered. This, therefore, includes entity-specific factors such as the costs the customer would incur to obtain a suitable replacement asset, the importance of the asset to the customer's operations, and the availability of suitable replacement assets. As the customer operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement, it concludes that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be 7 years.

In the following scenario, in which both the lessee and lessor have termination options, IFRS 16 Paragraph B34 is relevant:

Example 10 – Assessment of Lease Term (both lessee and lessor have termination option)

Assume similar facts to the prior example except both the lessee and the lessor have a termination option at the end of Year 5 with a zero termination payment, which can be exercised without permission from the other party.

Assessment

The first criterion of IFRS 16.B34 does apply, since both the lessee and lessor have a termination option which is exercisable without permission from the other party. Therefore, the second criterion of IFRS 16.B34 is addressed to determine if there is no more than an insignificant penalty. This assessment determines whether the lease is 'enforceable' beyond the non-cancellable 5-year period.

The contract specifies there is no monetary penalty; however, this is only one kind of penalty that could arise. There needs to be no more than an insignificant penalty of any type for either party in order for the termination clause to have economic substance and the lease term to be enforceable for only 5 years. There could be other kinds of economic penalties in addition to those explicitly in the contract. In this instance, due to the remote location and likely difficulty in obtaining a new tenant, the lessor would have an economic penalty. In addition, as noted in Example 9, the lessee would also have economic penalties because it operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement. Therefore, the penalty is determined to be more than insignificant and the contract is enforceable.

The term of the lease is then determined based on the lessee factors similar to Example 9 with the conclusion that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be 7 years. Therefore, it is important to note that a lease contract containing a mutual termination option does not automatically limit the lease term to the period up to the point at which the mutual termination option is exercisable.

IFRS Interpretations Committee tentative agenda decision — Interaction between leasehold amortisation period and lease term

At its June 2019 meeting, the IFRS Interpretations Committee (the Committee) considered a request about whether the useful life of non-removable leasehold improvements is limited by the lease term of the associated lease. For example, if an entity installs non-removable leasehold improvements that would normally have a useful life of 10 years, but the underlying lease, as determined by IFRS 16, is only 5 years, would the useful life of the leasehold improvements be limited to the 5 year lease term?

The Committee observed that IAS 16.56(d) specifies that in determining the useful life of an asset, an entity considers any legal or similar limits on the use of the asset, such as expiry dates of related leases. In determining the lease term, including the effect of any extension or termination options, IFRS 16.B37 requires a lessee to consider all relevant facts and circumstances that create an economic incentive for the lessee. This includes leasehold improvements which are expected to have a significant economic benefit for the lessee when an option to extend or terminate the lease becomes exercisable.

Therefore, in determining the useful life of leasehold improvements, an entity considers whether it expects to use the leasehold improvements beyond the lease term. If the entity does not expect to use the leasehold improvements beyond the lease term of the related lease, then it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term. The Committee observed that an entity might often reach this conclusion for leasehold improvements that the entity will use and benefit from only for as long as it uses the underlying lease.

Therefore, **the useful life of leasehold improvements** is not automatically limited to the **lease term as** determined under **IFRS 16**. However, the lessee is also required to consider the broader economics of the contract. If leasehold improvements are expected to be used for a period which is longer than the initial lease term, this indicates that the lessee might incur a more than insignificant penalty if it terminates the lease. Consequently, it is necessary to consider whether the requirements of IFRS 16.B34 mean that the lease is enforceable for a period which is longer than the initial lease term.

4.3. Revisions to the Lease Term

A lessee is required periodically to reassess whether it is reasonably certain to exercise extension and termination options and to revise the lease term if there is a change. The lease term may also change due to modifications to the lease contract.

Reassessment of Original Estimate

Changes in the lease term may occur due to a change in an entity's intentions, the entity's business practice, and other circumstances unforeseen since it was first estimated.

A lessee is required to reassess the likelihood of it exercising or failing to exercise options upon the occurrence of an event or a change in circumstances that:

(a) Is within the control of the lessee; and

(b) Affects whether the lessee is reasonably certain to exercise an option not previously included in the determination of the lease term, or not to exercise an option previously included in its determination of the lease term.

Solely a favourable or unfavourable change in market rental rates therefore does not trigger a reassessment as it is not 'within the control of the lessee'.

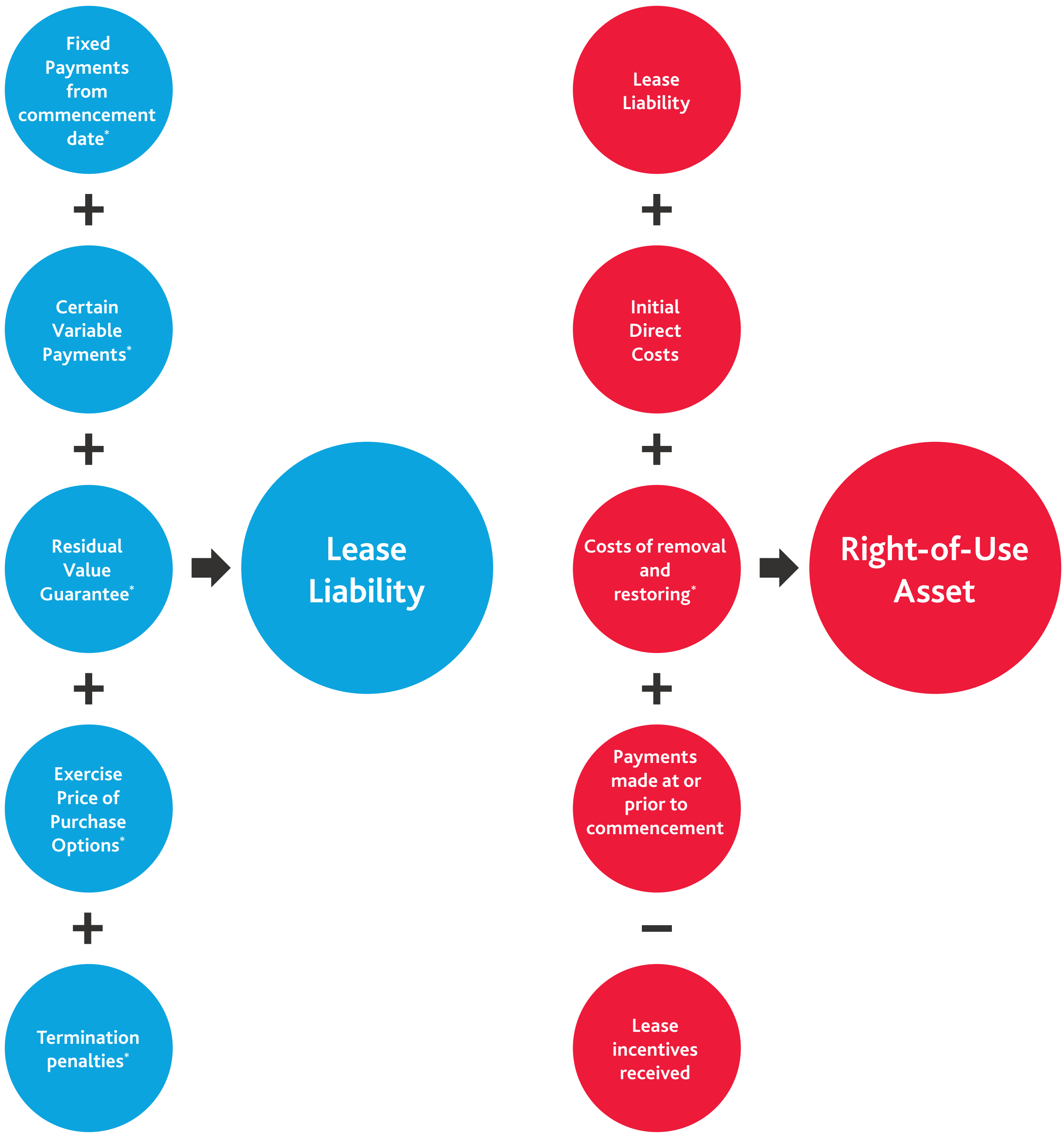
Revisions to original estimates of the lease term resulting from reassessments as to the likelihood of exercising options result in remeasurement of the carrying value of leased assets and liabilities. This is discussed in Sections 5.6. and 5.7. below.

Remeasurements due to Modifications to the Lease Contract

The lease term may be changed if the lessee and lessor agree to modify the lease contract (as distinct from re-estimating the lease term due to revising judgments about whether options will be exercised). Contract modifications, which also result in remeasurement of the lease assets and liabilities, are discussed in Section 5.7. below.

5. RECOGNITION AND MEASUREMENT

At the commencement date of a lease, i.e. the date on which the lessor makes an underlying asset available for use by a lessee, the lease liability and right-of-use asset comprise the items noted below. It should emphasised that a lease is recognised as at the commencement date (the date on which a lessor makes an underlying asset available for use by the lessee). A lease is not recognised until this point in time, therefore, a lessee entering into a lease agreement with a lessor does not trigger the recognition of assets and liabilities until the commencement date of the underlying lease contract.



* *Discounted payments (see Section 5.2. – Discount Rate on Initial Recognition)*

5.1. Lease Liability – Initial Recognition

As outlined in the illustration above, the initial measurement of the lease liability is made up of several components. All components of the liability are added together and discounted at an appropriate rate (see Section 5.2.). The following components are included to the extent that they arise over the lease term (as defined in Section 4.):

Fixed Payments

These include the set payments outlined in the lease contract. Some payments may be structured in a way such that they appear to have variability, but based on their nature or circumstance are unavoidable and therefore are 'in-substance fixed lease payments'. In-substance fixed lease payments may take several forms:

- Payments based on a presumed underlying assumption (e.g. that a leased asset will have to operate during the period);
- Payments structured as containing genuine variable components, where the variable component will be resolved during the term of the lease (e.g. payments that becomes fixed once the lessee's base level of use of the asset has been established in the first year). Such payments become in-substance fixed payments when the variability is resolved;
- There is more than a single set of potential payments a lessee may have to make, but only one option is realistic;
- There is more than a single set of potential payments, but at least one must be made. In this case, the minimum (on a discounted basis) payments are the fixed lease payments.

Example 11 – In-Substance Fixed Payments

Below are several examples of scenarios in which it is considered whether variable payments are in-substance fixed payments.

Scenario #1 – Low minimum payments

Lessee enters into a 15-year lease of retail space in a shopping centre. The minimum rent is CU 100 per annum, unless sales exceed CU 1,000 per annum. If sales revenue exceeds CU 1,000 per annum, the lease payments are CU 50,000. The lessee has historically generated sales revenue at its retail locations of between CU 150,000 and CU 250,000 per annum. The store must operate within certain specified regular operating hours.

Analysis – The lease contract technically specifies variable payments in that rental payments can be either CU 100 or CU 50,000. However, it is not realistically possible that the lessee will have less than CU 1,000 in sales per annum given its history with past retail locations. In this case, there is no true variability in the lease payments as only one outcome is realistically probable to occur. The lessee would include the lease payments of CU 50,000 per annum in its initial measurement of the lease contract.

Example 11 – In-Substance Fixed Payments (continued)

Scenario #2 – Payments entirely based around sales

Lessee enters into a 15-year lease of retail space in a shopping centre. There are no fixed lease payments. Lease payments are 5% of annual sales. The lessee demonstrated to the lessor in negotiating the contract that it generates at least CU 125,000 per annum at each location, and on average, CU 150,000.

Analysis – Although there is a high degree of certainty that the lessee will incur a lease expense of at least CU 6,250 (CU 125,000 x 5%) per annum, variable lease payments that are linked to the future performance or use of an underlying asset are excluded from the definition of lease payments. Consequently, no liability is recognised for those variable lease payments.

BDO comment

In reaching the decision that variable lease payments that are linked to the future performance or use of an underlying asset should be excluded from the definition of lease payments, some IASB Board members considered that these variable payments do not meet the definition of a liability for the lessee until the performance or use occurs. Other IASB Board members considered that all variable lease payments meet the definition of a liability for the lessee, with the decision to exclude them from lease liabilities being made purely for cost benefit reasons (for example, to avoid the potential need for lessees with turnover based lease payments to make estimates of sales far into the future), and in response to concerns expressed by constituents about the high level of measurement uncertainty that would arise and the large number of leases held by some lessees.

Scenario #3 – Consumables contract attached to a lease

Lessor leases medical equipment to hospitals and sells consumables used in the operation of the equipment. Lessor grants the lessee (a hospital) the right to use the equipment at no cost for a period of 10 years. However, in return, the customer agrees to the following:

- The lessee is not obligated to a minimum purchase of consumables, but lessor must be the exclusive supplier of consumables if the lessee chooses to purchase them.
- The price per consumable ordered is CU 10.
- Based on past experience, the lessee estimates consumption of 25,000 consumables per annum. At a minimum, the lessee believes 5,000 will be used.

Analysis – The contract does not contain a minimum order for consumables that the lessee must place. Consequently, as with Scenario #2, because the variable payments are linked to the future use of the medical equipment (payments for the equipment are included in the price of the consumables), they are excluded from the definition of lease payments and no lease liability is recognised. Even if there is a high probability that a particular number of consumables will be ordered due to operational needs, this does not affect the conclusion. However, if the contract contained a minimum order quantity, this would give rise to the need to record a lease liability.

Variable Payments

Variable lease payments can take multiple forms. They may be indexed to a rate such as inflation, specified indices or the consumer price index, take the form of a market rent review or be linked to the performance of the asset itself (e.g. a percentage of sales for a retail store in a shopping centre).

The treatment of variable lease payments is summarised as:

Variable payments that depend on an index or a rate	– Include in the initial measurement of the lease using the index or rate as at the commencement date. – Remeasure lease in the period the rate or index changes (see Section 5.6.).
In-subtance fixed payments	– Include in the initial measurement of the lease. – Remeasure the lease in the period in-substance fixed payments are changed or are resolved (see Section 5.6.).
Other variable payments	– Do not include in the initial measurement of the lease. – Recognise in profit or loss (or in the carrying value of another asset as required by another Standard) when the event or condition that triggers the payments occur.

Example 12 – Variable Lease Payments that Depend on an Index or Rate

Year One – Beginning of Lease

Lessee enters into a 10-year lease of property with annual lease payments of CU 50,000 payable at the beginning of each year. The contract specifies that lease payments will increase every two years in line with the increase in the Consumer Price Index for the preceding 24 months. The Consumer Price Index at the commencement date is 125.

The lessee has determined the appropriate rate to discount lease payments is 5% (see Section 5.2. for a discussion on how to determine the appropriate discount rate.)

At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at the present value of the remaining nine payments of CU 50,000, discounted at the interest rate of 5 per cent per annum, which is CU 355,391.

Assessment

Lessee initially recognises assets and liabilities in relation to the lease as follows:

Dr		Right-of-use asset	CU 405,391		
	Cr	Lease liability		CU 355,391	
	Cr	Cash		CU 50,000	(lease payment for the first year)

In measuring the lease liability, Lessee does not make any estimate of how future changes in CPI will impact future lease payments. Rather it assumes the initial lease payment will remain constant during the lease term.

Example 13 – Interaction Between Index-Linked Lease Payments and Rent Escalation Clauses

Entity K enters into a 5-year lease with a base rental cost of CU 200 per annum payable in advance. The rent will escalate at a fixed rate for the first 3 years as follows:

Year 1	200
Year 2	202
Year 3	204

This escalation is meant to approximate increases in CPI; however, the increases are fixed and are not variable lease payments dependent on an index or rate.

For Years 4 and 5, the payments will be determined based on the CPI for the immediately preceding year (i.e. Year 4's lease payment will be based on the Year 3 payment adjusted for the increase/decrease in CPI during Year 3, as determined on the first day of Year 4).

There are no floors or ceilings in the contract, therefore, the payments in Years 4 and 5 may go up or down relative to Year 3 depending on the movement in the CPI for Year 3.

The issue is which amounts for Years 4 and 5 should be included in the measurement of the lease liability as at the commencement date.

Example 13 – Interaction Between Index-Linked Lease Payments and Rent Escalation Clauses (continued)

Assessment

The lease payments in Years 1-3 are fixed, and are therefore included in the measurement of the lease liability.

The lease payments in Years 4 and 5 are 'variable lease payments that depend on an index or rate' (IFRS 16.27(b)), and are therefore included in the measurement of the lease liability, but they are initially measured using the index or rate as at the commencement date.

One approach is that, applying IFRS 16.27(b) literally, the lessee is required to base the Years 4 and 5 payments on the index or rate as at the commencement date, which is a lease payment of CU 200. However, in our view this is not appropriate.

IFRS 16.42(b) provides guidance on how the measurement of a lease contract functions when the change is due to a change in index or rate. It states that 'a lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.'

Illustrative Example 14A in IFRS 16 demonstrates that when a lease is remeasured due to the cash flows of one or more periods being affected by a change in index or rate, the subsequent periods are remeasured based on the year whose appl Measurement of Lease Liability for 'Interest-Only' Leases icable index or rate has now been resolved. This is demonstrated in Example 28.

The fixed escalation clause and the escalation due to changes in CPI are 'linked' in that the payment in Year 4 will be based on how movements in CPI affect the fixed payment in Year 3, which is 204.

When IFRS 16.27(b) states that variable lease payments that depend on an index or rate are initially measured using the index or rate as at the commencement date, we believe that it should be read to mean that the fixed payments that exist as at the commencement date are used, not necessarily the payment in the first period of a lease contract. Therefore, since Year 3's lease payment is fixed as at the commencement date, and it will be the base for remeasurement in Year 4 once the movement in CPI for Year 3 is known, then Year 3's fixed payment should be used to initially measure the lease contract for Years 4-5.

Consequently, the following payment profile is required to be used in measuring the lease liability as at the commencement date:

Year 1	200
Year 2	202
Year 3	204
Year 4	204
Year 5	204

Example 14 – Measurement of Lease Liability for 'Interest-Only' Leases

Lessee enters into a 7-year lease where the notional capital of the underlying lease asset is CU 10,000. Annual payments are based on LIBOR multiplied by the notional capital amount (e.g. LIBOR x CU 10,000), payable annually in arrears, and the notional amount is due at the end of the lease term. LIBOR as at the commencement date of the lease is 3%. The issue is whether any amount other than the CU 10,000 due at the end of the lease should be included in measurement of the lease.

Assessment

IFRS 16.27(b) requires the lease liability to include 'variable lease payments that depend on an index or rate, initially measured using the index or rate as at the commencement date'. The only unknown element in the formula to determine the lease payments from Years 1-6 is the LIBOR rate, however, IFRS 16.27(b) requires the lessee to use the rate as at the commencement date for initial measurement. Therefore, the lessee would include a payment of CU 300 (3% of CU 10,000) for Years 1-6 and a payment of CU 10,300 for Year 7, discounted using an appropriate rate. The lessee would be required to remeasure the lease at each reporting date as LIBOR changes (see Section 5.6.).

BDO comment

Forecasting Indices and Rates

The IASB considered whether IFRS 16 should require entities either to forecast an estimate of what the index or rate will be at each repricing date over the lease term, or to assume the index or rate in effect as at commencement date would be constant over the lease term). Ultimately, the IASB rejected both of these approaches as they could require lessees to make estimates using macroeconomic data that may not be readily available and the costs may outweigh the benefits to users of the statements (IFRS 16.BC166). Therefore, the final standard does not require a lessee to makes assumptions or obtain forecasts about the future. Instead it requires the lessee to measure lease liabilities using lease payments that assume no changes to passing rent over the remainder of the lease term.

However, as and when the amount of rent payable changes as a result of lease payments being linked to a rate or index, leased assets and liabilities have to be remeasured. Long-term real estate leases often contain lease escalations linked to indexes such as the consumer price index, inflation rates posted by government agencies or periodic uplifts to market rent. Section 5.6. below covers such remeasurements in more detail.

Common Area Maintenance Costs and Variable Lease Payments

As discussed in Section 3., lease contracts for multi-unit real estate (e.g. office buildings, shopping centres) often include common area maintenance costs, under which lessees are charged for their proportionate share of common costs, which may include utilities, security, cleaning, etc. These common area maintenance costs may be in the form of a percentage of rent, a fixed fee per square foot occupied, or as estimated 'instalment' payments, which are compared to final, actual costs on a regular basis.

As discussed in Section 3., lessees may elect, as a practical expedient by class of underlying asset, to include non-lease components in the measurement of lease liabilities. In making this accounting policy choice, lessees should consider whether non-lease component payments would fall within the scope of 'other variable payments' (see above) and therefore not be included in the measurement of lease liabilities. This is illustrated in Example 15 below.

Example 15 – Common Area Maintenance Costs

Lessee has entered into two real estate leases for retail locations in two different shopping centres.

Location A has common area maintenance costs which are charged as a set percentage of rent, which is pre-determined over the term of the lease. There is no comparison of actual costs to fees collected from tenants; all payments are final.

Location B has common area maintenance costs charged based on an estimated amount per square foot occupied, which is then compared to actual costs incurred every 6 months, with either a credit being issued to the tenants or an additional payment being required by tenants, depending on whether fees collected were sufficient to cover costs.

Assessment

Location A's common area maintenance costs are fixed, as they are set based on a portion of the rental payment each period. If Lessee elects the practical expedient to include non-lease components in the measurement of lease liabilities, then these common area maintenance costs would be included in the measurement. If Lessee elects to not include the common area maintenance costs in the measurement of the lease liability, then Lessee would need to determine whether the split between rental cost and common area maintenance fees approximates their standalone values. If they do not, then Lessee would be required to reallocate the payments between the lease and non-lease components.

Location B's common area maintenance costs are variable in nature, as they have true variability based on the amount of the costs that occur for the shopping centre in total for the period, and that variability does not arise from an index, rate or market rent review. Regardless of whether Lessee elects to utilise the practical expedient to include non-lease components in the measurement of lease liabilities, these common area maintenance costs would not be included in the measurement of the lease contract as they are variable payments that do not depend on an index or rate. Instead, the maintenance costs would be expensed in the period to which they relate.

If Lessee elects to not separate non-lease components, then it must determine how it accounts for the 'instalment payments' of common area maintenance costs for Location B. As the payments are not linked to an index or rate, and they have no floor or minimum value, the entire payment is accounted for as a variable payment until the variability is resolved (i.e. when the lessor assesses the final costs for the relevant period). Payments of common area maintenance costs prior to this event are accounted for as prepayments by the Lessee.

Example 16 – Co-tenancy Clauses

Lessee enters into a non-cancellable, 5-year lease in a commercial shopping centre. Lease payments are CU 10,000 per month for Years 1-3 and CU 12,000 per month for Years 4-5 ('base rent').

The lease contains a 'co-tenancy' clause, which adjusts the amount of lease payments downwards if an 'anchor tenant' vacates the shopping centre. Anchor tenants are large tenants that drive significant numbers of customers to the shopping centre (e.g. large department stores).

Under the co-tenancy clause, if the anchor tenant leaves, the base rent payments are replaced by an amount equal to 5% of sales revenue arising from the lessee's location in the shopping centre. If the anchor tenant space becomes re-occupied, the payments revert to the base rent.

At the beginning of Year 2, the anchor tenant vacates its space, which triggers the co-tenancy clause.

There are two issues:

1. As at the commencement date of the lease, how should the lease liability be measured (i.e. are the base rent payments 'fixed lease payments' or, because the payments could be changed to 5% of sales revenue, are they all variable lease payments not dependent on an index or rate which would be excluded from the lease liability)?
2. At the beginning of Year 2, when the co-tenancy clause is triggered, what is the effect on the measurement of the lease?

Assessment

Issue #1

The lease liability is measured based on conditions that exist as at the lease commencement date. Consequently, because the anchor tenant is in place at that date, the lease liability is measured on the basis of the fixed base rent amounts. These fixed amounts meet the definition of 'lease payments' in IFRS 16 – Appendix A.

The co-tenancy clause is designed to be protective in nature for the lessee and is only activated upon the occurrence of an uncertain future event that is not within the control of the lessee.

Issue #2

The triggering of the co-tenancy clause at the beginning of Year 2 does not meet the requirements in IFRS 16.39-43 to be accounted for as a reassessment (i.e. an adjustment to the lease liability and ROU asset) because it does not result from any of the situations set out in IFRS 16.40 or 42 (that is, a change in whether the lessee is reasonably certain to exercise, or has exercised, an extension or termination option or there is a change in the assessment of an option to purchase the underlying asset, or a change in either the amount expected to be payable under a residual value guarantee or a change in lease payments resulting from a change in an index or rate that is used to determine those payments). The requirements for lease modifications do not apply, because there has been no change to the contractual terms of the lease.

Consequently, the lease liability is not remeasured. Instead, the amount actually paid (5% of sales revenue arising from the location in the shopping centre) reduces the lease liability. The lease liability is also reduced for the difference between that amount and the fixed base rent amount with a corresponding credit to profit or loss (IFRS 16.38(b)). As a result, the changes in lease payments are accounted for as negative variable lease payments in the periods to which they relate.

It is not appropriate to apply by analogy the requirements of IFRS 16.B42(a)(ii), which applies when payments that are initially structured as variable lease payments linked to the use of an underlying asset subsequently become fixed for the remainder of the lease term. This is because the fixed base rent payments do not become variable 'for the remainder of the lease term'. The co-tenancy is reversible in the future, and therefore the variable payments (5% of revenue) could at some point revert to the fixed base rent payments.

Example 17 – Variable Lease Payments not included in the Initial Measurement of the Lease

Assume the same facts as Example 12 except that Lessee is also required to make variable lease payments for each year of the lease, which are determined as 1 per cent of Lessee's sales generated from the leased property.

Assessment

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in Example 12. This is because the additional variable lease payments are linked to future sales rather than to a rate or index. Consequently, those payments are not included in the initial measurement of the leased asset and liability, and so will be recognised in each period in addition to the depreciation and interest charges arising from the amounts recorded on balance sheet.

Lessee initially recognises assets and liabilities in relation to the lease as follows:

Dr		Right-of-use asset	CU 405,391		
	Cr	Lease liability		CU 355,391	
	Cr	Cash		CU 50,000	(lease payment for the first year)

Residual Value Guarantees

Some leases require the lessee to guarantee the value of an asset when it is returned to the lessor. These create an incentive for the lessee to maintain the asset properly and provide regular maintenance and upkeep, and mean the lessor is not exposed to risks of obsolescence thereby giving it greater assurance over the return it will earn over the period of the lease. The excess of the guaranteed value over the expected fair value of the asset at the end of the lease would result in the lessee having to make an additional payment to the lessor. Any amounts that a lessee expects to pay under residual value guarantees are included in the initial measurement of the lease liability.

Purchase and Termination Options

Amounts that a lessee expects to pay to either purchase an underlying asset or to terminate a lease by exercising a termination option, and which have therefore been included in the determination of the lease term, are also included in the initial measurement of the lease liability.

BDO comment

Determining whether a lessee is reasonably certain to exercise a purchase option at the end of a lease term may have a significant effect on the initial measurement of the lease liability and right-of-use asset recognised in the financial statements.

The amount of judgement involved in this assessment is especially high for lease contracts with a significant lease term, as uncertainties and assumptions inherently increase when the period of time covered by forecasts increases. It may therefore be appropriate to disclose the judgements and estimates made in accordance with IFRS 16.B50 and additional information required by Paragraph 125 of IAS 1 Presentation of Financial Statements.

Other Consideration

A lease may include amounts payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease. Such amounts do not give rise to a separate component of the contract, but are considered to be part of the total consideration. This is common in leases of real estate, which require payments for items that do not transfer a separate service, such as property taxes and insurance. The treatment of these payments would differ from payments made for maintenance costs (such as common area maintenance costs in multi-unit property leases), which do transfer a service to the lessee and are in the scope of IFRS 15. The lessee first needs to determine whether there are certain payments that relate specifically to a particular (lease or non-lease) component of the contract. This entails careful consideration and the exercising of judgment. Payments that cannot be directly attributed to the individual (lease or non-lease) components are then allocated on a relative stand-alone basis to the lease and non-lease components.

However, for additional costs that are considered to form part of the lease payments, it is also necessary to determine whether these constitute variable lease payments and, if so, whether they are based on an index or rate.

Example 18 – Non-refundable value-added taxes (VAT)

A lessee enters into a lease of a property for 10 years for annual lease payments of CU 3 million, payable quarterly in advance. In addition, the lessee will pay a 10% value-added tax (VAT) to the lessor, who must remit the tax to the applicable government. As the lessee operates in a specific industry, based on the applicable tax law, 50% of the VAT is non-recoverable.

Assessment

The payment of the VAT to the lessor could be viewed as not being a 'lease payment' as it is not a payment relating to the right to use an underlying asset; it is a charge levied by a government relating to goods and services with the lessor acting as collection agent for the government. Under this approach, the VAT can be viewed as being within the scope of IFRIC 21 *Levies*, as it is a payment imposed by a government. The VAT would not be included in the measurement of the lease liability or right-of-use asset.

Another view might be that the VAT is an initial direct cost of the right-of-use asset. However, the obligation to pay the VAT would only arise at the related tax point (often the invoice date), meaning that only the first quarter's VAT would be capitalised.

This issue of scoping would not be relevant if all of the VAT were recoverable/refundable to the lessee, as the entire payment would be recorded as a receivable or a reduction of VAT payable. For the non-refundable portion, it would be expensed when the underlying transaction occurs (i.e. the scheduled lease payment that gives rise to the VAT).

Embedded Derivatives in Leases

Although IFRS 16 provides guidance for variable payments linked to an index like CPI, this guidance does not apply to embedded derivatives. Consequently, embedded derivatives are required to be accounted for separately from the lease in accordance with IFRS 9 *Financial Instruments* (IFRS 9). An embedded derivative needs to be separated if its economic characteristics and risks are not closely related to the host contract.

Example 19 – Embedded derivatives in Leases

Company B has entered into several multi-year operating leases of buildings. The rental payments are denominated in dollars and are adjusted as follows.

During the first 8 years, the annual increase in rent is determined by multiplying the change in the consumer price index by a factor of 1.85, subject to a floor of 2.5% for the first three years. Beginning in Year 9 until the end of the lease term, the increase in rent will be determined by multiplying the index by 1.5.

Assessment

Although adjustments for inflation indices in lease contracts are common, floors and multipliers on those rates are not. The adjustment to lease payments occurring is linked to CPI, which may be viewed as closely related to the risks of the host lease contract. However, the contract includes a multiplier on the index and a floor, both of which affect the lease payments in ways that decouple the cash flows from the risks inherent in the lease asset.

These characteristics of the contract would be an embedded derivative not closely related to the host lease contract, and would therefore require separation from the lease contract. Separated embedded derivatives would be accounted for in accordance with IFRS 9.

Deferred Tax Implications of IFRS 16

In many jurisdictions, the recognition of lease liabilities and right-of-use assets will differ from the taxation treatment of leases. For tax purposes, it is common for leases to be included in the calculation of taxable income based on the cash paid in a particular period plus any unpaid, but accrued lease payments. This treats leases in a similar way to the ‘off balance sheet’ treatment of operating leases under IAS 17.

In many cases, the carrying amount of the right-of-use asset and corresponding lease liability for a lease may equal one another as at the commencement date of the lease. The difference in treatment between IFRS and taxation may give rise to deferred tax balances as the lease liability and right-of-use asset are subsequently reduced due to the subsequent measurement of the balances (e.g. reduction of the lease liability due to lease payments, amortisation of the right-of-use asset, etc.). Consider the following example:

Example 20 – Measurement of Lease Contract and Deferred Tax

Company V enters into a lease with a lease term of 10 years, with lease payments of CU 1,000 paid in arrears. The interest rate implicit in the lease is not readily determinable, therefore, Entity V will use its incremental rate of borrowing, which is 5%. There are no incremental costs to obtain the lease, or other amounts that may cause the lease liability and right-of-use asset to differ. At the commencement of the lease, the lease liability and right-of-use asset are both recognised at CU 7,722. As at the end of the first year of the lease, the carrying value of the lease liability is CU 7,107 and the right-of-use asset is CU 6,950.

The applicable income tax rate is 25%. In Company V's jurisdiction, the only deduction permissible for leases are those made in cash. Depreciation of the right-of-use asset and finance expenses on the lease liability are both non-deductible.

Assessment

As at the lease commencement date, the tax bases of the right-of-use asset and liability are both zero. The subsequent depreciation on the right-of-use asset will not be deductible for tax purposes, therefore, its tax base is zero. IAS 12 states that the tax base of a liability is its carrying value, less any amount that will be deductible for income tax purposes in respect of that liability in future periods, therefore, the lease liability also has zero tax basis.

The difference between the carrying value and tax base of the asset and liability meet the definition of temporary differences, however, there has been inconsistency in practice as to whether the initial recognition exemption applies. The initial recognition exemption states that deferred tax assets and liabilities shall not be recognised if the deferred tax asset or liabilities arises from:

- The initial recognition of goodwill; or
- The initial recognition of an asset or liability in a transaction, which is not a business combination and at the time of the transaction, affects neither accounting profit not taxable profit.

It could be interpreted that for each of the lease liability and right-of-use asset, the initial recognition exemption applies since the recognition of each item individually does not relate to a business combination and the initial recognition does not affect accounting profit or taxable profit at that time. The consequence of this assessment is that if the initial recognition exemption applies, deferred tax assets and liabilities would never be recognised with respect to the lease. Others have interpreted that the initial recognition exemption does not apply in this situation.

In response to this issue, in July 2019 the IASB has proposed an amendment to IAS 12, *Deferred Tax related to Assets and Liabilities arising from a Single Transaction*. The exposure draft proposes to clarify that when equal amounts of taxable and deductible temporary differences arise from assets and liabilities in a single transaction (e.g. the initial recognition of a lease or an asset retirement obligation in the scope of IAS 37), the initial recognition exemption would not apply. At the time of this publication's release, the exposure draft is open for public comment until 14 November 2019. For entities that have interpreted IAS 12 to mean that the initial recognition exemption does not apply, then assuming the proposals are finalised as drafted it is possible that the proposed amendment will have no impact. However, if entities have interpreted that the initial recognition exemption does apply, the amendment may have a significant impact.

Assuming that Company V has an accounting policy that the initial recognition exemption does not apply, then equal and off-setting deferred tax assets and liabilities exist as at the commencement date, so zero net deferred tax exists, as the deferred tax asset and liability would meet off-setting criteria in IAS 12.74 (legally enforceable right of off-set and the taxes are levied by the same taxation authority).

As at the end of Year 1, the right-of-use asset gives rise to a deferred tax liability of CU 1,738 (CU 6,950 carrying value - zero tax base) and the lease liability gives rise to a deferred tax asset of CU 1,775 (CU 7,101 carrying value - zero tax base). The net deferred tax liability of CU 37 (CU 1,775 - CU 1,738) would be presented in the statement of financial position.

5.2. Discount Rate on Initial Recognition

All the components of the lease liability as described in Section 5.1. are required to be discounted to reflect the present value of the payments. The discount rate to use is the rate implicit in the lease, unless this cannot readily be determined, in which case the lessee's incremental borrowing rate is used instead.

The definition of the lessee's incremental borrowing rate states that the rate should represent what the lessee 'would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.' In applying the concept of 'similar security', a lessee uses the right-of-use asset granted by the lease and not the fair value of the underlying asset. This is because the rate should represent the amount that would be charged to acquire an asset of similar value for a similar period. For example, in determining the incremental borrowing rate on a 5 year lease of a property, the security for the portion of the asset being leased (i.e. the 5 year portion of its useful life) would be likely to vary significantly from the outright ownership of the property, as outright ownership would confer rights over a period of time that would typically be significantly greater than the 5-year right-of-use asset contained in the lease.

In practice, judgement may be needed to estimate an incremental borrowing rate in the context of a right-of-use asset, especially when the value of the underlying asset differs significantly from the value of the right-of-use asset.

An entity's weighted-average cost of capital ('WACC') is not appropriate to use as a proxy for the incremental borrowing rate because it is not representative of the rate an entity would pay on borrowings. WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings. The use of WACC would therefore result in the carrying amounts of both lease liabilities and right-of-use assets being understated.

BDO comment

Use of rate of implicit in the lease vs. incremental borrowing rate

The rate implicit in the lease is the rate that would cause the present value of the lease payments and unguaranteed residual to equal the sum of the fair value of the underlying asset(s) and initial direct costs incurred. Using the implicit rate presents the true financing cost of leasing an asset as opposed to paying for it up-front or buying it outright without financing.

Allowing the incremental borrowing rate to be used acknowledges that a lessee is often not able to determine the implicit rate. A lessor often does not disclose the rate in the contract, or may offer a rate as being promotional (i.e. a below market interest rate), but also charge above-market lease rates to compensate for the low interest rate). Ultimately, to calculate the rate implicit in the lease requires not only information about the fair value of the leased asset at the start of the lease, but also its 'unguaranteed residual value' (the fair value at the end of the lease if the residual value is not being guaranteed). However, in many leases it will not be possible to make a reliable estimate of this, particularly where the lease term is less than the leased asset's useful economic life.

Therefore, it is likely that many lessees will use their incremental borrowing rate for a wide variety of leases.

BDO comment (continued)

Interest rate implicit in the lease for lease and non-lease components

If a lessee uses the interest rate implicit in the lease to measure leases (not the lessee's incremental borrowing rate), the lessee must also consider lease and non-lease components. While IFRS 16 contains a practical expedient that permits lessees to combine lease and non-lease components in the measurement of a lease contract (e.g. an automobile lease payment with built in maintenance services), in our view, lessees still must bifurcate these payments for purposes of determining the rate implicit in the lease. This is because the practical expedient (IFRS 16.15) permits lessees to not separate lease and non-lease components by accounting for them as a single lease component.

In determining the interest rate implicit in the lease, lessees must still comply with the definition, which states that it is the rate of interest that 'causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor'. The term 'lease payments' is defined as 'payments made by a lessee to a lessor relating to the right to use an underlying asset…', meaning that the input into the determination of the rate implicit in the lease relates only to lease components, not non-lease components.

This creates additional complexity for entities using the rate implicit in the lease for the measurement of lease contracts.

Timing of the determination of the discount rate

The timing of the determination of the discount rate may affect lease measurement if there is a delay between contract inception and the commencement of the lease This can arise in situations where significant events occur between the inception and commencement dates, which would affect either the lessee's incremental borrowing rate or the rate implicit in the lease. For example, credit deterioration of the lessee would affect the incremental borrowing rate and significant geopolitical or technological events could affect the fair value of the underlying asset, which would in turn impact the rate implicit in the lease.

In our view, the determination of the discount rate from the lessee's perspective is at the commencement date of the lease, as IFRS 16.23 requires a lessee to measure the right-of-use asset at the commencement date. The applicable discount rate is a component of the measurement of the lease, therefore, it is determined at the same time as other components of the measurement of the lease.

For lessors, the guidance differs, as IFRS 16.66 states that lease classification between operating and finance type occurs at the inception date. The applicable discount rate is a component in determining how a lease is classified, as it affects the criteria used to analyse whether a lease is finance or operating. Consequently, the discount rate is determined at the inception of the lease contract for lessors.

BDO comment (continued)

Discount rate for leases acquired in a business combination

IFRS 3 includes the following requirements for the measurement of leases acquired in a business combination when the acquiree is a lessee (emphasis added):

28A — The acquirer shall recognise right-of-use assets and lease liabilities for leases identified in accordance with IFRS 16 in which the acquiree is the lessee. The acquirer is not required to recognise right-of-use assets and lease liabilities for:

(a) Leases for which the lease term (as defined in IFRS 16) ends within 12 months of the acquisition date; or

(b) Leases for which the underlying asset is of low value (as described in Paragraphs B3-B8 of IFRS 16).

28B — The acquirer shall measure the lease liability at the present value of the remaining lease payments (as defined in IFRS 16) ***as if the acquired lease were a new lease at the acquisition date****. The acquirer shall measure the right-of-use asset at the same amount as the lease liability, adjusted to reflect favourable or unfavourable terms of the lease when compared with market terms.*

This raises the question of whether, in a transaction where a business combination is effected through the acquisition of a separate legal entity (e.g. a corporation), when applying IFRS 3.28B, does the acquiring entity determine a discount rate from its own perspective (i.e. the acquirer) or from the perspective of the acquiree? Note that if a lease is acquired by the acquirer in a business combination through methods other than the acquisition of a separate entity (i.e. a trade and asset purchase, which requires the acquirer to amend the underlying lease contract to make the acquirer the new lessee), then the lease is a new contract at the acquisition date, and the applicable discount rate would be determined from the perspective of the acquirer.

This affects the measurement of the lease contract when the lessee's incremental rate of borrowing is used, as the effects of various economic factors (in particular credit risk) are included when the rate is determined.

In a business combination where the lease liability and right-of-use asset are measured at an amount equal to one another, this will not have a net impact on goodwill. However, when leases have 'off-market' terms, then this will impact the determination of goodwill in the business combination because the off market terms will be reflected in the measurement of the right-of-use asset.

IFRS 3.28B requires the acquirer to apply IFRS 16 in measuring the acquired lease as if it were a new lease as at the commencement date. In measuring a new lease, entities must consider all relevant information in determining inputs such as the lease term, lease payments, etc.

In determining the discount rate used to measure the lease liability, assuming that the interest rate implicit in the lease is not available and the lease is not restructured at the date of the business combination, then the lessee's incremental rate of borrowing is determined from the perspective of the party to the contract (i.e. the lessee/acquiree in the business combination). This is consistent with IFRS 16.BC160:

> *'The IASB's objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced.'*

Regardless of the fact that the lease acquired is a new lease from the perspective of the acquirer, the initial recognition is still driven by the guidance in IFRS 16, therefore, the 'lessee' remains the acquiree in the business combination. This means that the subsidiary cannot default to the parent IBR.

However, the acquirer's incremental rate of borrowing may be relevant if the leases acquired in the business combination are simultaneously restructured at the time of the business combination to include the addition by the new parent of credit enhancements to the lessee (e.g. a guarantee provided by the parent to the lessor). In such cases, the credit enhancement is considered in the determination of the incremental rate of borrowing, and hence in the initial measurement of the lease contracts in the acquirer's purchase price allocation.

BDO comment (continued)

Determining the incremental borrowing rate

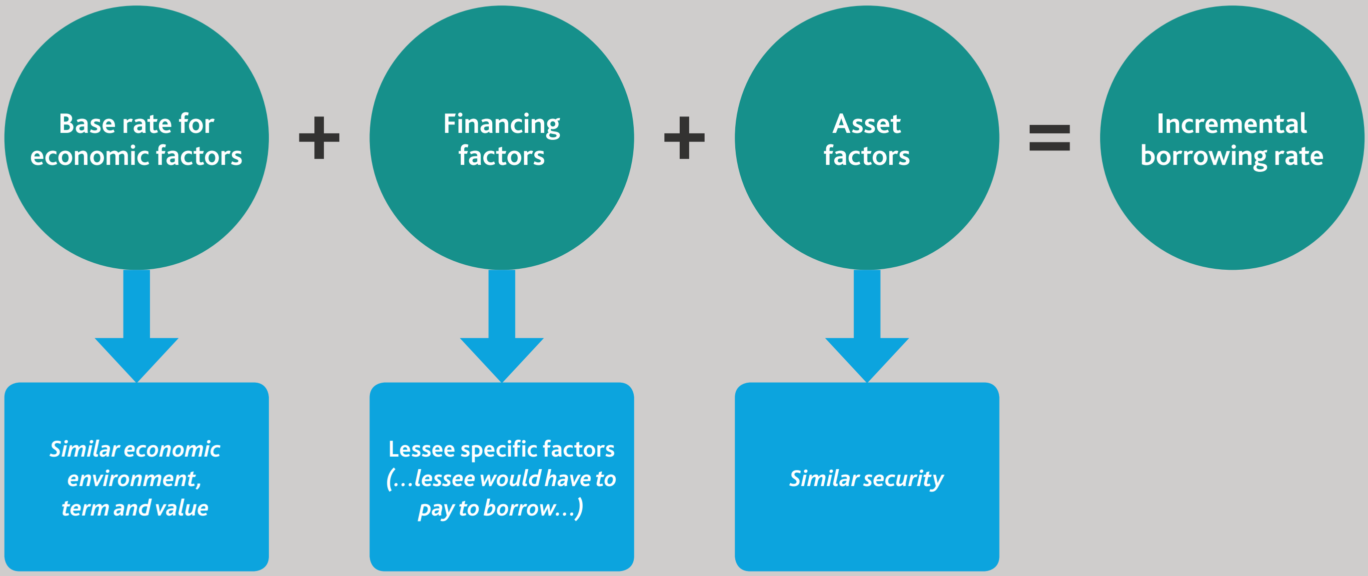
IFRS 16 does not contain significant guidance on how to determine the incremental borrowing rate beyond the definition provided (emphasis added):

> *'The rate of interest that a **lessee would have to pay to borrow** over a **similar term** and with **similar security**, the funds necessary to obtain an asset of **similar value** to the right-of-use asset in a **similar economic environment**.'*

In the absence of specific requirements in IFRS, preparers will have to apply judgment in determining the incremental borrowing rate. For entities with relatively small lease portfolios that are not material in the context of the entity's financial statements, then the work effort involved in determining the incremental borrowing rate for those leases may be lower. For entities with significant lease portfolios, the determination of the discount rate may have a very material impact on the statement of financial position as well as financial performance.

Determining the incremental borrowing rate is more complex than simply determining the weighted rate that an entity pays on its current borrowings. Such borrowings may have economic characteristic entirely dissimilar to the definition of the lessee's incremental borrowing rate as noted above.

In our view, the following methodology may provide a reasonable base for determining the incremental borrowing rate for a lease, as it incorporates the key elements denoted above in italics:



BDO comment (continued)

Base rate for economic factors: similar economic environment, term and value

The starting point in estimating the incremental borrowing rate is a 'base rate', which may be a risk-free rate derived from government bonds or other types of low risk financing. To achieve a 'similar economic environment', this rate should consider the applicable geographic location where the lessee operates. For example, the risk-free rate in the United States of America and sub-Saharan Africa would be very different.

The base rate should also consider the term of the lease, as risk-free rates differ depending on the period of time of the lending arrangement. For example, the risk-free rate for a 3-year lease of equipment would differ from the risk-free rate for a 20-year real estate lease, as the cost of borrowing tends to increase as the period of time increases.

An issue arises in developing this base rate, as there are often significant differences in the timing of cash flows between risk-free rates and leases. Low risk lending arrangements, such as government bonds, tend to have cash flows heavily weighted towards the end of the term (i.e. a 'bullet loan'). In some cases, all cash flows, including interest, may be deferred until this point in time. In contrast, most leases have period cash flows that occur over the lease term on a weekly, monthly, or annual basis. However, IFRS 16 does not contain specific guidance for the determination of the incremental borrowing rate.

At its September 2019 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of determining the lessee's incremental borrowing rate. In its agenda decision, the Committee observed that an entity must apply judgment in determining its incremental rate of borrowing. The Committee observed that it would be consistent with the Board's objective for an entity to refer to readily observable rates for loans with similar payment profiles in developing the entity's incremental borrowing rate for a lease. Many lease contracts are amortising in nature with regular payments, meaning that an appropriate approach would be to use readily observable rates for loans that would also be amortising in nature (e.g. an amortising government bond with similar payment profile to the underlying lease).

One approach could be to use the yield curve for government bonds (which have a bullet repayment on maturity), with an appropriate rate being used to discount each of the lease payments. This would result in the determination of a 'base rate' which reflected the capital repayment profile of the lease.

An alternative approach which may be acceptable to account for this difference in the timing of cash flows (depending on the contractual payment terms of the lease) would be for entities to select reference bonds with cash flows that approximate the weighted cash flows for the underlying lease. For example, the rate attributable to a 10-year property lease with monthly cash flows may be satisfactorily represented by a 5-year bond with a bullet capital repayment on maturity. The weighted cash flows of the bond would be approximately 5-years. However, this may not always be an appropriate approach, for example where rates are low for the initial five year period but increase sharply for years five to ten.

BDO comment (continued)

Financing factors

IFRS 16 is clear that the intention of the discount rate guidance is to ensure the discount rate reflects how the contract is priced. As the 'base rate' discussed above represents a risk-free rate of borrowing, it must be adjusted to consider the credit risk of the entity. Entities may consider using readily observable rates for loans with similar payment profiles as a starting point.

Once an appropriate base rate is determined, it must be adjusted for characteristics of the lease that are dissimilar from the reference rate. This may be accomplished by obtaining credit spread information for the entity itself from recent borrowings; however, obtaining this information specific to one particular entity may be difficult in practice. Entities may also consider utilising industry data and making adjustments for the entity's specific credit risks relative to industry composites.

It should be noted that in group structures where central treasury functions obtain financing for groups across multiple jurisdictions, special considerations may apply. It is common for conglomerates and large corporate entities to centralise their borrowing function in order to lower borrowing costs for the group as a whole through economies of scale. In determining an appropriate incremental borrowing rate, entities must consider that it would generally not be appropriate to use a 'consolidated' borrowing rate for the group as a whole. This is because a group borrowing rate generally considers the blended credit characteristics of all entities in the group, which will normally differ from the terms of a lease obtained in each individual subsidiary. For example, a group treasury rate for a revolving credit facility may consider guarantees and diversification adjustments, which lower the rate for the group as a whole and not for each separate subsidiary. Upon consolidation of many entities within a corporate group, the incremental borrowing rate may differ significantly across different entities that operate in different geographic regions and industries, even if the underlying leased asset is similar.

Special consideration – Foreign currency leases

Entities may enter into lease agreements in currencies other than their functional currency. For example, an entity may have a functional currency of Euro, and enter into leases for aircraft, which are routinely denominated in US dollars worldwide. In our view, entities should determine their incremental borrowing rate based on the rate of interest they would have to pay in the same currency in which the lease payments are denominated.

In some situations, an entity may utilise foreign currency derivatives in order to achieve a similar economic outcome as borrowing in the foreign currency itself. Using the example noted above, the entity may acquire a loan in Euros and then acquire a cross-currency swap to economically modify the payments to be in US dollars. In a situation where an entity routinely enters into such arrangements, then depending on the precise facts and circumstances, it may be appropriate to use this 'swapped' borrowing rate in determining the incremental borrowing rate for a lease in the swapped currency. Factors to consider include the approach that an entity actually uses in practice for borrowing USD and which approach would give a lower cost of borrowing.

BDO comment (continued)

Special consideration – Use of 'real' discount rates and interrelationship with inflation

In some jurisdictions, lease payments are adjusted on a regular basis to reflect the accumulated inflation of the past twelve months. This may be more common in jurisdictions with relatively high rates of inflation. This results in the lease having variable payments that are dependent on an index or rate. This raises the question of whether a nominal or a real rate should be used in determining the lessee's incremental rate of borrowing.

A nominal discount rate does not consider inflation, whereas a real discount rate does. A real discount rate aims to remove the effects of inflation to reflect the real cost of debt to the borrower and thus is lower than the nominal discount rate.

In our view, a nominal discount rate is required to be used because the lessee's incremental borrowing rate is defined as:

> *'The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.'*

The rate a lessee 'would have to pay to borrow' funds would be a nominal rate, not a real rate.

Asset factors

In determining how the type of asset affects the incremental borrowing rate, entities should consider that a lease is in substance a 'secured loan', in that the lessor typically has recourse to repossess the underlying asset (which includes the lessee's right-of-use asset) if a lessee defaults.

IFRS 16 intends the incremental borrowing rate to represent the rate that would be charged to purchase the right-of-use asset. However, there are conceptual differences in achieving this in practice. For example, a lessor is typically exposed to residual value risk in leasing to an entity, which it would be expected to incorporate into the rate implicit in the lease. In our view, it would not be appropriate for the lessee to incorporate an asset risk premium for residual value risk because this is not consistent with the definition of the incremental borrowing rate. While the incremental borrowing rate and the rate implicit in the lease share many characteristics, exposure to residual value risk via an asset risk premium is not the same as security risk that a lender bears through the term of a borrowing arrangement.

In our view, it would still be appropriate to adjust the rate by a value that considers a borrower's view as to the risk of the type of asset that is being leased (e.g. the risk related to repossessing right-of-use assets for laptop computers compared to commercial office space would differ substantially). Significantly different costs would exist for these two examples, and the ability of a lender to realise a residual amount from the underlying collateral would differ substantially.

Example 21 – Determination of Discount Rate for a Portfolio of Similar Leases

Note: this example illustrates the concepts discussed above in determining the discount rate for lease contracts. Additionally, this example illustrates how a lessee may make materiality decisions concerning the discount rate in measuring lease contracts. Such decisions must be made by management with appropriate analysis to support the simplifications used. The decisions noted below may not be appropriate to every entity; careful analysis of the facts and circumstances in each case is required.

Entity L is a new freight and logistics firm that has entered into a large number of leases for railcars in order to transport its customers' goods. It has also entered into a number of leases for smaller equipment such as automobiles and forklifts. The interest rate implicit in the leases is not readily determinable, therefore, Entity L will discount the lease liability upon initial recognition of the leases using its incremental borrowing rate. In determining the discount rate to apply to the total portfolio of leases, Entity L elects to utilise the practical expedient to apply IFRS 16 to a portfolio of leases with similar characteristics.

Entity L's major lease portfolio consists of two major types of railcars: heavy rail and light rail, therefore, Entity L will determine the discount rate for these portfolios of leases separately. These portfolios are hereafter referred to as the 'heavy portfolio' and 'light portfolio'. The smaller equipment lease portfolio (e.g. automobiles and forklifts) is referred to as the 'minor equipment portfolio'.

For all leases, Entity L will make quarterly payments in advance of equal amounts over the related lease term.

Entity L applies the methodology discussed in the previous section to determine the discount rate for these three portfolios.

Example 21 – Determination of Discount Rate for a Portfolio of Similar Leases (continued)

Base rate for economic factors: similar economic environment, term and value

Heavy portfolio
Entity L analyses its portfolio of leases and notes that the lease terms vary between 4 and 6 years, with the leases being evenly dispersed over that period (in number and value). Consequently, Entity L concludes that the weighted average lease term is 5 years.

Entity L then reviews interest rates applicable to high quality bonds in its jurisdiction and notes that:

- The bonds pay interest quarterly and have 'bullet' capital repayments on maturity (in contrast to the lease liabilities which are amortising balances);
- Interest rates for bonds with maturities of between 1 and 5 years rise evenly over the 4 year period.

Consequently, Entity L concludes that a reasonable approximation of the 'base' rate will be obtained by referring to the interest rate for bonds with a 2.5 year duration. Utilising instruments with a duration equal to 50% of the weighted average lease term accounts for the fact that the referenced bonds are bullet loans with 'back loaded' cash flows compared to the cash flows of the lease, which are evenly dispersed. The base rate is determined to be 3.10%.

If the lease portfolio had been different, then additional analysis would have been required. For example, Entity L might have found that while the average lease term is 5 years, there are a significant number of leases in this portfolio with lease terms of 18 months-2 years compared to another large number of leases with terms of 7-8 years. While the applicable reference bonds for these more granular segments carry different interest rates, Entity L would need to carry out a sensitivity analysis to determine whether the use of a single 2.5 year reference rate would potentially have a material impact in the measurement of the lease contracts.

In addition, if an approximation is used, it is necessary to revisit the approach as and when additional leases are added in future to determine whether the approximation remains acceptable.

Light portfolio
Entity L performs an analysis similar to above, noting that the average lease term in the light portfolio is 3 years. The applicable rate after referencing a series of high quality bonds in the applicable jurisdiction is 2.65%.

Minor equipment portfolio
The minor equipment portfolio is made of many different types of equipment with various lease terms ranging from 1 to 4 years, with lease terms and values evenly spread in this range. Entity L notes that the minor equipment portfolio is immaterial in comparison to its railcar portfolios and to the financial statements as a whole Consequently, Entity L considers that it is acceptable to use a 3.00% discount rate for the minor equipment portfolio of lease contracts, rather than determining different rates for various sub-portfolios of different types of equipment with different lease terms. Entity L performs a sensitivity analysis and notes that a reasonably possible shift in the discount rate would not result in a material difference in the measurement of this portfolio. Although financing factors are also considered, an adjustment for asset factors is not considered necessary as its effect would be immaterial.

Example 21 – Determination of Discount Rate for a Portfolio of Similar Leases (continued)

Financing factors

Heavy portfolio

To adjust the base rate for credit risk factors, Entity L refers to the spread between the credit rating of bonds in the reference portfolio compare to Entity L's own credit risk. The credit rating for the bonds in the reference portfolio were AAA, meaning they have a low risk of defaulting on the payments. Entity L consults with several banks in its jurisdiction and obtains a number of different interest rate 'spreads' between AAA borrowers and Entity L for loans of 2.5 years in duration. The average of these spreads is 1.75%.

Light portfolio

Entity L performs an analysis similar to above, however, for a reference portfolio with an average duration of 1.5 years (i.e. half of the light portfolio's weighted average lease term). The average of these spreads is 1.25%.

Minor equipment portfolio

Entity L considers the range of lease terms in this portfolio and the credit spreads for the heavy and light portfolios. It concludes that a reasonable approximation of the credit spread applicable to the minor equipment portfolio is 1.50%.

Asset factors

Heavy portfolio

The base rate and credit spread determined above relate to an unsecured borrowing position. Entity L notes that the security in its leases are the underlying right-of-use asset, therefore, an adjustment to the borrowing rate should take this into account. Entity L consults with several banks on the adjustment to the rate on a secured borrowing position. Entity L notes that in discussions with banks, they note that the underlying asset provides less relevant security than say, commercial real estate in a major city centre, since realising on the underlying security (rail cars) is more difficult and would include more significant costs. The adjustment for the asset factors is -0.45%.

Light portfolio

Entity L performs an analysis similar to above, however, the nature of the security (light rail cars) differs slightly. The banks that Entity L consults that light rail cars are used less frequently and have shorter useful lives, therefore, the nature of the security provides a lower adjustment than the heavy portfolio. The adjustment for the asset factors is -0.35%.

Minor equipment portfolio

Entity L performs an analysis similar to that of the heavy portfolio. As the minor equipment has a relatively short useful life, Entity L believes the adjustment for asset factors is minor. The adjustment for asset factors is -0.10%.

Example 21 – Determination of Discount Rate for a Portfolio of Similar Leases (continued)

Conclusion

Combining the relevant factors together results in the following discount rates:

Heavy portfolio	=	base rate + financing factors + asset factors
Heavy portfolio	=	3.10% + 1.75% + (-0.45%)
Heavy portfolio	=	4.40%
Light portfolio	=	base rate + financing factors + asset factors
Light portfolio	=	2.65% + 1.25% + (-0.35%)
Light portfolio	=	3.55%
Minor equipment portfolio	=	base rate + financial factors
Minor equipment portfolio	=	3.00% + 1.50% + (-0.10%)
Minor equipment portfolio	=	4.40%

Example 22 – Negative Implicit Interest Rates

Entity M leases a unit in a shopping centre for 5 years. Lease payments are fixed at CU 150,000 per annum plus a 5% variable payment dependent on Entity M's annual sales revenue. The lessee's incremental borrowing rate is 8%. The unit in the shopping centre has a current fair value of CU 1,300,000 and an unguaranteed residual value of CU 350,000. Initial direct costs are nil.

Assessment

IFRS 16 first requires the rate implicit in the lease to be used, if it is readily determinable. As Entity M knows the fair value of the property at the commencement of the lease and has estimated the fair value of the asset at the end of the lease, the rate implicit in the lease agreement can be calculated.

IFRS 16 defines the 'interest rate implicit in the lease' as:

> *"The rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor."*

Based on the facts provided above, the discount rate that causes the present value of (a) and (b) to equal the sum of (i) and (ii) is ***minus*** 8.52%. If this were used it would result in the lessee recognising interest income rather than interest expense over the lease term.

If the fair value of the property at the beginning and end of the lease are reasonably determinable and a significant portion (or all) of the lease payments are variable (and therefore not included in the measurement of the lease liability), the rate implicit in the lease may be negative. This is because the lease payments in (a) exclude the variable payments equal to 5% of sales revenue and therefore do not reflect what the lessor ultimately anticipates to be the 'true' return over the lease term.

The use of a negative discount rate in such circumstances is not appropriate, because it does not reflect the objective which is to reflect how the contract is priced. In addition, it will be very rare that a lessee will have information about the lessor's direct costs and other expectations that would be required to calculate the rate implicit in the lease. Consequently, the lessee will use its incremental borrowing rate to discount the lease payments.

5.3. Right-of-Use Asset – Initial Recognition

The right-of-use asset's value is initially linked to the calculated value of the financial liability with several additional adjustments.

Initial Direct Costs

These are incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained. These might include costs such as finder's fees, commissions to agents for establishing the lease and legal fees.

BDO comment

IFRS 16 emphasises that direct costs must be 'incremental' in the context of each individual lease (and not on the basis of a portfolio of leases). This precludes an entity from making an allocation of administrative costs relating to obtaining a lease, such as a portion of finance and management salaries. Such costs would not be incremental as they would be incurred regardless of whether an entity enters into a specific lease.

Shipping and installation expenses are common costs that lessees incur to be able to use underlying lease assets. For example, leased manufacturing equipment may require significant costs to install into a pre-existing assembly line.

The definition of 'initial direct costs' states that they are the cost of 'obtaining a lease'; it is unclear as to whether this means costs strictly related to executing the lease agreement (e.g. legal costs), or if this may include costs associated with the underlying asset itself.

In our view, it is preferable for a lessee to capitalise costs associated with the physical underlying asset (e.g. shipping and installation), as this produces consistency with the outcome if the lessee had purchased the asset outright. Despite this, since IFRS 16 is unclear, we believe it is also acceptable for a lessee to expense initial direct costs that are associated with the underlying physical asset.

Removal and Restoration Costs

Some leases contain a requirement for lessees to return an asset in a specified condition, such that the lessee would be required to incur costs to restore it. Certain types of asset may also have significant transportation and removal costs to return them to the lessor as specified in the lease agreement.

These types of obligations may be incurred at the commencement date of a lease or as a consequence of using an underlying asset.

Example 23 – Initial Recognition of a Lease

Entity Z (the lessee) enters into a 5-year lease of a floor of a building, with an option to extend the lease for a further 5 years. Lease payments are CU 50,000 per annum during the initial term and CU 55,000 per annum during the optional period, all payable at the beginning of each year. To obtain the lease, Entity Z incurs initial direct costs of CU 20,000 (CU 15,000 to the former tenant occupying the floor and CU 5,000 for real estate commissions). The lessor agrees to reimburse the lessee the real estate commission of CU 5,000.

At the commencement date, Entity Z concludes that it is reasonably certain to exercise the option to extend the lease. Therefore the lease term is 10 years.

The rate implicit in the lease is not readily determinable. Entity Z's incremental borrowing rate is 5% per annum. This rate reflects the fixed rate at which it could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, with similar collateral.

Assessment

The entries required to record this transaction are as follows (see corresponding superscripts for notes reconciling each component of the entry):

To record the initial value of the lease asset and liability:

Dr		Right-of-use asset	CU 423,200[1]	
	Cr	Lease liability		CU 373,200[2]
	Cr	Cash		CU 50,000

[1] CU 50,000 in advance plus PV of 4 payments at CU 50,000 and 5 payments at CU 55,000, discounted at 5%.

[2] PV of 4 payments at CU 50,000 and 5 payments at CU 55,000, discounted at 5%.

To record the initial direct costs:

Dr		Right-of-use asset	CU 20,000	
	Cr	Cash		CU 20,000

To record lease incentive (the reimbursed real estate commission) relating to the lease:

Dr		Cash	CU 5,000	
	Cr	Right-of-use asset		CU 5,000

Lease Incentives

It is common in many leases for the lessee to receive a lease incentive at the commencement of a lease. These are commonly in the form of cash. Such incentives are deducted from the value of the right-of-use asset, as in the example above. However, an issue can arise where all lease payments are variable (meaning that it is possible that no lease liability will be recorded) and a lease incentive is received. This is illustrated in the following example.

Example 24 – Lease Incentives that Exceed Right-of-use Asset

Entity U enters into a 10-year lease contract for retail space where all of the lease payments are variable and do not depend on an index or rate (e.g. lease payments are based on a percentage of sales generated from using the retail space).

At the time of lease commencement, the lessee receives a CU 100,000 incentive from the lessor. There are no repayment conditions for the incentive.

Entity U measures the lease liability at zero as of the commencement of the lease, as the lease has no fixed payments, residual value guarantees, purchase options or in-substance fixed payments.

The lessee measures the right-of-use asset at an amount equal to the lease liability (i.e. zero), but must also apply IFRS 16.24(b) and deduct the lease incentive from the carrying value of the right-of-use asset.

Assessment

IFRS 16 does not contain specific guidance for circumstances in which a right-of-use asset might be recorded at a negative carrying amount. However, applying the requirements of IFRS 16.24 results in a negative asset being recorded, which is subsequently accounted for applying the cost model (assuming the lessee is not using the revaluation model and the lease does not meet the definition of investment property).

Therefore, the lessee is required to record a 'negative right-of-use asset' and amortise the resulting credit to profit or loss over the shorter of the lease term and the useful life of the underlying asset (see Section 5.5. for discussion of the subsequent measurement of right-of-use assets).

Note that this example assumes the lease incentive is received in cash as at lease commencement. In our view, the conclusion would not change if the lease incentive were receivable as at commencement, assuming there are no conditions related to receipt of the lease incentive.

5.4. Lease Liability – Subsequent Measurement

Interest on the lease liability is recognised in profit or loss, unless it is included in the carrying amount of an asset as required by another standard (e.g. IAS 23).

BDO comment

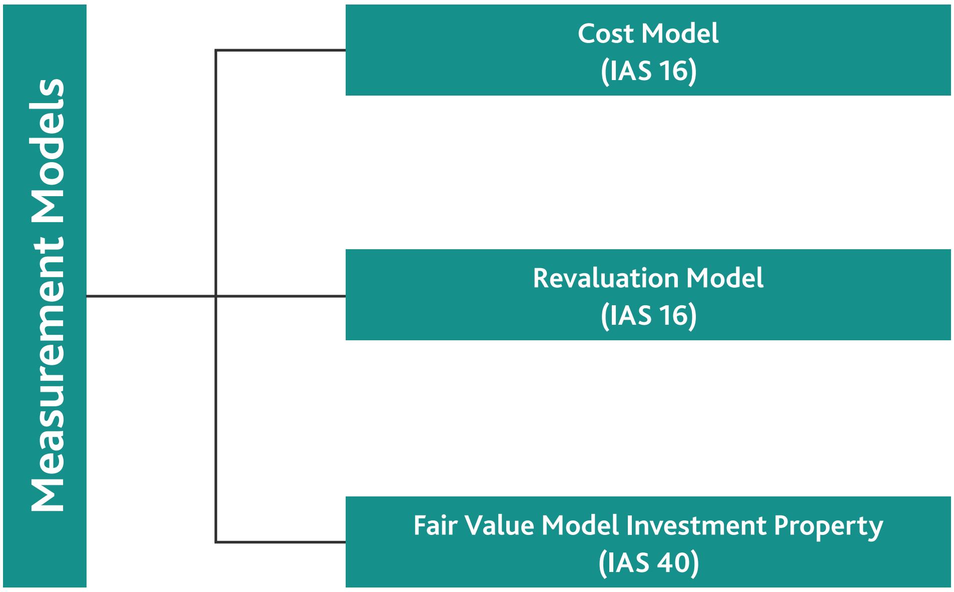
IAS 23 Borrowing Costs was consequentially amended to clarify that interest in respect of lease liabilities recognised in accordance with IFRS 16 are 'borrowing costs'. Therefore, the amount of borrowing costs that are subject to the requirements of IAS 23 (i.e. potential capitalisation) may increase as a consequence of IFRS 16.

Situations where interest on lease liabilities may be capitalised into the cost of other assets include:

- *The production of inventory;*
- *The construction of property, plant and equipment and investment property; and*
- *The development of intangible assets.*

5.5. Right-of-Use Asset – Subsequent Measurement

Subsequent to initial recognition, an entity may apply three potential models to account for right-of-use assets:



BDO comment

IFRS 16 references IAS 16 and IAS 40 for guidance on subsequent measurement, but it does not state that the right-of-use asset in a lease contract is property, plant and equipment or investment property.

Right-of-use assets are, therefore, a class of asset distinct from both property, plant and equipment and investment property. Section 6. below discusses how right-of-use assets should be presented in the statement of financial position.

Cost Model

Under the cost model, an entity measures a right-of-use asset at:

- Cost measured in accordance with Section 5.3. above;
- Less accumulated amortisation (recognised in accordance with the depreciation requirements of IAS 16) and accumulated impairment losses (recognised in accordance with IAS 36);
- Adjusted for remeasurements (see Sections 5.6. and 5.7.).

The right-of-use asset is amortised over the lease term (see Section 4. above), unless the initial recognition contemplates the exercise of a purchase option or the lease transfers ownership of the underlying asset to the lessee by the end of the lease term. In those cases, the right-of-use asset is amortised over the useful life of the underlying asset.

Example 25 – Amortisation of a ROU asset when Lease Payments are Initially Variable

Company W is the lessee of retail space for a period of three years and the lease does not contain any extension, termination or purchase options. Lease payments are as follows:

- Year 1: 5% of the lessee's sales using the retail space;
- Years 2 and 3: higher of CU 300 and 5% of the lessee's sales in the year.

Ignoring the effect of discounting, Company W recognises a lease liability and right-of-use asset of CU 600, which represents the contractual minimum to be paid in Years 2 and 3 (CU 300 per year). Actual sales are as follows:

- Year 1: CU 6,500
- Year 2: CU 6,240
- Year 3: CU 6,160.

Therefore, Company W pays CU 380, CU 312 and CU 308 in each of the years (5% of sales, as this figure exceeds the contractual floor of CU 300 established in Years 2 and 3).

The issue is whether the right-of-use asset of CU 400 should be amortised on a straight-line basis over the 3-year term (Approach 1 in the table below), or should the depreciation be re-allocated to account for the fact that Year 1's total expense is 'front loaded' (Approach 2 in the table below)?

	Approach 1			Approach 2		
	Variable lease expense	**Amortisation**	**Total**	**Variable lease expense**	**Amortisation**	**Total**
Year 1	325	200	525	325	Nil	325
Year 2	12**	200	212	12	300	312
Year 3	8**	200	208	8	300	308
Total	**345**	**600**	**945**	**345**	**600**	**945**

** *Only the amount of the payment that exceeds the contractual minimum of CU 300 is included in profit or loss in the period in which the payment comes due, as the contractual minimum was included in the measurement of the lease as at the commencement date.*

In Approach 1, the requirements of IFRS 16 result in the right-of-use asset being amortised on a straight line basis over the 3-year term. This results in much higher expense in Year 1, since one third of the total amortisation is recorded in that period in addition to the variable lease amount, since Year 1's payment is based entirely on a percentage of sales.

In Approach 2, since the total expense in Year 1 does not reflect the underlying economics of the transaction (i.e. that the benefit of the retail space in the lease is being consumed evenly), amortisation is modified to 'smooth' the total expense across the periods. Amortisation in Year 1 is set to nil such that the total expense in Year 1 is more in line with approximately one third of the total cash payments expected over the lease term (CU 945/3 = 315).

Assessment

IFRS 16's requirements relating to the subsequent measurement of right-of-use assets under the cost model are clear that the right-of-use asset is amortised based on the requirements of IAS 16, subject to the requirements in IFRS 16.32. IFRS 16.32 states that the period of amortisation is the shorter of the lease term and the useful life of the underlying asset, assuming that no reasonably certain to be exercised purchase options exist. As the useful life of the retail space exceeds 3 years, the amortisation period of the right-of-use asset is 3 years. There is no conceptual basis for charging reduced amounts in particular reporting periods and reallocating the amortisation expense to different reporting periods in order to achieve a 'smoothing' effect.

BDO comment

Componentisation of right-of-use assets

IFRS 16 directs entities to record amortisation based on the requirements of IAS 16, and IAS 16.43 requires each item with a cost that is significant in relation to the total cost be amortised separately. In our view, similar accounting is required for right-of-use assets with significant components when the lessee is required to incur the cost of replacing or maintaining such components. Componentising right-of-use assets into distinct units of account for amortisation purposes would create significantly different amortisation expense for underlying assets that have differing useful lives for sub-components.

For example, aircraft leases often contain clauses requiring lessees to perform major overhaul and maintenance of aircrafts based on specific increments of time and/or flight hours. If an aircraft lease contained a 10-year lease term, but the engines in the aircraft would require replacement after 4 years at the cost of the lessee, then the engines should be amortised separately over their 4-year useful life. Determining the basis for componentising significant leased assets may require significant judgment.

Timing of commencement of amortisation

IFRS 16 states that entities apply IAS 16's guidance relating to how ROU assets should be amortised, subject to the requirements of IFRS 16.32. Lessees may enter into leases that require 'fit out' periods where the underlying asset will take a period of time to be ready for the ultimate intended use by the lessee. For example, a lessee may lease office space where the first few months of the lease are spent installing leasehold improvements and preparing the space to be used by the lessee's employees. The question arises as to whether the lessee would be permitted to defer the commencement of amortisation of the ROU asset until the asset is ready for its intended use, which would be a 'usage based' amortisation model, which is permitted by IAS 16 in some situations.

In our view, while IFRS 16 directs entities to IAS 16 for amortisation requirements, this is still subject to the requirements of Paragraph 32 of IFRS 16, which states that '…the lessee shall depreciate the right-of-use asset from the commencement date…'. Therefore, the commencement of amortisation cannot be deferred to a period later than the commencement date of the lease. This is because the entity is benefiting from its right to use the underlying asset during the fit out period, regardless of whether the underlying asset is being used for its ultimate intended purpose

Non-consecutive lease terms and amortisation impact

In amortising the right-of-use asset, special consideration should be made for leases with non-consecutive periods of use. For example, a lessee enters into a lease where it will utilise retail space in a shopping centre for 3 months in each calendar period (i.e. 15 months in total). Based on the initial recognition requirements of IFRS 16, the lessee recognises the lease liability and right-of-use asset as at the commencement date of the lease as CU 150,000. In each period of use (i.e. each 3 month period when the retail space is utilised), the lessee would recognise CU 10,000 of amortisation expense (150,000/15 months of total use). The lessee would not record amortisation expense in the periods when the retail space is not utilised, as IAS 16.60 states that the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed. As no economic benefit is consumed in the period when the retail space is not utilised, amortisation is only recorded during the periods of use by the lessee. However, in contrast to the depreciation expense which is based on the periods in which the asset is available for use, the lessee would recognise a finance expense in all months in each calendar year.

Revaluation Model

If right-of-use assets relate to a class of property, plant and equipment to which an entity applies the revaluation model under IAS 16, a lessee may elect to apply the revaluation model to those right-of-use assets. An entity must be consistent in its classification of a class of property, plant and equipment, and right-of-use assets for the purposes of IAS 16 and IFRS 16.

BDO comment

The option to apply the revaluation model for right-of-use assets where the same class of property, plant and equipment is revalued under IAS 16 results in the potential for inconsistency because an entity is not required to apply the revaluation model to those right-of-use assets. Therefore, an entity may have a group of owned assets (e.g. land and/or buildings) to which it applies the revaluation model, whilst applying the cost model to property leases.

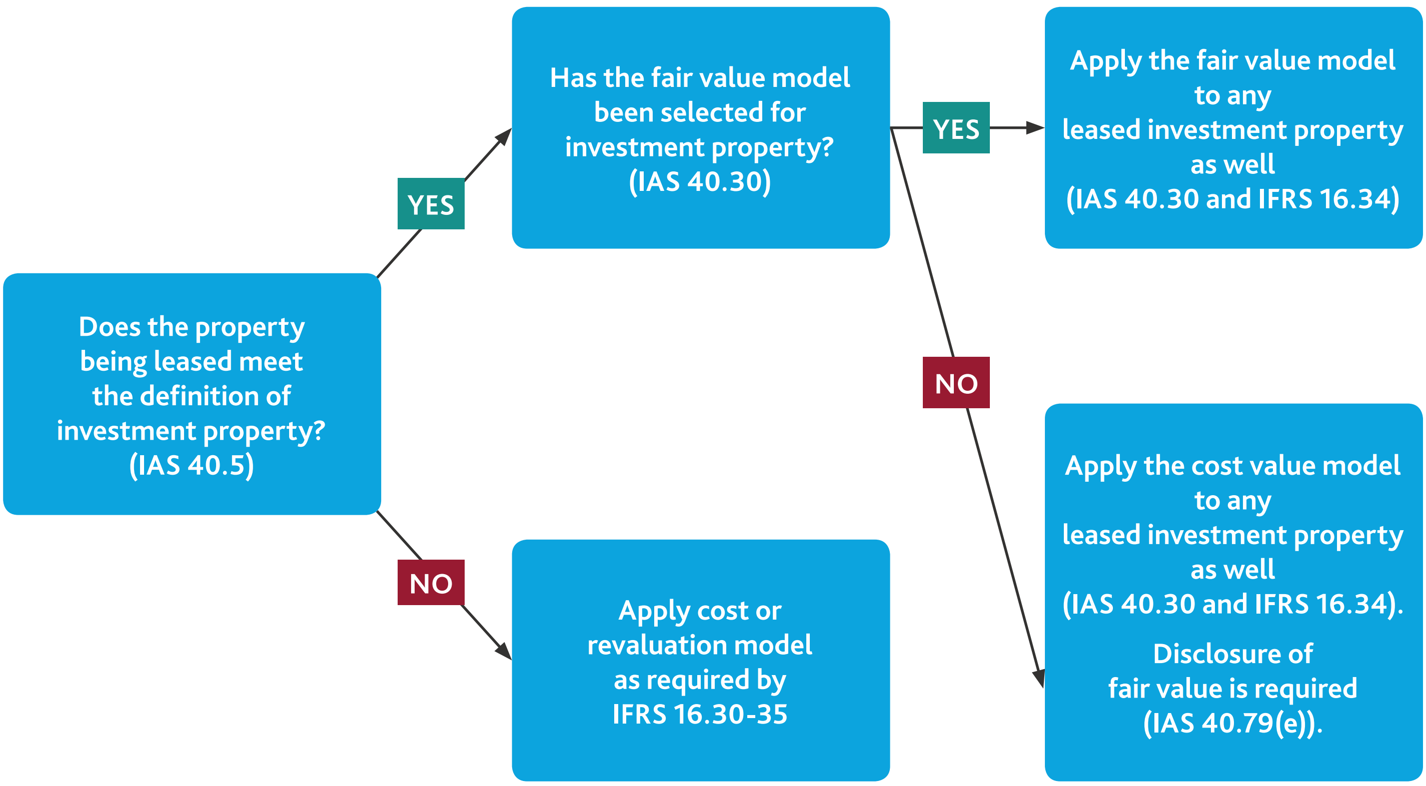
Fair Value Model

If an entity applies the fair value model in IAS 40, the same model must also be applied to right-of-use assets that meet the definition of investment property , regardless of the accounting policy that is applied (cost model or fair value model). This requirement removes the choice that entities had prior to the effective date of IFRS 16. Under IAS 40, prior to the transition to IFRS 16, if an entity was a lessee where the underlying operating lease met the definition of investment property, the entity could elect to account for the lease like other operating leases (i.e. 'off balance sheet'), or on a lease-by-lease basis, the entity could account for the lease 'on balance sheet'. This 'on balance sheet' accounting resulted in the recognition of a liability for the lease payments and an asset, an investment property, which was required to be measured at fair value.

Since IFRS 16 removes the distinction between operating and finance leases for lessees, this optionality has been removed. Any right-of-use assets that meet the definition of investment property are therefore accounted for under the same accounting policies as owned investment property.

Right-of-use assets may meet the definition of investment property in cases where the entity leases a property as a lessee and then sub-leases portions of the property under leases classified as operating from the perspective of the intermediate lessor (e.g. an apartment complex).

This flowchart summarises how a lessee determines the accounting for leases of property:



BDO comment

In contrast to the revaluation model, which may be used if applied to the same class of property, plant and equipment, the fair value model ***must*** *be applied to right-of-use assets meeting the definition of investment property where a lessee applies the fair value model in IAS 40 to owned investment property.*

Leased Investment Property and Determination of Fair Value when Lease contains Variable Lease Payments not based on an Index or Rate

The initial measurement of a right-of-use asset that meets the definition of investment property is the same as other, non-investment property leases. It is based on the measurement of the lease liability, adjusted for certain items such as initial direct costs, etc. Included in the lease liability are fixed lease payments and variable lease payments based on an index or rate. Variable lease payments not based on an index or rate (e.g. based on a percentage of rental income earned on the underlying property) are excluded. Therefore, if a lease contained only variable lease payments based on a percentage of rental income earned on the underlying property, the right-of-use asset and lease liability would both be initially measured at zero at initial recognition.

If the entity elects to account for investment property using the fair value model, subsequent to initial recognition of the lease, the lessee is required to measure the right-of-use asset at its fair value. The issue is whether in applying IFRS 13 to determine the fair value of the right-of-use asset, would a 'day 2' gain be possible since the fair value of the right-of-use asset would consider the variable lease payments that are not based on an index or rate, while the lease liability would not.

In our view, a 'day 2' gain on a right-of-use asset that is classified as an investment property would not be appropriate. While IFRS 16 specifies that it is the right-of-use asset being measured at fair value (not the underlying property itself), the lessee would typically be unable to transfer the right-of-use asset without also transferring the underlying lease liability. Therefore, in determining the fair value of the right-of-use asset, a market participant would also make assumptions concerning the transfer of any contractual cash flows associated with the lease liability, regardless of whether they are recognised as liabilities in the statement of financial position.

In addition, consequential amendments arising from IFRS 16 were made to IAS 40. IAS 40.41 is clear that the remeasurement of a right-of-use asset from cost to fair value should not give rise to any gain or loss on initial recognition. In addition, IAS 40.50(d) clarifies that the fair value of an investment property which is held as a right-of-use asset reflects expected cash flows which include all lease payments as well as receipts. In order to arrive at the carrying amount of the investment property using the fair value model, it is then necessary to add back any recognised lease liability to the fair value of the net cash flows that have been included in the initial valuation.

5.6. Remeasurement of Leases

Lease liabilities and right-of-use assets are remeasured in the following situations:

Change in original assessment of lease term or purchase/termination options

- Remeasure lease liability reflecting revised estimate of lease term and cash flows
- Discount revised payment using ***current*** rate
- Adjust carrying amount of right-of-use asset by the same amount so no gain or loss recognised

Change in estimate of residual guarantee

Change in index or rate affecting payments including market rent reviews

- Remeasure lease liability reflecting revised estimate of cash flows
- Discount revised payments using ***original*** rate
- Adjust carrying amount of right-of-use asset by the same amount so no gain or loss recognised

In most cases of a reassessment the carrying amount of the right-of-use asset is adjusted by the same amount as the adjustment to the carrying value of the lease liability. Therefore, there is no immediate gain or loss; rather the impact of the revised cash flows impacts the income statement over the remaining term of the lease. Exceptions to this general principle are when a reduction in the carrying value of the lease liability is greater than the carrying value of the related right-of-use-asset at the point of remeasurement, in which case the asset is reduced to nil and the excess is recognised in profit or loss, and in many cases where a lease modification decreases the scope of an existing lease.

Note that prior period figures are not adjusted, with all of these remeasurements being accounted for prospectively.

Example 26 – Unresolved Rent Review as at Reporting Date – Timing of Remeasurement

Lessee entered into a 3 year real estate lease commencing on 1 January 20x1. The lease has a 2 year extension option, at which time a market rent review takes place. The market rent review modifies the lease payments for years 4-5 and applies with effect from 1 January 1 20x4 (the first day of the extended period). Rent reviews can take up to 18 months to complete and, as at 31 December 20x4 the rent review for the lease has not yet been completed. The lessee paid the Year 4 rent based on the Year 3 amount, although an adjustment will be required once the rent review is completed in mid 20x5. As at 31 December 20x4, the lessee can make a reliable estimate of the retrospective 'top-up' payment that will be required for 20x4.

The issue is whether the lessee must remeasure the lease liability its estimate of the revised rent prior to the rent review occurring, since the effect of the review is retrospective.

Assessment

The lessee should not remeasure the lease prior to the rent review being completed, since IFRS 16.42(b) states that a lessee is required to remeasure a lease liability if 'there is a change in the future lease payments… including for example a change to reflect changes in market rental rates following a market rent review.' As at 31 December 2014, the Year 4 and 5 lease payments have not changed as the rent review has not been completed. Consequently the lease is not remeasured until the rent review is complete.

Example 27 – Renewal Terms at Negotiated Rental Rates

Lessee Z enters into a 15 year lease of land with fixed payments of CU 10 million per annum. Lessee Z and the lessor are unrelated parties and are dealing at arm's length.

Lessee Z constructs an apartment building on the land. At the end of the 15 year fixed term, the lease contains a clause that states the lessee extend the lease for additional 5 year periods of time, at amounts to be negotiated on each extension date. If the lessee and lessor cannot agree on an amount, arbitration will commence and an independent arbitrator will determine the amount of rental payments based on a market study.

Since Lessee Z has constructed an apartment building on the leased land, it is considered reasonably certain to exercise the options to extend the lease up to a total term of 50 years, which is the useful life of the apartment building.

The issue is whether the yet to be negotiated lease payments are 'variable lease payments based on an index or rate'. The consequence is that if they are, they would be included in the measurement of the lease liability and right-of-use asset.

Assessment

IFRS 16.28 states that 'variable lease payments that depend on an index or rate' include payments that vary to reflect changes in market rental rates. This is commonly interpreted to include market rent reviews, which are contractual terms that require a market study of a property to be performed in order to determine the revised rental payment.

While Lessee Z's lease does not explicitly require a market rent review to be performed by a third party, Lessee Z and the lessor are unrelated parties dealing at arm's length, and therefore have no realistic alternative but to negotiate what would be considered a 'market rent'. Negotiations between the parties would inherently reflect changes in market rental rates.

Therefore, Lessee Z's lease of land has a lease term of 50 years, consisting of:

1. 15 year initial, non-cancellable term; plus
2. 35 years of reasonably certain to be exercised lessee extension options up until the end of Year 50 (these lease extension options are reasonably certain to be exercised as Lessee Z has invested significant amounts into building an investment property on the land).

Lease payments included in the initial measurement of the lease as of the commencement date include 15 years of CU 10 million payments, plus another 35 years of CU 10 million payments ('variable payments based on an index or rate'). The 35 years of payments under the reasonably certain to be exercised extension options will be remeasured each year from Years 15-50 as the annual renewals are renegotiated between Lessee Z and the lessor.

Example 28 – Timing of Remeasurement of Leases with Variable Lease Payments based on an Index or Rate

Lessee W enters into a lease for a five-year term with a lessor for a retail building, commencing on 1 January. Lease payments are payable annually in advance (i.e. at the beginning of the year, 1 January). The lease contract states that lease payments will increase each year on the basis of the increase in the CPI from the period 1 December - 30 November. The updated CPI is published on 15 December. That is to say, at the beginning of each calendar year, the lessee makes a payment based on the reference amount stated in the lease contract, adjusted by the movement in the CPI from 1 December - 30 November of the previous year.

The issue is whether the lessee should remeasure the lease liability for Years 2-5 on 15 December of Year 1 since all variability for Year 2 has been resolved at that point, as the CPI index affecting the lease payments were published on 15 December. Alternatively, should the Lessee remeasure the lease on 1 January of Year 2, which is the point at which the cash flow change takes effect (i.e. the revised payment is made to the lessor)? IFRS 16.42(b) states that the lessee remeasures the lease liability to reflect revised lease payments only when there is a change in the cash flows (i.e. when the adjustment to the lease payments take effect), therefore, the issue is how one should interpret when the adjustment has 'taken effect'.

Assessment

The change in payments for Year 2 take effect when all variability relating to them is resolved; at this point they become in-substance fixed. As the revised payment that will be made on 1 January for Year 2 is known once the CPI index is published on 15 December, the revised payment has 'taken effect' on 15 December. If the revised payment were not known until after the balance sheet date (i.e. payments were based on a calendar year CPI movement, which is published on 15 January of the following year), then it would not be appropriate to remeasure the lease liability until the applicable rate is published, as the revised lease payments would not have been known as of the reporting period year-end. That is to say, the revised lease payments would not have 'taken effect' in that case.

Remeasuring lease liabilities based on indices or rates published subsequent to the balance sheet date could result in two entities with identical leases reporting different lease liabilities depending on when they issue their financial statements, which we do not believe is consistent with the objective of IFRS 16. Therefore, in our view, the condition required to remeasure the lease liability is that the revised lease payment must be known before the lease can be remeasured.

Example 29 – Effect of Multiple Rent Reviews Within a Single Lease

Lessee enters into a 15-year lease for office space. The payments at the commencement of the lease are set at CU 10,000 per annum (the current market rent). Market rent reviews occur twice throughout the term of the lease at the start of Years 6 and 11. Based on these rent reviews, the rental payment may increase or decrease.

For initial measurement of the lease liability, the lessee uses the current market rent of CU 10,000 for 15 years (IFRS 16.27(b) – variable lease payments that depend on an index or rate as at the commencement date of the lease).

The rent included in the liability is adjusted only when the market rent review occurs (i.e. when the adjustment to the lease payments takes effect).

The market rent at the start of Year 6, at the time of the first review, is CU 13,000. The rent review at Year 6 means that the variability has been resolved for Years 6-10 and so these cash flows will be updated in the liability calculation, consistent with the remeasurement requirements of IFRS 16.

The cash flows for Years 11-15 remain variable - they will not become known until the market rent review in Year 11.

The measurement issue is whether Years 11-15 are based on the original assumption of CU 10,000 per annum in lease payments, or the revised market rate of CU 13,000 per annum.

Assessment

In our view, at the time of remeasurement in Year 6, all remaining years in the lease should be remeasured based on the revised CU 13,000 payment, including Years 11-15. In remeasuring a lease, IFRS 16.42(b) states that 'a lessee shall determine the revised lease payments for the remainder of the lease term based on the **revised contractual payments** (emphasis added), therefore, all remaining payments should reflect this revision to the lease payments based on the market rent review.

Example 30 – Effect of Multiple Rates or Indices Affecting Lease Payments

A lessee enters into a 10-year lease. The initial payments are CU 10,000 per annum, which is the current market rent. There is a market rent review at the start of Year 6. In other years, the payments increase based on changes in the Consumer Price Index (CPI) in the preceding year.

There is no floor on either the CPI changes or the market rent reviews.

To summarise, the payments are:

Year(s)	Payments
1	CU 10,000
2-5	CU 10,000 adjusted for CPI changes since the start of Year 1
6	Market rent at the start of Year 6
7-10	Market rent at the start of Year 6 adjusted for CPI changes since the start of Year 6

For initial measurement of the lease liability, the lessee uses the current market rent of CU 10,000 for 10 years.

Assume that CPI increases by 3% in the first year and therefore the payment for Year 2 will be CU 10,300.

Consistent with Example 22, the cash flows for Years 2-5 will be updated to CU 10,300 to reflect the revised cash flows.

The cash flows for Years 6-10 remain variable since they will not become known until the market rent review occurs in Year 6.

The measurement issue is whether at the time of the remeasurement in Year 2, should the lessee assume the payments in Years 6-10 should be calculated as CU 10,300 per annum since additional variability exists due to the eventual market rental review to occur in Year 6.

Assessment

In our view, at the time of the remeasurement in Year 2 due to CPI changes, all remaining 9 years of payments should be calculated as CU 10,300, the base payment using the revised CPI rate. For the same rationale as discussed in Example 29, when a remeasurement occurs, IFRS 16.42(b) states that it is required to be based on the revised contractual payments. The fact that multiple drivers of variability exist in the lease contract does not remove this requirement.

Example 31 – Remeasurement of a Lease due to Reassessment of an Option

Entity B entered into a 10 year property lease, with an option to renew for another 5 years. On initial recognition of the lease Entity B was not reasonably certain that it would exercise this option and so the lease term was estimated as 10 years. At the end of Year 6 of the lease Entity B acquires Entity A. Following the acquisition of Entity A, Entity B determines that it would be more cost effective to relocate Entity A's staff and remain in its current premises for longer than the originally assessed 10 year period.

Assessment

Moving Entity A's staff to the same building occupied by the Lessee creates an economic incentive for Entity B to extend its original lease at the end of the non-cancellable period of 10 years.

Consequently, at the end of Year 6, Entity B concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Entity A's staff. The remaining lease term is revised to 9 years (i.e. the period from the end of Year 6 to the end of Year 15) and so Entity B remeasures its lease liability to reflect 9 years of future lease payments discounted at its incremental borrowing rate at that date (assuming the interest rate implicit in the lease is not readily determinable). The resulting increase in the carrying amount of the lease liability is added to the right-of-use asset. The revised carrying amount of the right-of-use asset is then depreciated over the revised remaining lease term of 9 years.

It should be noted that the circumstances above that resulted in the remeasurement of the lease liability and the right-of-use asset did not arise from any modification to the contractual terms agreed between the lessor and the lessee. Instead they arose from revisions to estimates and judgements made on the initial recognition of the lease. The accounting for lease modifications is addressed in Section 5.7.

Example 32 – Lessee's Accounting for Termination Penalties Paid by the Lessor

Lessee enters into a 5-year lease for 2,000 square metres of office space. The annual lease payments are CU 100,000 payable at the end of each year. The lease contract includes a termination option with a penalty that is exercisable at the option of Lessor during Year 2. The termination option includes a notification period of 1 year such that, once exercised, the lease contract will terminate in Year 3. The termination penalty is CU 40,000 and is payable in Year 3. As only the lessor has the right to terminate the lease, the lease term is determined to be 5 years at inception (IFRS 16 B35).

At the beginning of Year 2, the lessor exercised the option to terminate the lease.

Assessment

In our view, the adjustment of the lease term and the payment due from the Lessor should be accounted for as adjustments to the right-of-use asset and the lease liability. At the time the termination notice is received by the Lessee, CU 100,000 of payments remain (the Year 3 lease payment). Lessee would adjust the lease liability to include the receipt of the lessor's termination penalty at the end of Year 3 (CU 100,000 – CU 40,000 = CU 60,000 net payments remaining) and discount this net amount using a newly determined discount rate. The offsetting effect of this adjustment would be recorded against the right-of-use asset, with any excess being recorded in profit or loss.

This accounting achieves the same effect as if the Lessor's penalty was in the form of an adjustment to the remaining lease payment of CU 40,000. If this had been the case, using IFRS 16's remeasurement accounting model would be clear as the remaining lease payments had been modified by the exercising of the Lessor option. The underlying economics of the two variations of case facts are identical; therefore, we consider that there should be similar accounting outcomes.

5.7. Lease Modifications

Lease modifications arise from changes to the underlying contract agreed between the lessee and the lessor subsequent to commencement of the lease. The accounting for the modification depends on whether the modified terms increase or decrease the scope of the lease, and whether increases in scope require consideration to be paid that is commensurate with a 'standalone price' for the new scope of the lease.

IFRS 16 requires that a modification of a lease that is accounted for as a short-term lease (i.e. off balance sheet) to be considered a new lease if:

– There is a lease modification; or
– There is any change in the lease term (e.g. the lessee exercises an option not previously included in its determination of the lease term).

BDO comment

Judgement must be applied to assess whether the extension of lease terms between existing parties are treated as new leases or the modification of the original lease. For example, consider a lease that does not include any renewal option. During the lease term, the parties enter into a new lease for the same identified asset that commences when the original lease ends. This change is not accounted for as a separate lease as it does not convey the right to use additional underlying assets; the asset in question is the same. In our view, this would be accounted for as a lease modification which would be accounted for at the date on which the agreement between the lessee and the lessor is modified. The remeasurement would not be delayed until the end of the term on the original underlying lease since, in substance, this is a modification to the contractual terms of the original lease.

Modifications – Separate Leases

A lease modification is accounted for as a separate lease if:

- 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 standalone price for the increase in scope.

If both criteria are met, a lessee would follow the previous guidance in this publication on the initial recognition and measurement of lease liabilities and right-of-use assets.

Example 33 – Lease Modification that is a Separate Lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to include an additional 3,000 square metres of office space in the same building. The additional space is made available for use by Lessee at the end of the second quarter of Year 6. The increase in total consideration for the lease modification is commensurate with the current market rate for 3,000 square metres of office space, except for a discount that Lessee receives reflecting that Lessor does not incur costs that it would otherwise have incurred if leasing the same space to a new tenant (for example, marketing costs).

Assessment

Lessee accounts for the modification as a separate lease, i.e. separately from the original 10-year lease, the accounting for which is unaffected by the lease modification. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the new right is commensurate with its stand-alone price. In this example, the additional right-of-use asset is the extra 3,000 square metres of office space for three and a half years. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space for three and a half years. Lessee does not make any adjustments to the right-of-use asset or lease liability relating to the original lease of 2,000 square metres of office space which continue to be accounted for as if there had been no modification.

BDO comment

The legal form of a lease agreement may be modified to add additional assets (e.g. additional floors of an office building). In cases where the additional right-of-use assets are added to the contract at a price commensurate with their standalone price, the modification is in substance a new lease contract and the modification is accounted for as a separate lease under IFRS 16.

Modifications – Not Separate Leases

The accounting treatment required for lease modifications that are not accounted for as separate leases is summarised below:

Decrease in scope	– Decrease right-of-use asset and lease liability by their relative amounts compared to the original lease taking the difference to P&L – Remeasure lease liability using revised discount rate* with off-set to right-of-use (ROU) asset
All other lease modifications	– Remeasure lease liability using revised discount rate* – Remeasure right-of-use asset by same amount – No P&L impact

* *The prevailing incremental borrowing rate at date of modification is used unless the implicit rate in the lease is readily determinable.*

If a lease modification results in the lessee obtaining additional rights to use one or more underlying assets, but not at an amount that is commensurate with the standalone price for the increase in scope, the liability is remeasured by discounting all of the future lease payments as revised in the modified contract at the lessee's incremental borrowing rate at the date of modification (assuming the rate inherent in the lease is not readily determinable). It does not use the discount rate that applied to the pre-modified lease payments. The remeasurement of the lease liability is adjusted against the carrying value of the right-of-use asset such that no gain or loss arises as a result of the modification. The same accounting is applied if the term of the original lease is extended without adding any additional rights to use any more underlying assets.

Example 34 – Lease Modification that Increases the Lease Term

Entity A has a 10-year lease on 5,000 square metres of office space with annual payments of CU 100,000 payable at the end of each year. The rate used to discount the payments is Entity A's incremental borrowing rate of 6% as the implicit rate is not readily determinable. At the beginning of Year 7, Entity A and the lessor amend the lease by extending it for an additional 4 years. The annual payments remain unchanged. At the beginning of Year 7, Entity A's incremental borrowing rate is 7%.

Assessment

The modification is not accounted for as a new lease as it does not convey the right to use any additional assets. The lease is for the same underlying property.

Therefore, the lease is remeasured using a revised discount rate (i.e. the incremental borrowing rate at the time of the modification; not the original discount rate).

The lease liability immediately prior to the modification is CU 346,511.

Present value of Years 7-14 (8 years), CU 100,000 a year, 7% discount = CU 597,130

Adjustment required	= newly remeasured liability - previous carrying value of liability
	= CU 597,130 - CU 346,511
	= CU 250,619

Entry required as a result of the modification:

Dr		Right-of-use asset	CU 250,619	
	Cr	Lease liability		CU 250,619

If the modification results in a decrease in scope (e.g. by reducing the lease term or reducing the amount of asset(s) that are being leased) the accounting is more complex. Although the resulting liability is measured in the same way as above by discounting the lease payments in the modified contract at the lessee's prevailing incremental borrowing rate (if the rate implicit in the lease is still not readily determinable), this adjustment is undertaken in two steps:

– **Step 1** – The carrying amount of the right-of-use asset at the date of modification is reduced to reflect the partial or full termination on the lease, with an equivalent adjustment being made to the lease liability. If there is a reduction in the scope of the asset being leased (for example, a reduction in the area being leased from 5,000 square metres to 2,000 square metres), then the proportionate reduction in the right-of-use asset and lease liability will be the same amount (see Example 35a). If there is a reduction in the lease term, the proportionate change in the right-of-use asset will be different from the proportionate change in the lease liability, because of the effect of discounting the future lease payments that have been eliminated (see Example 35b). The difference between the carrying amount of the right-of-use asset and lease liability derecognised gives rise to a gain or loss.
– **Step 2** – The carrying amount of the liability resulting from Step 1 is adjusted again to ensure its carrying amount equals the future lease payments in the modified contract discounted at the lessee's incremental borrowing rate at the modification date. This second adjustment to the lease liability is accounted for by making a corresponding adjustment to the right-of-use asset. No gain or loss is recognised in this step.

Example 35a – Lease Modification that Decreases Scope

Entity B has a 10-year lease on 5,000 square metres of office space with annual payments of CU 50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable. At the beginning of Year 6, Entity B and the lessor agree to reduce the lease to 2,500 square metres and reduce the remaining payments to CU 30,000 a year. At the beginning of Year 6, Entity A's incremental borrowing rate is 5%.

Assessment

The modification is a decrease in scope from the original contract so the lease liability and right-of-use asset must be remeasured.

The lease liability immediately prior to the modification is CU 210,618 and the right-of-use asset is CU 184,002.

The scope of the decrease in the right-of-use asset is 50%, as the leased space has decreased from 5,000 square metres to 2,500.

Present value of years 6-10 (5 years), CU 30,000 a year, 5% discount = CU 129,884

Entry required to adjust the carrying balances to reduce scope (Step 1):

Dr		Lease liability	CU 105,309		(CU 210,618 original x 50%)
	Cr	Right-of-use asset		CU 92,001	(CU 184,002 original x 50%)
	Cr	Gain		CU 13,308	(remainder)

Entry required to adjust lease liability to the required revised balance of CU 129,884 (Step 2):

Dr		Right-of-use asset	CU 24,575		(corresponds to liability adjustment)
	Cr	Lease liability		CU 24,575	(CU 210,618 - CU 105,309 + CU 24,575 = CU 129,884)

BDO comment

There are two consequences arising from the required accounting for lease modifications that reduce the scope of the lease, but not the lease term itself, that may seem counterintuitive:

- *Firstly, a lease modification that reduces the amount(s) of assets being leased will often result in a gain. This is because at any point in time a lease liability will generally be greater than the leased asset as higher interest charges in the earlier years of the lease result in the lease liability being reduced at a lower rate than the straight line depreciation charge that is typically applied to the right-of-use asset. As the adjustment in Step 1 results in the pre-modification carrying amounts of the right-of-use asset and lease liability being reduced by the same proportion, generally more of the lease liability will be derecognised than the right-of-use asset. This may not be the case if the right-of use asset is not being depreciated on a straight-line basis or the majority of lease payments prior to modification were paid in advance and the reduction in scope was not resulting in a refund of those advance payments;*
- *Secondly, the gain will be the same irrespective of the amount by which future lease payments are being modified. This is because it is Step 2 which ensures the carrying amount of the liability reflects the present value of future lease payments, which is only adjusted against the right-of-use asset. No gain or loss arises from Step 2.*

The accounting for this type of lease modification reflects that the reduction in scope was effected for nil consideration with total future lease payments being recognised as an expense over the remaining term of the lease. Consequently, any change in the lease cost that relates to future periods will be reflected in depreciation and interest expenses in those future periods. This timing of expense recognition is therefore similar to how changes in operating lease expenses arising from a modification if an operating lease would have been presented under IAS 17, albeit that under IFRS 16 the future expense is presented as amortisation and interest charges, and not a single operating lease expense.

For modifications that reduce the lease term, whether a gain or loss is recorded will depend on a number of factors, in particular the point at which in the original lease term the reduction takes place. This is because the reduction in the right-of-use asset will typically be calculated on a straight line basis, while the reduction in the lease liability will be equivalent to the discounted present value of lease payments that are being eliminated.

Example 35b – Lease Modifications that Reduce the Lease Term Only

In contrast to Example 35a, this example demonstrates how a lease modification is accounted for when the only change is a reduction in the lease term.

Entity B has a 10-year lease of 5,000 square metres of office space with annual payments of CU 50,000 payable at the end of each year. The rate used to discount the payments due is Entity B's incremental borrowing rate of 6% as the rate implicit in the lease is not readily determinable. At the beginning of Year 6, Entity B and the lessor agree to reduce the lease term to 8 years in total (3 years remaining as of the beginning of Year 6). At the beginning of Year 6, Entity A's incremental borrowing rate is 5%.

Assessment

The modification is a decrease in scope from the original contract so the lease liability and right-of-use asset must be remeasured.

The lease liability immediately prior to the modification is CU 210,618 and the right-of-use asset is CU 184,002.

The remeasurement takes place with two steps:

– Step 1 – Remeasure based on the decrease in scope (i.e. the decrease in the lease term)
– Step 2 – Remeasure based on the change in discount rate.

Step 1 – Remeasurement for Decrease in Scope

Dr		Lease liability	CU 76,967[1]	
	Cr	Gain		CU 3,366[2]
	Cr	Right-of-use asset		CU 73,601[3]

[1] The lease liability is remeasured as the difference between its carrying value immediately prior to the modification (CU 210,618) and its carrying value based on the revised, shorter lease term, using the original interest rate. The remeasurement related to the change in the discount rate is reflected in Step 2. Three payments of CU 50,000 occurring in arrears, discounted at 6% (the original discount rate) equals CU 133,651. CU 210,618 less CU 133,651 results in a remeasurement of CU 76,967.

[2] The gain is the difference between the adjustment to the lease liability and right-of-use asset (i.e. the balancing entry).

[3] The right-of-use asset is remeasured based on the change in scope of the lease. As the remaining lease term has been reduced from 5 years to 3 years, the reduction in scope is calculated as the carrying value of the right-of-use asset immediately prior to the modification (CU 184,002) / 5 x 3.

Step 2 – Remeasurement for the Change in Discount Rate

Dr		Right-of-use asset	CU 2,511[4]	
	Cr	Lease liability		CU 2,511[5]

[4] The right-of-use asset is adjusted at an amount equal to the lease liability.

[5] After Step 1, the revised carrying value of the lease liability is its original carrying value (CU 210,618) less the remeasurement of CU 76,967, resulting in a revised value of CU 133,651. The lease liability now needs to be remeasured to reflect the change in the lessee's incremental rate of borrowing, as the adjustment of CU 76,967 was calculated using an unchanged discount rate. Three payments of CU 50,000 occurring in arrears, discounted at 5% equals CU 136,162. The difference between the revised lease liability of CU 136,162 and the previous value of CU 133,651 is CU 2,511.

BDO comment

In contrast to Example 35a, in which the scope of the lease was decreased by the number of square feet occupied being reduced, Example 35b reduces the scope of the lease by only reducing the remaining lease term. This difference creates a different result in profit or loss, as a reduction in the lease term may result in a gain or a loss, whereas a reduction in scope other than the lease term will often result in a gain.

A reduction in lease term may result in a gain or a loss because of the difference in how the lease liability and right-of-use asset are remeasured in Step 1 of the 2-step remeasurement process.

The right-of-use asset is remeasured based on the proportion of the previous carrying value that will remain, based on straight line amortisation. In this example, the revised, remaining lease term is 3 years instead of the original 5, therefore 2/5th of the previous carrying value of the right-of-use asset is eliminated. However, the lease liability is remeasured to eliminate the present value of lease payments that are no longer payable due to the reduction in lease term (discounted at the lessee's original incremental borrowing rate).

6. PRESENTATION

The requirements for the presentation of lease balances and transactions are summarised as follows:

Statement of Financial Position	Statement of Profit and Loss	Statement of Cash Flows
– Right-of-use assets: present in its own line item or combine with property, plant and equipment, with separate disclosure.* – Lease liabilities: present separately or include with other liabilities and disclose which line item they have been included.	– Interest expense with other finance costs. – Amortisation of right-of-use assets.**	– Cash payments of lease liabilities as financing activities. – Cash payments for interest in accordance with IAS 7's requirements for interest paid. – Short-term, low-value and variable lease payments within operating activities.

* *Right-of-use assets that meet the definition of investment property are required to be grouped with investment property.*

** *IFRS 16 does not require separate presentation of amortisation expense of right-of-use assets on the face of the income statement, nor does it mandate which line item the amortisation expense should be included (which will in part be driven by whether the entity presents its expenses 'by function' or 'by nature'). However, the expense does need to be disclosed by class of underlying assets in the notes.*

IFRS 16.47(a)(i) states that if an entity wishes to group right-of-use assets with other assets, they must be grouped 'within the same line item as that within which the corresponding underlying assets would be presented if they were owned'. As an exception to this requirement, if a right-of-use asset meets the definition of investment property under IAS 40, then the asset must be presented within the same line item as other investment property (i.e. not combined with other right-of-use assets that do not meet the definition of investment property).

For example, if a lessee had a right-of-use asset relating to a lease of heavy equipment, that right-of-use asset would be grouped with property, plant and equipment in the statement of financial position, unless the lessee elects to present right-of-use assets as a separate line item. Right-of-use assets are not aggregated with intangible assets on the face of the statement of financial position.

The presentation requirements of IFRS 16 represent a fundamental change from those in IAS 17 as a result of leases previously classified as operating leases having to be recognised on balance sheet. Whereas the lease expense would have been charged in full as an operating expense, some of the expense will now be presented as a finance charge on the lease liability. The balance of the charge, amortisation of the right-of-use asset, will still be charged in arriving at operating profit but will, along with depreciation of property, plant and equipment, be categorised as a non-cash expense.

BDO comment

The presentation requirements may shift key metrics for entities significantly. EBITDA (earnings before interest, taxes, depreciation and amortisation) is often a key measure of short-term profitability for many industries and entities.

The pattern of overall expenses being recognised in profit or loss will also change. See the example below for the effect on an entity with a typical real estate lease.

Example 36 – Illustration of Effect on Profit and Loss for Leases Previously Classified as Operating

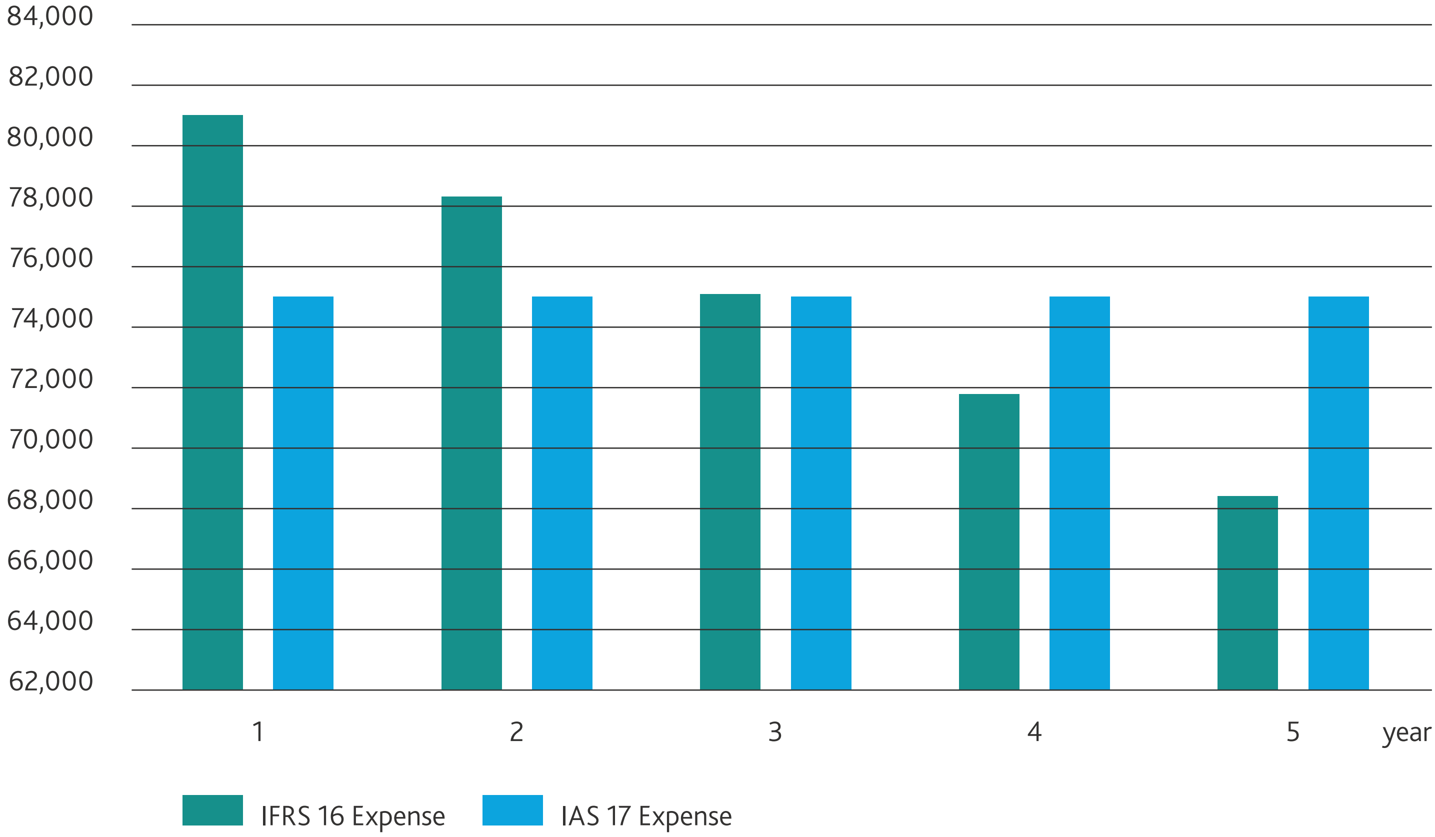
Entity C has a 5-year lease for the floor of an office building. It pays CU 75,000 a year and has an incremental borrowing rate of 5% (the rate implicit in the lease is not readily determinable). The table below illustrates the impact on net income and EBITDA depending on whether IAS 17 or IFRS 16 is used to account for the lease. Assume the entity has no other transactions other than CU 100,000 of sales in each year.

	IAS 17				IFRS 16			
	Amortisation	**Interest**	**Operating Cost**	**Net income**	**Amortisation**	**Interest**	**Operating Cost**	**Net income**
Year 1	-	-	75,000	25,000	64,942	16,235	-	18,823
Year 2	-	-	75,000	25,000	64,942	13,297	-	21,761
Year 3	-	-	75,000	25,000	64,942	10,212	-	24,846
Year 4	-	-	75,000	25,000	64,942	6,972	-	28,086
Year 5	-	-	75,000	25,000	64,942	3,571	-	31,487
Total	**-**	**-**	**375,000**	**125,000**	**324,711**	**50,289**	**-**	**125,000**

As illustrated, the net income for the entire 5 year period does not change, but the timing of expense recognition is faster in IFRS 16 since the financing element (interest) is higher at the beginning of the lease and reduces over time. The more significant difference is the calculation of EBITDA:

	IAS 17	IFRS 16
	25,000	100,000
Year 2	25,000	100,000
Year 3	25,000	100,000
Year 4	25,000	100,000
Year 5	25,000	100,000
Total	**125,000**	**500,000**

Total IFRS 16 and IAS 17 Expense Compared



BDO comment

IFRS 16 results in significantly higher EBITDA than under IAS 17, as all components of the expenses relating to the leases (amortisation and interest expense) are added back, thus increasing EBITDA.

Entities may need to revisit bonus arrangements, earn outs, covenants and regulatory calculations, while financial statement users' methods of analysing results may need to be updated.

7. DISCLOSURE

IFRS 16 has extensive disclosure requirements for lessees in both qualitative and quantitative form. Quantitative disclosure requirements by primary statement include:

Quantitative Disclosure Requirements		
Statement of Financial Position	**Statement of Profit and Loss**	**Statement of Cash Flows**
– Additions to right-of-use assets. – Carrying value of right-of-use assets at the end of the reporting period by class. – Maturity analysis of lease liabilities separately from other liabilities based on IFRS 7 *Financial Instruments: Disclosures* requirements.	– Depreciation for assets by class. – Interest expense on lease liabilities. – Short-term leases expensed.* – Low-value leases expensed.* – Variable lease payments expensed. – Income from subleasing. – Gains or losses arising from sale-and-leaseback transactions.	– Total cash outflow for leases.

* *These disclosures need not include leases with lease terms of one month or less.*

IFRS 16 requires that the quantitative disclosures should be presented in a tabular format, unless another format is more appropriate. To the extent amounts are included in the carrying amount of other assets (e.g. interest on lease liabilities capitalised into the cost of inventory), this must also be disclosed.

Other disclosure requirements include:

- For right-of-use assets that meet the definition of investment property, the disclosure requirements of IAS 40, with a few exclusions.
- For right-of-use assets where the revaluation model has been applied, the disclosure requirements of IAS 16.
- Where the short-term and/or low-value lease exemptions has been used, that fact as well as the amount of short-term lease commitments, if the portfolio of short-term leases that gave rise to the current period expense is dissimilar to the portfolio of short-term leases to which the lessee is committed at the end of the reporting period.

Qualitative Disclosure Requirements

- A summary of the nature of the entity's leasing activities;
- Potential cash outflows the entity is exposed to that are not included in the lease liability, including:
  - Variable lease payments;
  - Extension options and termination options;
  - Residual value guarantees; and
  - Leases not yet commenced to which the lessee is committed.
- Restrictions or covenants imposed by leases; and
- Information about sale-and-leaseback transactions.

BDO comment – Disclosure Initiative

In line with the IASB's focus in other standards requiring disclosure of the most relevant information rather than simply a prescriptive list, IFRS 16 similarly contains an overarching requirement for an entity to provide information to enable users to understand the impact that leasing transactions have on its financial position and performance. The disclosure requirements as prescribed by the standard may not meet this objective by themselves. Determining the appropriate level of disclosure is a matter of judgment and may be complex for entities with significant or unusual leases.

In addition, the disclosure requirements should be viewed in light of the IASB's Disclosure Initiative project. The initiative aims to reduce unnecessary disclosure and improve the overall quality of financial statements by highlighting the most relevant information to users and not disclosing information that is immaterial or irrelevant. An entity with very few, straightforward and relatively low-value leases may consider certain of the disclosures required by IFRS 16 to be immaterial.

8. LESSOR ACCOUNTING

The accounting requirements in IFRS 16 for lessors are unchanged in most respects from IAS 17. Leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases. All other leases are operating leases.

BDO comment

The IASB acknowledges there is asymmetry in lessee and lessor accounting under IFRS 16. For leases that are classified as operating leases by the lessor, the lessee will also recognise an asset for the same underlying asset in its statement of financial position: the lessor the actual asset and the lessee a right-of-use of that asset. However, feedback received during the project indicated that, ultimately, a symmetrical approach to lessee and lessor accounting was not necessary. Lessor accounting under IAS 17 was well understood and most users of financial statements did not adjust the financial statements of lessors for the effects of leases, indicating that the lessor accounting model in IAS 17 provided the information that they required. Consequently, the IASB concluded that the costs associated with making changes to lessor accounting at this point would be difficult to justify, and therefore decided substantially to carry forward the lessor accounting model in IAS 17.

The areas that may affect lessors are those where IFRS 16 expands guidance or provides guidance on issues not previously addressed in IAS 17, such as:
- The new definition of a lease (see Section 3.);
- Clarification that variable payments that depend on an index or a rate are factored in to the definition of lease payments, and so could impact the assessment as to whether the present value of the lease payments amounts to substantially all of the fair value of the underlying asset for the purposes of classifying a lease as a finance lease or operating lease;
- Revised sale-and-leaseback guidance (see Section 9.);
- Separation of lease and non-lease components in a contract (see below);
- Sub-lease guidance (see below);
- Lease modifications (see Section 8.3.);
- Guidance on lease modifications (see below); and
- Enhanced disclosure requirements (see below).

8.1. Separation of Lease and non-Lease Components

Unlike lessees, lessors do not have an option to account for a contract that contains both a lease and non-lease component as a single lease. Lessors must use the principles within IFRS 15 for allocating consideration to components of a contract.

This may result in significantly different outcomes than if the entire contract were within the scope of IFRS 15. For example, IFRS 15 contains specific guidance on variable consideration, where variable consideration should be included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved ('the variable consideration constraint').

Variable payments under a lease classified as an operating lease for a lessor would typically be included in income as the contingency is resolved.

Therefore, determining whether a contract is in the scope of IFRS 15, IFRS 16 or partially within both standards, may significantly alter the pattern of revenue recognition. It should be noted that separation is required even if it only affects presentation and disclosure. Disaggregation of different revenue streams is required by IFRS 15 and 16.

8.2. Sub-Leases

A lessee may become an intermediate lessor if it sub-leases an asset it in turn leases from another lessor (the 'head lessor'). An intermediate lessor assesses whether the sub-lease is a finance or operating lease in the context of the right-of-use asset being leased, not the actual underlying asset.

Example 37 – Sub-Lease Assessment

An intermediate lessor enters into a 5 year lease for 5,000 square metres of office space (the head lease) with Entity A (the head lessor).

At the beginning of Year 3, the intermediate lessor subleases the 5,000 square metres of office space for the remaining three years of the head lease to a sub-lessee.

Assessment

From the intermediate lessor's perspective, at the time the sub-lease is entered into, the right-of-use asset has a remaining economic life of 3 years, and it is being sub-leased for the entirety of that period. As the sub-lease is for all of the remaining useful economic life of the right-of-use asset the sub-lease is classified as a finance lease, even though 3 years is unlikely to be the full remaining useful economic life of the underlying property.

BDO comment

Sub-leases may result in right-of-use assets being classified as finance leases from the perspective of the intermediate lessor while being classified by the head lessor as operating leases. In the example above, the underlying asset is real estate, which would typically be classified as an operating lease by the head lessor since most real estate leases do not transfer substantially all of the risks and rewards of ownership.

However, because the asset held by the intermediate lessor is a right-of-use asset with a much shorter useful economic life, the classification of the sub-lease by the intermediate lessor may differ from that of the head lessor.

Assessing whether a sub-lease is a finance or operating lease may be more difficult in situations where the whole asset is not sub-leased (e.g. a portion of real estate for a portion of the head lease term).

When a head lease is short-term and the intermediate lessor takes advantage of the related practical expedient not to recognise short-term leases in its statement of financial position in its capacity as a lessee, the intermediate lessor must classify the sub-lease as an operating lease.

In summary, the accounting treatment required for a sub-lease depends on its classification by the intermediate lessor as follows:

Finance leases	– Derecognise the right-of-use asset (1) and recognise instead a lease receivable equal to the net investment in the sub-lease (2);* – Recognise the difference between (1) and (2) as a gain or loss in the income statement; – Retain the previously recognised lease liability in capacity as lessee and recognise interest expense thereon; and – Recognise interest income on the lease receivable in capacity as finance lessor.
Operating leases	– Retain the right-of-use asset in capacity as lessee and continue to recognise depreciation thereon; – Retain the lease liability in capacity as lessee and continue to recognise interest expense thereon; – Recognise lease income from the sub-lease in capacity as operating lessor.

* *A lessor uses the interest rate implicit in the lease to measure the net investment in the sublease. If the interest rate implicit in the sublease cannot be readily determined, the intermediate lessor may use the discount rate used for the head lease, adjusted for any initial direct costs associated with the sublease.*

8.3. Lease Modifications

The accounting for lease modifications depends on whether the lease is classified as a finance lease or an operating lease from the lessor's perspective immediately prior to the modification.

8.3.1. Finance Leases

Modifications – Separate Leases

A finance lessor needs to consider the same criteria as the lessee when the contract is modified. Therefore, a modification to a lease classified as a finance lease is accounted for as a separate lease if both:

– 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 standalone price for the increase in scope.

If both criteria are met, a lessor would follow the lessor guidance on recognition and measurement of that separate lease.

Modifications – Not Separate Leases

If a modification to a finance lease does not meet both of the above criteria, the lessor follows the following guidance:

Applying the modified contract from inception, the lease would have been classified as an operating lease	– Account for the lease modification as a new lease from the effective date of the modification; and – Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
All other lease modifications	– Apply the requirements of IFRS 9 *Financial Instruments*.

The remeasurements above occur on the inception date of the lease modification on a prospective basis.

8.3.2. Operating Leases

Any modification to a lease contract that was classified as an operating lease results in the modified contract being accounted for as a new lease from the date of modification. Any debtor or deferred rental income that is on balance sheet in respect of the original lease at the modification date is considered to be part of the lease payments for the new lease.

Therefore, if the modified lease contract is also classified as an operating lease, no adjustment is made to the carrying value of the leased asset, although the period over which it is depreciated may change. The period over which any previously recognised debtor (relating to accrued rents received) is settled or deferred income (relating to rents received in advance) released to the income statement may also change.

If the modified lease contract is classified as a finance lease, then the asset being leased is derecognised and a receivable recognised instead equal to the net investment in the lease.

8.4. Disclosure Requirements

Disclosure requirements for lessors are summarised as follows:

Quantitative Disclosure Requirements

Finance leases	– Selling profit or loss; – Finance income on the net investment; – Income from variable lease payments; – Qualitative and quantitative explanation of changes in the net investment; and – Maturity analysis of lease payments receivable.
Operating leases	– Lease income, separately disclosing variable lease payments; – Disclosure requirements of IAS 16 for leased assets, separating leased assets from non-leased assets; – Other applicable disclosure requirements based on the nature of the underlying asset (eg. IAS 36, 38, 40, 41); and – Maturity analysis of lease payments.

The standard requires the quantitative disclosures to be presented in a tabular format, unless another format is more appropriate.

Qualitative Disclosure Requirements

Similar to the lessee disclosure requirements, IFRS 16 requires a lessor to disclose additional qualitative information about its leasing activities in order to provide users with a basis for assessing the impact on the financial statements from lease contracts.

This disclosure would include the nature of the lessor's leasing activities and how the lessee manages risks associated with those activities, including risk management on rights retained in underlying assets and risk management strategies including:

- Buy-back agreements;
- Residual value guarantees;
- Variable lease payments for excess use; and
- Any other risk management strategies.

9. SALE-AND-LEASEBACK TRANSACTIONS

In a sale-and-leaseback transaction ('SALT'), an entity (seller-lessee) sells an asset to another entity (buyer-lessor) who then leases it back to the seller-lessee. The seller-lessee can thereby immediately receive liquid funds from the buyer-lessor and still keep its right to use the asset sold through the leaseback side of the contract. Often the fair value of the asset is greater than its book value, and so entering into a SALT can result in an accounting profit being recognised.

The accounting for a SALT under IFRS 16 is significantly different to that required by IAS 17. Under IAS 17 a lessee defers the gain on the sale side of the transaction if the resulting leaseback is classified as a finance lease. If the resulting leaseback is classified as an operating lease, however, the gain could be recognised in full if the proceeds on the sale side of the transaction are equal to the asset's fair value, otherwise it would be deferred and spread over the lease term.

In order to determine the appropriate accounting treatment under IFRS 16, the sale must first be assessed as to whether it qualifies as a sale in accordance with the requirements of IFRS 15 (please refer to BDO's IFRS In Practice publication on IFRS 15).

BDO comment

If the underlying lease in a SALT would be classified as a finance lease by the buyer-lessor, it is unlikely that the transaction would satisfy the conditions in IFRS 15 (i.e. it is likely that control would not have passed). However, the indicators used to assess whether a lease is operating or finance focuses on risks and rewards rather than control (which is the criterion in IFRS 15).

Despite this distinction, it would be unusual for a SALT to satisfy the control criteria in IFRS 15 if the resulting lease transferred substantially all of the risks and rewards to the seller-lessee. However, in very limited circumstances a transaction may satisfy the control criteria in IFRS 15, but nonetheless be classified as a finance lease (for example, in a situation where the lease is classified as a finance lease due to the underlying asset being of a highly specialised nature (IFRS 16.63(e))).

	Lessee (seller)	Lessor (buyer)
Transfer to buyer-lessor qualifies as a sale	– Derecognise underlying asset and apply lessee accounting requirements. – Measure right-of-use asset as the retained portion of the previous carrying value. – Recognise gain/loss on the rights transferred to the lessor.	– Apply applicable IFRS to the asset purchased and lessor accounting requirements to the lease contract.
Transfer to buyer-lessor does not qualify as a sale	– Continue recognition of asset. – Amounts received are recognised as a financial liability under IFRS 9 *Financial Instruments*.	– Asset purchased is not recognised. – Amounts paid are recognised as a financial asset under IFRS 9 *Financial Instruments*.

If the sale side of the transaction does qualify as a sale under IFRS 15, similar to IAS 17 it is necessary to consider whether the sales price as stated in the contract is equal to the asset's fair value. In an arm's length transaction it is highly likely that the totality of the sale-and-leaseback transaction is on-market. However, this does not prevent the consideration received on the sale side of the contract being off market, with compensating off-market lease payments on the leaseback side of the transaction. Therefore, IFRS 16 requires the profit or loss on the sale side of the transaction from the lessee's perspective (and initial measurement of the asset purchased from the lessor's perspective) to be determined by reference to the fair value of the asset, not the stated contractual sale price. Consequently, lessees need to determine the fair value of the asset in order to ensure they recognise the correct profit or loss on sale (as do lessors for the purposes of accounting for the cost of the asset) rather than assuming the asset's fair value equals the stated contractual sales price.

BDO comment

In determining the fair value of an asset in a SALT, there is uncertainty as to which of the requirements in IFRS a seller/lessee should follow in determining that fair value. While IFRS 13, Fair Value Measurement is typically the standard that provides guidance on the determination of fair value, IFRS 13.6(b) scopes out leasing transactions accounted for in accordance with IFRS 16. Fair value is defined in IFRS 16 itself, however, the definition of fair value in IFRS 16 is prefaced with 'for the purpose of applying the lessor accounting requirements in this Standard…'. Therefore, it is unclear which definition of fair value a seller/lessee should apply when applying the SALT guidance in IFRS 16.

In our view, since IFRS 16 refers to IFRS 15, Revenue from Contracts with Customers in determining whether the transfer of an asset is accounted for as a sale, and IFRS 15 is included in the scope of IFRS 13 for fair value measurement, a lessee should refer to IFRS 13 in applying the SALT guidance in IFRS 16.

If it is determined that the fair value of the asset is less than or greater than the contractual sales price, then the difference is accounted for by the lessee as additional borrowing or a prepayment, respectively. Similarly, the lessor accounts for the difference as rents receivable or deferred rental income, respectively, (if the leaseback is classified as an operating lease) or an adjustment to the finance lease receivable (if the leaseback is classified as a finance lease).

In some cases, it may be easier to compare the contractual leaseback rentals to market rentals rather than the contractual sales price to the fair value of the leased asset, in which case the standard also permits this approach when determining whether both sides of the SALT transaction are at open market rates.

As a further complication in the calculation of the lessee's profit or loss on disposal, it needs to be remembered that a seller-lessee does not transfer control of the whole asset to the buyer-lessor, because it continues to control the same asset during the leaseback period. It is only losing control of the asset subsequent to the leaseback period. Therefore, the seller-lessee's profit or loss on disposal will not simply be equal to the fair value of the asset less its carrying amount (as it may have been under IAS 17). Instead, it is the amount of consideration attributable to the portion of the asset for which control has passed to the buyer-lessor (i.e. monies received which do not have to be paid back to the lessor over the leaseback period) less the portion of the asset's carrying amount attributable to the period after the end of the leaseback and for which control has passed to the buyer-lessor.

Example 38 – Sale-and-leaseback transaction where transfer is a sale (lessee)

A seller-lessee enters into a sale-and-leaseback transaction whereby it sells a property to a buyer-lessor for CU 2,000,000. Simultaneously, the seller-lessee leases the property back from the buyer-lessor for a period of 18 years with annual lease payments at the end of each year of CU 120,000. The sale meets the criteria of IFRS 15 to be accounted for as a sale. There are no initial direct costs in the transaction. Before the transaction occurs, the property has a carrying value of CU 1,000,000.

The fair value of the property at the time of sale is CU 1,800,000. Since the consideration does not equal fair value, adjustments must be made to determine any gain or loss arising by reference to the asset's fair value. The excess consideration of CU 200,000 (CU 2,000,000 - CU 1,800,000) is therefore accounted for as additional financing provided by the buyer-lessor to the seller-lessee, not consideration on the sale side of the transaction.

The discount rate is 4.5% per annum determined by reference to the seller-lessee's incremental borrowing rate as the rate inherent in the lease is not readily determinable. The present value of the annual leaseback payments (18 payments of CU 120,000, 4.5% discount per annum) is CU 1,459,200.

Example 38 – Sale-and-leaseback transaction where transfer is a sale (lessee) (continued)

Assessment

The entry to record this transaction is as follows (see corresponding notes reconciling each component of the entry):

Dr	Cash	CU 2,000,000[1]	
Dr	Right-of-use asset	CU 699,555[2]	
Cr	PPE (the property sold)		CU 1,000,000[3]
Cr	Lease liability		CU 1,459,200[4]
Cr	Gain on rights transferred		CU 240,355[5]

1 Total cash received from the buyer-lessor.

2 The retained right-of-use of the asset sold is measured by reference to the previous carrying value of the property. The fair value of the property is CU 1,800,000, whilst the fair value of the leaseback rental is CU 1,259,000 (i.e. CU 200,000 less than the repayments that the lessee is required to make). Therefore, the cost of the property for which control has not passed to the buyer-lessor = CU 1,000,000 x CU 1,259,000/CU 1,800,000 = CU 699,355.

3 The previous carrying value of the property is derecognised.

4 Present value of future lease payments of CU 1,459,200 (CU 120,000 per year for 18 years, 4.5% annual discount). This includes the difference between the consideration received and the fair value of the property of CU 200,000 (CU 2,000,000 – CU 1,800,000). In other words, had proceeds on sale been on-market at CU 1,800,000, then the present value of the leaseback payments would only have been CU 1,259,000. The proceeds above market on the sale side of the transaction are therefore treated as additional financing.

5 The gain on sale is the balancing entry in the transaction, but can be reconciled as follows:

Gain = Proceeds attributable to the portion of the asset for which control is transferred

LESS

Carrying value of the portion of the asset for which control is transferred

Proceeds attributable to the portion of the asset being disposed:

= Total proceeds less total amount of financing received

= CU 2,000,000 - CU 1,459,200

= **CU 540,800**

Carrying value of the portion of the asset being sold:

= Carrying value less right-of-use asset retained

= CU 1,000,000 - CU 699,555

= **CU 300,445**

Therefore gain on disposal:

= CU 540,800 - CU 300,445

= **CU 240,355**

BDO comment

The application of IFRS 16 results in a consistent treatment for SALTs by lessees. The accounting required by IAS 17 varied depending on whether the leaseback qualified as a finance or operating lease.

SALTs are common for transactions involving real estate, which normally resulted in the leaseback being classified as an operating lease by the seller-lessee under IAS 17. Due to the lessee having to exclude from the calculation of profit on disposal the total consideration attributable to the financing received, the accounting required by IFRS 16 will typically result in smaller gains on disposal when recognising the sale side of the transaction. Taking the same facts as the example above, IAS 17 would have resulted in a profit on the sale side of the transaction of CU 800,000 (total proceeds of CU 2,000,000 less CU 200,000 to be deferred less asset's carrying value of CU 1,000,000), which is significantly more than the CU 240,355 recognised under IFRS 16.

It should be noted that the carrying value of the asset being sold and leased back must be at its appropriate carrying amount following the application of other IFRSs prior to the SALT. For example, if land had a carrying value of CU 100,000 immediately prior to a SALT, where the sales price (at the fair value of the land) was CU 90,000, the seller would have to apply IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations prior to accounting for SALT. Applying IFRS 5.15, the seller would measure the land at the lower of its carrying amount and fair value less costs to sell. As the SALT is about to take place, the lower of carrying amount (CU 100,000) and fair value less costs to sell (CU 90,000 from the SALT) is CU 90,000, therefore, the land should be written down prior to the SALT accounting.

Example 39 – Sale-and-leaseback transaction with variable payments

Example 38 above illustrates how IFRS 16's requirements should be applied in circumstances where the lease payments in the SALT are fixed. However, applying the requirements becomes more complex when the underlying lease has variable payments that are not dependent on an index or rate.

For example, assume a seller-lessee enters into a SALT for one of its buildings with the following characteristics:

- Carrying value of the building immediately before the SALT of CU 2,000,000;
- Fair value of the building is CU 5,000,000;
- Sales price for the building is CU 5,000,000;
- The resulting lease has no fixed payments; lease payments are based on a percentage of sales revenue that will arise from the business activities that will be conducted in the building; and
- The remaining useful life of the building is 20 years and the lease term is also 20 years.

Assessment

IFRS 16.100(a) states:

> *The seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right-of-use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.*

Applying the guidance in illustrative Example 24 of IFRS 16 (which is similar to Example 38 in this publication), the proportion of the rights retained by the seller-lessee is the ratio of:

Rights retained = Discounted lease payments / Fair value of the underlying asset

In this example, the lease payments (as defined by IFRS 16) are zero, since there are no fixed payments; they are all variable lease payments not dependent on an index or rate. Applying this formula to this fact pattern:

Rights retained = Discounted lease payments / Fair value of the underlying asset

Rights retained = Nil / 5,000,000

Rights retained = Nil

If rights retained are nil, then the difference between the cash received (CU 5,000,000) and the derecognition of the building (CU 2,000,000) would be accounted for as a gain (CU 3,000,000).

In our view, this outcome is not consistent with the requirements in IFRS 16.100(a), since the calculation of the gain is meant to represent the rights transferred to the buyer-lessor. In this fact pattern, the entire remaining useful life of the building (20 years) will be used by the lessee, since the lease term is also 20 years.

Consequently, using the lease payments as a percentage of the fair value of the underlying asset is a reasonable way of determining the extent to which the rights have transferred if the payments are entirely fixed, but this calculation will not be appropriate for every scenario. Other methods of calculating the portion of rights transferred might include determining the portion of the asset's remaining useful life covered by the resulting lease.

10. EFFECTIVE DATE AND TRANSITION

IFRS 16 is effective for periods beginning on or after **1 January 2019**. Entities may early adopt the standard, but if they elect to do so, they must also adopt IFRS 15 as there can be significant interactions between the two standards.

Significant transitional exemptions and simplifications are available to entities.

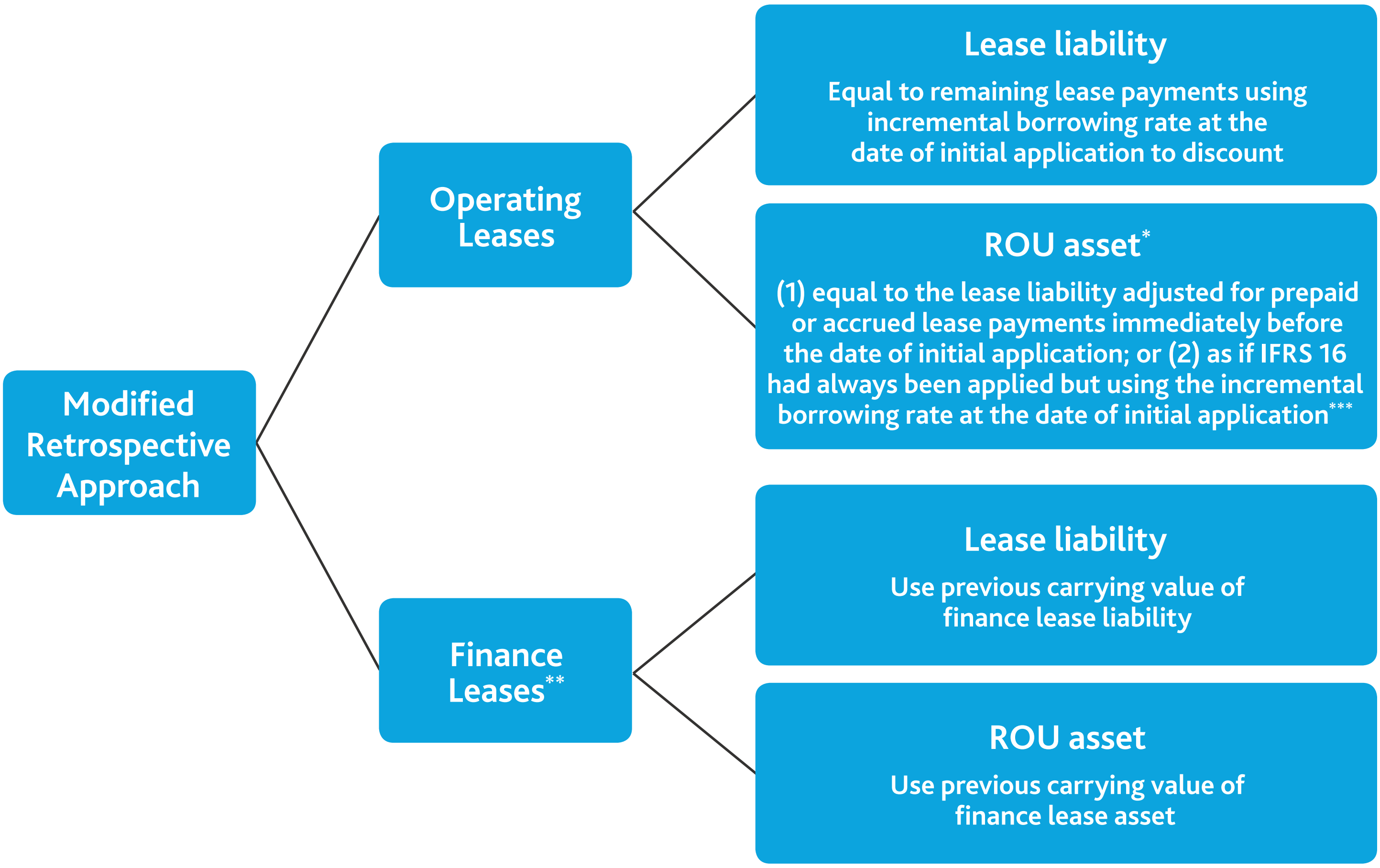
10.1. Retrospective Application Options – Lessees

An entity is permitted to follow one of two approaches in adopting IFRS 16: the **full retrospective approach** or the **modified retrospective approach**.

Full Retrospective Approach
This approach results in an entity applying IFRS 16 to all periods presented as if it had always been applied. Application of the full retrospective approach requires presentation of a third statement of financial position in accordance with IAS 1 *Presentation of Financial Statements*. Further, there is only limited transitional relief related to applying the definition of a lease as (discussed in Section 10.3.). This may lead entities to follow the modified retrospective approach instead as it provides for significantly more transitional relief and also does not require presentation of a third statement of financial position.

Modified Retrospective Approach
The modified retrospective approach does not require restatement of comparative periods. Instead the cumulative impact of applying IFRS 16 is accounted for as an adjustment to equity at the start of the current accounting period in which it is first applied, known as the 'date of initial application'.

The modified retrospective approach is summarised as follows:



BDO comment

* *The choice between options (1) and (2) may be made on a lease-by-lease basis. If option (2) is chosen, the rate to be used is the incremental borrowing rate as at the date of initial application of IFRS 16, not the commencement date of the lease. No adjustment is required to lease assets previously accounted for as investment property under the fair value model in IAS 40.*

** *On transition, the issue arises as to whether leases accounted for as finance leases under IAS 17 must use the above-noted transition guidance (i.e. bring forward the existing 'on balance sheet' accounting), or whether finance leases that could be classified as low-value leases may follow that recognition exemption once IFRS 16 is adopted. For example, if a lessee had 1,000 laptop computer leases that were classified as finance leases under IAS 17, the issue is whether those leases can be taken 'off balance sheet' if the lessee chooses an accounting policy of using the low-value lease exemption under IFRS 16, despite the transition guidance noted above. In our view, the low-value and short-term lease exemptions are 'gating' type assessments, where leases are assessed under an entity's accounting policy for the scope of IFRS 16 prior to applying the transition requirements of the new standard. Consequently, finance leases recorded in accordance with IAS 17 for leases that qualify for the low-value exemption under IFRS 16 need not be accounted for 'on balance sheet' upon transition to IFRS 16 if the low-value lease exemption is utilised. It should be noted that the low-value lease exemption is available on a lease-by-lease basis, meaning that entities are permitted to apply the exemption to some, but not all, low-value leases and not simply to all or none of them.*

For leases classified as finance-type under IAS 17 where the low-value or short-term lease exemption is not applied on transition, the asset and liability determined under IAS 17 is 'brought forward' as at the date of initial application. Under IAS 17, certain payments may not have been included in the measurement of the asset and lease liability because IAS 17 was unclear. For example, payments based on movement in CPI or inflation may have been accounted for as contingent rentals, and therefore expensed as incurred under IAS 17. This raises the question as to how these types of payments are accounted for on transition to IFRS 16, where clear guidance is provided. In our view, the transitional requirements of IFRS 16 for finance leases under the modified retrospective approach should be applied as a rule (i.e. carrying value of assets and liabilities are brought forward unmodified). A 'day 2' adjustment may then occur to remeasure the lease because, for example, the lease contains payments links to CPI or inflation that had never previously been included the measurement of the lease.

*** *For leases acquired in a business combination prior to the date of initial application of IFRS 16, the question arises as to whether the guidance to recognise the right-of-use asset 'as if IFRS 16 had always been applied' means the commencement date of the lease should be that of the previous acquiree's original lease commencement date (which will be prior to the date of the business combination) or the date of the business combination itself. In our view, since the lease did not exist from the perspective of the reporting entity (the acquirer), the right-of-use asset should be measured based on the commencement date being the date of the business combination.*

*** *Prior to the effective date of IFRS 16, entities may have recognised asset retirement obligations ('AROs') relating to operating leases. For example, there might be a requirement for the lessee to remediate leased space at the end of a lease term. Prior to IFRS 16, the cost of this ARO would typically be capitalised as a component of property, plant and equipment under IAS 16. For new leases entered into after the date of transition to IFRS 16, these costs would be included in the measurement of the ROU asset (see Section 5.3.). On transition to IFRS 16 using the modified retrospective approach with the ROU asset measured at an amount equal to the lease liability (adjusted for accrued and prepaid lease payments), applying the transitional provisions literally would result in the cost of the previously recognised ARO remaining in the leasehold improvement's carrying value. This is because the transitional provisions are written as a rule, where the ROU asset is measured equal to the lease liability, only adjusted for accrued and prepaid lease payments. In our view, it would be acceptable either to continue to record the asset within leasehold improvements, or to reclassify the carrying amount of the asset relating to the ARO as an addition to the underlying ROU asset, as this would not result in a different pattern of amortisation over the remaining term.*

BDO comment

The modified retrospective approach may initially seem significantly simpler than the full retrospective approach simply because there is no need to restate comparatives. However, lessees still need to calculate how much to bring on balance sheet on the date of initial application for lease liabilities and, if the option to recognise at the same value as the lease liability is not taken, a separate calculation will be needed to determine the initial measurement of right-of-use assets on that date.

The main reason the modified retrospective approach is simpler is because it provides for more practical expedients (see below). However, current period financial statements will not be comparable with the prior period financial statements as the comparatives are not being restated and, therefore, the financial statements will be potentially less relevant and useful. Preparers should consult with relevant financial statement users and those charged with governance to assist them in determining which approach to transition is most suitable for their needs.

Other Disclosures – Modified Retrospective Approach

A lessee that follows the modified retrospective approach must comply with the disclosure requirements of Paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (earnings per share impact and the amount of the adjustment to each financial statement line item affected), as well as disclosing (IFRS 16.C12):

- The weighted average incremental borrowing rate applied to lease liabilities in the statement of financial position at the date of initial application;
- An explanation of the difference between:
  - Operating lease commitments disclosed under IAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application; and
  - Lease liabilities recognised in the statement of financial position at the date of initial application; and
- Which, if any, practical expedients were used.

BDO comment

Reconciling current and comparative year balance sheets

Under the modified retrospective approach comparative figures are not restated. This means that a lessee with a large portfolio of operating leases that were not recognised in the statement of financial position under IAS 17 in the comparatives for the year ended 31 December 2018 will recognise those leases in the statement of financial position for the first time on the date of initial application of IFRS 16 (i.e. 1 January 2019).

To assist users in understanding the adjustment to equity made on the date of initial application to bring the leases on the statement of financial position for the first time, IFRS 16 requires lessees to provide an explanation of any difference between the amount disclosed as operating lease commitments in accordance with IAS 17 as at 31 December 2018 and the amount of lease liabilities recognised on 1 January 2019. The primary reconciling items between these two figures would generally be the effects of:

- *Discounting: amounts included in the operating lease commitment note would not have been discounted;*
- *The assessment of renewal and termination options affecting the lease term as defined by IFRS 16, if different from the assessment made under IAS 17; and*
- *In-substance fixed payments: the lease commitment note may have considered only minimum lease payments.*

Entities will need to ensure that their IAS 17 disclosures for operating leases are accurate in accounting periods prior to adoption of IFRS 16 to avoid having to present a separate reconciling item in the year IFRS 16 is adopted for errors made in operating commitments disclosed in the preceding financial year.

The extent of the disclosure that is required to explain the difference between previously disclosed lease commitments and the opening lease liability as at the date of initial application will depend on the materiality of lease liabilities recognised. In instances where lease liabilities are not material, entities may determine that disclosure of the operating lease commitments discounted using the rate implicit in the lease or the lessee's incremental borrowing rate, together with a narrative explanation of the adjustment compared to previously disclosed lease commitments, is sufficient to meet this disclosure objective. For entities with significant differences between lease liabilities recognised and previously disclosed lease commitments, more detailed numerical disclosure in tabular format may be appropriate.

10.2. Practical Expedients – Modified Retrospective Approach

In applying the modified retrospective approach, several practical expedients are available for leases that were previously categorised as operating leases under IAS 17. On a lease-by-lease basis, a lessee may:

#1
Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.*

#2
Rely on its assessment of whether a lease is onerous by applying IAS 37 immediately before the date of initial application.**

#3
Not recognise leases whose term ends within 12 months of the date of initial application (use short-term lease accounting).***

#4
Exclude initial direct costs from the measurement of ROU assets at the date of initial application.

#5
Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

* *Practical expedient #1 is similar to the portfolio practical expedient that is available to entities at all times (see Section 3.), however, there are several differences. The ongoing practical expedient to apply the portfolio approach applies to more than the determination of the discount rate; it applies to all aspects of measurement, however, the ongoing practical expedient requires that an entity demonstrates that the application of the practical expedient would not result in a materially different result compared to applying IFRS 16 to the individual leases. While the practical expedient on transition to IFRS 16 only applies to the determination of the discount rate, it does not establish a requirement that entities must demonstrate that its application would not result in a materially different result. Therefore, while the practical expedient on transition to IFRS 16 relates to only one aspect of lease measurement (the discount rate), it may be more readily utilised, since entities may use the practical expedient for portfolios of leases with 'reasonably similar characteristics', which is a lower threshold than the ongoing portfolio practical expedient.*

** *Practical expedient #2 is provided as an alternative to applying IAS 36, Impairment of Assets at the date of initial application, which is a requirement if this practical expedient is not elected. If an entity applies IAS 36 instead of this practical expedient, an impairment calculation is only required if indicators of impairment exist, since the determination of the recoverable amount is only required in this case for assets other than indefinite life intangible assets and goodwill (IAS 36.9-10). If an impairment test is performed because indicators of impairment exist, in our view, the impairment test is performed at the level of the individual lease, unless it is not possible to estimate the recoverable amount of the individual lease. In this case, leases would be grouped using methodology similar to the guidance relating to cash-generating units (IAS 36.66). This may be the case in situations where certain leases do not generate cash flows independent of other leases (e.g. leases for many different pieces of equipment that operate together to produce inventory may need to be grouped together to determine impairment).*

*** *For lease contracts with tacit renewals (i.e. those that automatically renew with no action by the lessee or lessor), but which may be terminated by both parties at any time with no penalty (which, for the purposes of IFRS 16 would be both financial and economic), this practical expedient may be used if the period covered by each tacit renewal is 12 months or less. The lessee would continue to account for the lease 'off balance sheet'.*

BDO comment

The number of options available to lessees on transition to IFRS 16 are extensive due to the two different approaches and the range of practical expedients that are available. For lessees with significant lease portfolios, if the modified retrospective approach is to be used it may take a significant amount of work, effort and time to:

- *Determine which practical expedients should be used;*
- *Calculate the adjustments and amendments to systems and processes; and*
- *Draft the required disclosures.*

It would appear that the scope of practical expedient #2 is wide in that, provided an assessment of whether a lease was onerous under IAS 37 was carried out (regardless of whether an onerous lease provision was required), there is then no requirement to carry out an impairment test as at the date of initial application. For example, a retailer might have 100 stores and on the day immediately before the date of initial application of IFRS 16, having assessed those leases, conclude that 10 of these require a provision for an onerous lease. Although a provision has been made for only 10 leases, the practical expedient can be applied to all 100.

10.3. Definition of a Lease

IFRS 16 contains an option on transition for lessees to assess the existence of a lease using the definitions in either IFRS 16 or in IAS 17 and IFRIC 4 ('previous standards'). This option is available to all entities, regardless of which transitional approach they apply. The accounting implications of each option are as follows (an entity must apply its choice consistently):

IFRS 16	– **Reassess all leases using criteria in IFRS 16 as to whether they meet the definition of a lease within IFRS 16.**
Previous Standards	– **Apply IFRS 16 measurement guidance to contracts identified as leases under previous standards;** – **Do not apply IFRS 16 measurement guidance to contracts deemed to not meet the definition of a lease under previous standards;** – **Follow IFRS 16 guidance on the definition of a lease subsequent to the date of initial application.**

This practical expedient only applies to arrangements that were appropriately assessed under IAS 17 and IFRIC 4. If an entity was incorrect in its assessment of which arrangements met the definition of a lease prior to IFRS 16, this practical expedient does not relieve the entity from determining whether this assessment was correct.

Under the requirements of IAS 17, even if an entity incorrectly did not identify an arrangement as giving rise to a lease under IAS 17, there might not have been any significant effect on the underlying accounting. This is because if the lease should have been classified as an operating lease under IAS 17, the straight line pattern of expense recognition may have been identical to the expenses that were recognised by treating the arrangement as an executory service contract. However, the requirements of IFRS 16 mean that the accounting outcome from treating an arrangement as giving rise to a lease, or as an executory service contract, will typically be very different.

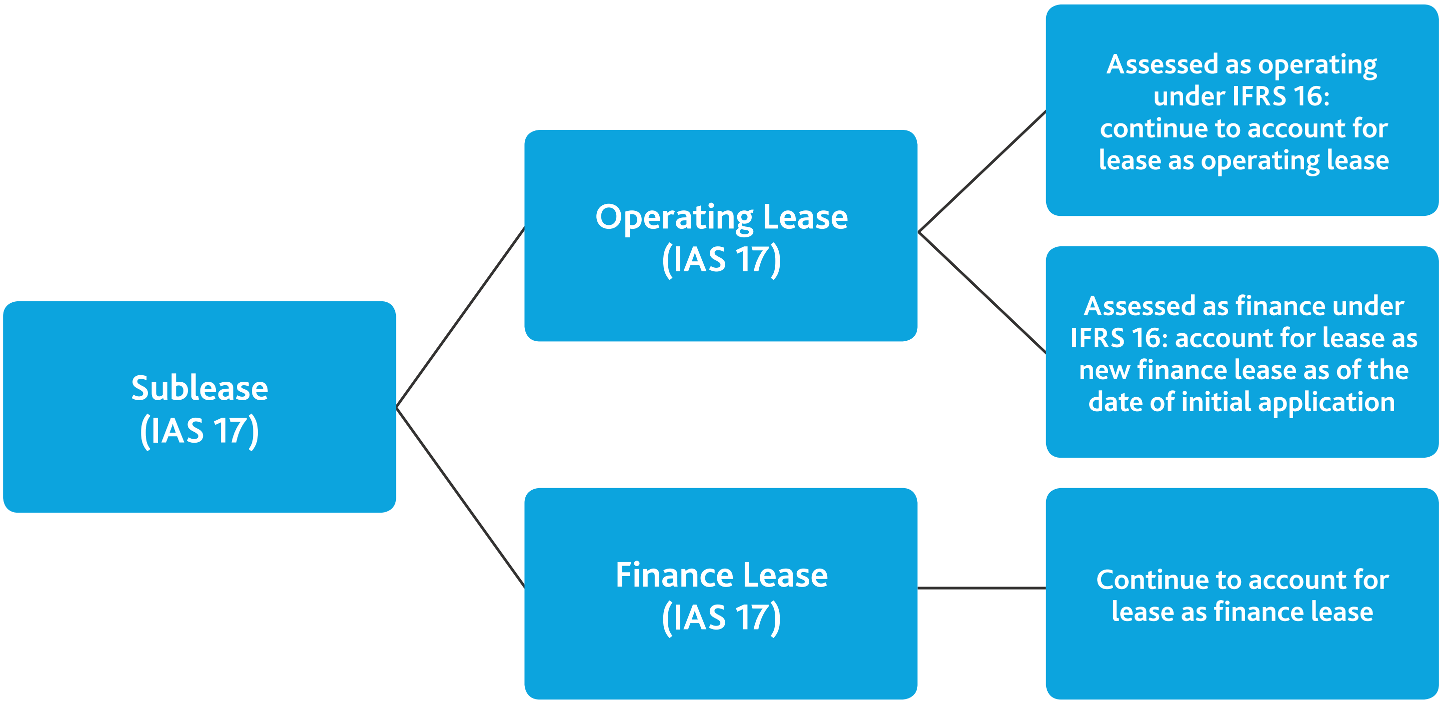
It is therefore necessary to determine whether additional arrangements should have been accounted for as giving rise to a lease prior to adoption of IFRS 16 and accounting for them appropriately on transition to IFRS 16.

10.4. Transition – Lessors

As discussed in Section 8., the impact of IFRS 16 on lessors is significantly less than for lessees. IFRS 16's transitional provisions do not require a lessor to make any adjustments for leases in which it is a lessor.

As IAS 17 contained limited guidance on subleases, transitional guidance is provided for intermediate lessors. An intermediate lessor must reassess on the date of initial application subleases that were classified as operating leases under IAS 17 to determine whether each sublease should be classified as operating or finance under IFRS 16. This assessment is made based on the remaining contractual terms as at the date of initial application and not as at the date when the sublease was first entered into.

The implications of this assessment are summarised as follows:



Example 40 – Sublease Classification and the Modified Retrospective Approach

Entity A leases a building from Entity B. This lease was classified as an operating lease under IAS 17, prior to the adoption of IFRS 16. Upon adoption of IFRS 16, Entity A elects to use the modified retrospective approach to transition and will measure the right-of-use asset at its carrying amount as if IFRS 16 had been applied since the commencement date. The right-of-use asset is measured as at the date of initial application as CU 100.

Entity A also sub-leases the entire building to Entity C. This sub-lease was accounted for as an operating lease under IAS 17 but, based on the guidance in IFRS 16, this sub-lease is determined to be a finance lease. Following the flowchart above (operating lease under IAS 17 -> finance lease under IFRS 16), Entity A accounts for the sub-lease at the date of transition to IFRS 16 as a new finance lease. As the lease is now accounted for as a finance lease under IFRS 16 at the date of initial application, Entity A must follow the guidance on finance lease accounting for sub-leases and derecognise the underlying right-of-use asset and recognise the net investment in the lease, while continuing to recognise the lease liability owing to Entity B. The net investment in the lease is determined to be CU 108.

The issue is where the difference between the derecognition of the right-of-use asset and the recognition of the net investment in the lease is recorded. To illustrate:

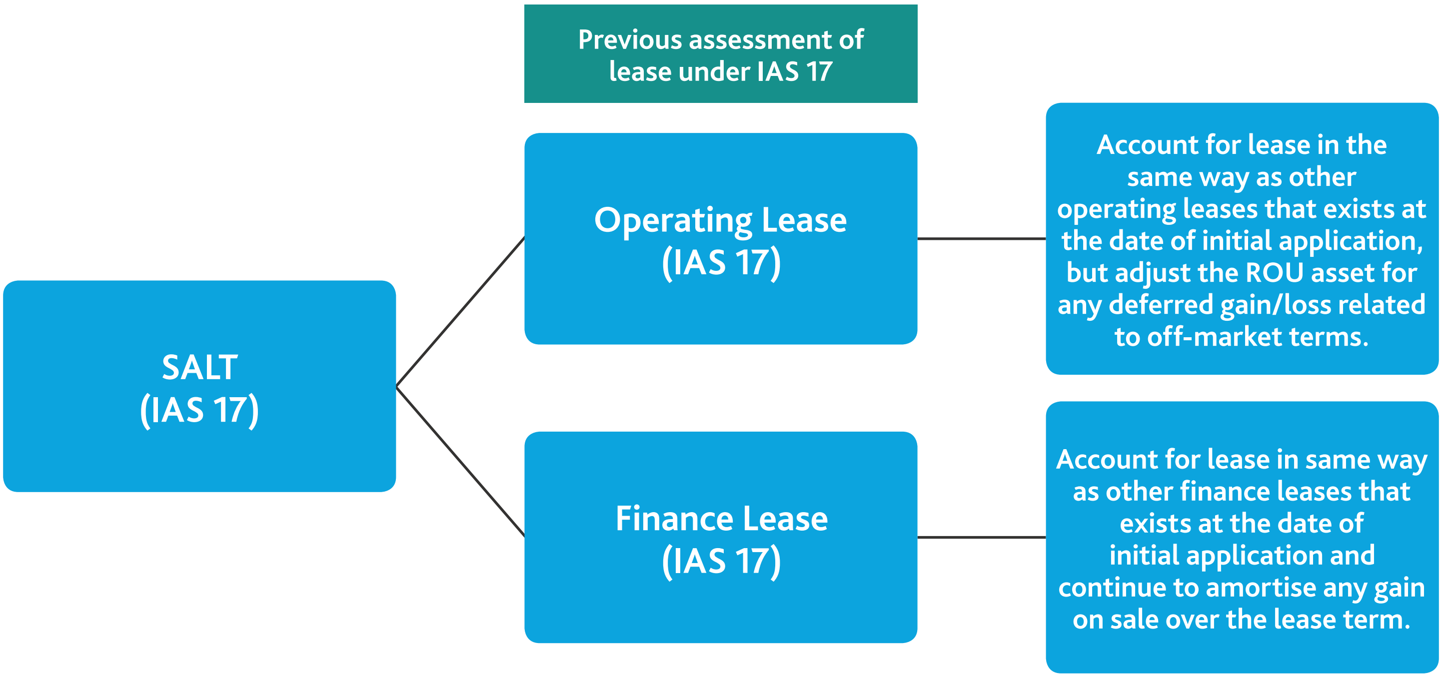
Dr		Net investment in the lease	CU 108	
	Cr	Right-of-use asset		CU 100
	Cr	??		CU 8

Assessment

In our view, the guidance in IFRS 16 on the application of the modified retrospective approach provides sufficient guidance in this scenario to record the balancing aspect of this entry in opening retained earnings (or another component of equity, as appropriate), as IFRS 16.C7 states that the cumulative effect of applying the modified retrospective approach is recorded in this manner.

10.5. Transition – Sale-and-Leaseback Transactions (SALTs)

The transitional provisions do not permit entities to reassess whether a SALT entered into before the date of initial application would qualify as a sale under IFRS 15. However, depending on the leaseback classification under IAS 17, transitional adjustments may be required by the seller-lessee. The requirements are summarised as follows:



BDO comment

Under the transitional provisions, leases that arose from SALTs are accounted for in an identical way to other leases that exist at the date of initial application, with other adjustments relating only to deferred gains and losses previously recognised under IAS 17.

Given that some leasebacks may have arisen on a sale-and-leaseback transaction first entered into many years ago the transitional provisions provide significant relief from full retrospective restatement. The specific transitional provisions in IFRS 16 for SALTS take precedence over the more general transition requirements for lessees. Consequently, when measuring the right-of-use asset upon transition to IFRS 16, an entity that has previously entered into sale-and-leaseback transactions before the initial date of application of IFRS 16 would not be permitted to measure the right-of-use asset at the proportion of the previous carrying amount of the asset that relates to the right-of-use retained by the seller-lessee. The transitional provisions for sale-and-leaseback transactions are expressed in absolute terms and not as options or exemptions.

10.6. Transition – Business Combinations

For leases acquired in business combinations prior to the date of initial application, an entity would apply the same transitional provisions as for other leases. In some cases, prior to the adoption of IFRS 16, an acquirer may have recognised assets and liabilities in relation to the acquiree's operating leases when, at the acquisition date, the lease was on favourable or unfavourable terms compared to the prevailing market rents. At the date of initial application, lessees are required to derecognise any remaining carrying amount of these assets and liabilities and adjust the carrying amount of right-of-use assets resulting from applying IFRS 16 by the corresponding amount.

10.7. Illustration of Transition Approaches

The calculations required to transition to IFRS 16, based on each of the three transitional approaches are as follows:

– Full retrospective approach: comparative figures are restated as if IFRS 16 had always been in effect.
– Modified retrospective approach #1: The right-of-use asset is recognised at the date of initial application as an amount equal to the lease liability, using the entity's prevailing incremental borrowing rate as at the date of initial application, adjusted for any prepaid or accrued lease payments relating to that lease that were recognised in the statement of financial position immediately before the date of initial application.
– Modified retrospective approach #2: Lease liability calculated in the same way as under modified retrospective approach #1. The right-of-use asset is recognised as at the date of initial application as if IFRS 16 had always been applied (but calculated as if the prevailing incremental borrowing rate as at the date of initial application also applied at lease commencement).

Example 41

Entity A enters into a 10 year lease for a piece of equipment on 1 January 2016 and in the process, incurs CU 500 of initial direct costs in the form of commissions, which were expensed under IAS 17. It will pay the lessor CU 1,500 per annum on 1 January of each year. The lease does not contain any termination, extension or purchase options. The rate implicit in the lease is 7%. Entity A's incremental borrowing rate as at 1 January 2019 is 5%. The lease was previously classified as an operating lease under IAS 17. The following additional assumptions are made:

– The contract meets the definition of a lease under both IAS 17 and IFRS 16;
– The lease does not meet the low-value or short-term lease exemptions under IFRS 16;
– Entity A has a calendar year-end, so IFRS 16 is effective as of 1 January 2019; and
– Entity A will use the cost model within IAS 16 to amortise the right-of-use asset.

The above facts are applied to each of the 3 approaches explained further in Sections 10.7.1., 10.7.2. and 10.7.3. below.

10.7.1. Illustration of Transition – Full Retrospective Approach

Under the full retrospective approach, Entity A is required to recognise the right-of-use asset and lease liability as if the standard had always been in effect, as well as restating comparative figures. The right-of-use asset and lease liability must be determined as at the opening balance sheet date for the comparative period (1 January 2018) as well as the date of initial application (1 January 2019). The process to adopt this approach can be summarised as follows:

– Step #1 **–** Calculate the lease liability as at the commencement date (1 January 2016).

– Step #2 **–** Calculate the right-of-use asset as at the commencement date (1 January 2016).

– Step #3 **–** Roll the lease liability forward to 1 January 2018 and 1 January 2019 using the effective interest method.

– Step #4 **–** Roll the right-of-use asset forward to 1 January 2018 and 1 January 2019 by amortising the asset.

Step #1 – Lease Liability as at 1 January 2016

As explained in Section 5. above, the lease liability as at 1 January 2016 comprises the following components:

Fixed Payments	+	Certain Variable Payments	+	Residual Value Guarantee	+	Exercise Price of Purchase Options	+	Termination penalties	=	Lease Liability
CU 9,773 (1)	+	Nil (2)	+	Nil (3)	+	Nil (4)	+	Nil (5)	=	CU 9,773

(1) The fixed payments are calculated at the present value of CU 1,500 per annum, 9 years of payments (the first payment was made at lease commencement), applying a 7% discount. If the rate implicit in the lease was not readily determinable, the lessee's incremental borrowing rate at the commencement date would be used.

(2) The lease does not contain any variable lease payments that depend on a rate or index such as inflation.

(3) The lease does not include a residual value guarantee.

(4) The lease does not include any purchase options.

(5) The lease does not include any termination options.

Step #2 – Right-of-use asset as at 1 January 2016

Also as explained in Section 5. above, the right-of-use asset as at 1 January 2016 comprises the following components:

Lease Liability + Initial Direct Costs + Costs of Removal and Restoring + Payments made at or prior to commencement - Lease incentives received = Right-of-Use Asset

CU 9,773 (1) + CU 500 (2) + Nil (3) + CU 1,500 (4) - Nil (5) = CU 11,773

(1) The lease liability component is equal to the value calculated in Step #1.

(2) Under the full retrospective approach, initial direct costs must be capitalised into the right-of-use asset. The practical expedient to exclude initial direct costs from the measurement of right-of-use assets is only available to entities applying the modified retrospective approach.

(3) The lease does not contain any costs of removal or costs to restore.

(4) The initial payment on the first day of the lease is capitalised into the right-of-use asset.

(5) The lessee has not received any lease incentives.

Step #3 – Lease Liability as at 1 January 2018 and 1 January 2019

The lease liability account is then projected forward in the usual way to determine its carrying amount at each relevant reporting date:

			(A - B) x 7%	A - B + C
Year ended	**Opening balance(A)**	**Payment (B)**	**Interest (C)**	**Closing balance(D)**
31 December 2016	CU 9,773	-	CU 684	CU 10,457
31 December 2017	CU 10,457	CU 1,500	CU 627	CU 9,584
31 December 2018	CU 9,584	CU 1,500	CU 566	CU 8,650

Step #4 – Right-of-use asset as at 1 January 2018 and 1 January 2019

The lessee has chosen to use the cost model under IAS 16 to amortise the right-of-use asset. Since the lease does not transfer ownership of the underlying asset to the lessee by the end of the lease term, Entity A depreciates the asset over the shorter of the lease term and the asset's useful economic life. Entity A has assessed that the useful economic life of the underlying asset exceeds the lease term, so the amortisation of the right-of-use asset will begin on the lease commencement date and be charged evenly over the lease term, as this best represents the consumption of the economic benefits of the asset. The annual amortisation charge is therefore 1/10th of CU 11,773, i.e. CU 1,177.

The carrying value of the right-of-use asset at each period end will be as follows:

Year ended	Opening balance	Amortisation charge	Closing balance
31 December 2016	CU 11,773	CU 1,177	CU 10,596
31 December 2017	CU 10,596	CU 1,177	CU 9,419
31 December 2018	CU 9,419	CU 1,177	CU 8,242

The closing figures as at 31 December 2017 and 2018 are CU 9,419 and CU 8,242, which are the opening right-of-use assets as at 1 January 2018 and 2019, respectively.

Summary

The figures calculated for the comparative period (31 December 2018) and the beginning of the comparative period (1 January 2018) are therefore as follows:

	31 December 2018	1 January 2018
Right-of-use asset	CU 8,242	CU 9,419
Lease liability	CU 8,650	CU 9,584
Adjustment to equity	(CU 408)	(CU 165)

In its financial statements for the year ended 31 December 2019, Entity A would also present the 1 January 2018 figures in a third statement of financial position as required by IAS 1 *Presentation of Financial Statements*, in addition to the comparative statement of financial position as at 31 December 2018.

10.7.2. Illustration of Transition – Modified Retrospective Approach #1

In the first variation of the modified retrospective approach, the right-of-use asset is recognised at the date of initial application (1 January 2019) at an amount equal to the lease liability, using the entity's current incremental borrowing rate. Comparative figures are not restated.

This method is simpler than the full retrospective approach in that an entity simply needs to determine what its lease liability is based on the remaining payments, and then sets the right-of-use asset as an amount equal to that figure (adjusted for any accrued or prepaid amounts recognised under IAS 17). Therefore, there is no impact on equity at the date of initial application.

The process to adopt this approach can be summarised as follows:

- Step #1 **–** Calculate the lease liability as at the date of initial application (1 January 2019).
- Step #2 **–** Set the right-of-use asset as an amount equal to the lease liability at the date of initial application (1 January 2019).

Step #1 – Lease Liability as at 1 January 2019

Fixed Payments	+	Certain Variable Payments	+	Residual Value Guarantee	+	Exercise Price of Purchase Options	+	Termination penalties	=	Lease Liability
CU 9,114 (1)	+	Nil (2)	+	Nil (3)	+	Nil (4)	+	Nil (5)	=	CU 9,114

(1) The fixed payments are calculated at the present value of CU 1,500 per annum, 7 years of payments remaining and applying a 5% discount. The discount rate under the modified retrospective approach is always the incremental borrowing rate as at the date of initial application even if the rate implicit in the lease is readily determinable. The lessee makes payments on the first day of each year. However, this calculation is at the beginning of this period, which would be immediately before the advance rental payment on that day. CU 9,114 therefore equals to CU 1,500 payable on 1 January 2019 plus a further 6 annual payments of 1,500 from 1 January 2020 discounted at 5%

(2) The lease does not contain any variable lease payments that depend on a rate of index such as inflation.

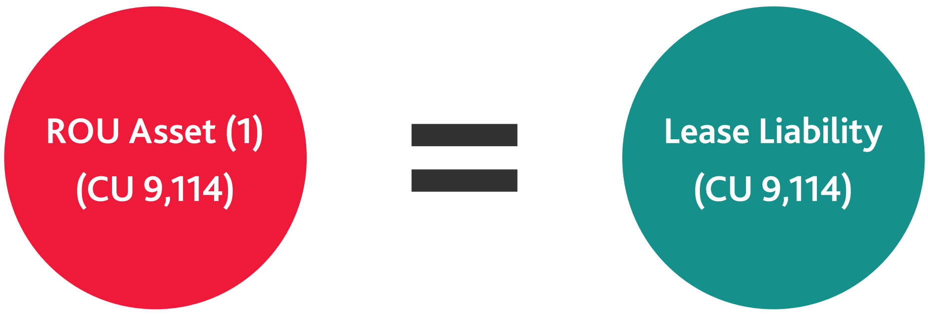
(3) The lease does not include a residual value guarantee.

(4) The lease does not include any purchase options.

(5) The lease does not include any termination options.

Step #2 – Right-of-use asset as at 1 January 2019

The right-of-use asset is simply measured at the same amount as the lease liability on date of initial application (1 January 2019), adjusted only for any prepaid or accrued lease payments recognised in the 31 December 2018 balance sheet under IAS 17 (which in this example are nil).



Summary

The figures calculated for the date of initial application (1 January 2019), the comparative period (31 December 2018) and the beginning of the comparative period (1 January 2018) are therefore as follows:

	1 January 2019	31 December 2018	1 January 2018
Right-of-use asset	CU 9,114	-	-
Lease liability	CU 9,114	-	-

This version of the modified retrospective approach is simplest in that it essentially requires a single calculation in most instances for the outstanding lease liability on 1 January 2019. As can be seen from the above table, the comparative period is not restated, so comparability between periods will be reduced. Additionally, the right-of-use asset is recorded at an amount higher than it would if the full retrospective approach (see Section 10.7.1. above) or the second version of the modified retrospective approach (see Section 10.7.3. below) were used. This will result in higher amortisation charges in subsequent periods and less comparability with new leases entered into subsequent to the date of initial application.

10.7.3. Illustration of Transition – Modified Retrospective Approach #2

In the second variation of the modified retrospective approach, the right-of-use asset is calculated on a retrospective basis (i.e. as if IFRS 16 had always been in effect), except that practical expedients are available in its calculation and the prevailing incremental borrowing rate as at the date of initial application (not the rate prevailing on lease commencement or the rate implicit in the lease) must be used. The lease liability is calculated as at the date of initial application using the same incremental borrowing rate as well, so the lease liability is identical to the first version of the modified retrospective approach in Section 10.7.2.

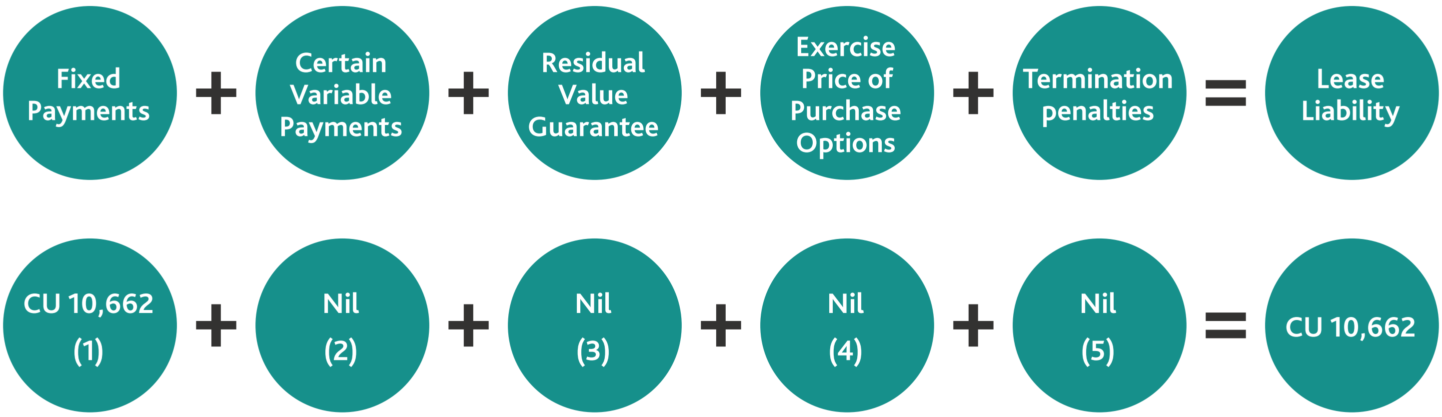
This method is simpler than the full retrospective approach in that it allows for practical expedients to be used. However, it does require a retrospective calculation of the lease liability in order to work out the amount to bring on balance sheet at the date of initial application for the right-of-use asset.

The process to adopt this approach can be summarised as follows:

- Step #1 **–** Calculate what the lease liability would have been at the commencement date (1 January 2016) using as the discount rate the prevailing incremental borrowing rate as at the date of initial application (1 January 2019). This is used as a proxy for the original cost of the right-of-use asset on commencement of the lease and, therefore, it is the starting point for calculating what to bring on balance sheet on the date of initial application under Step #2.
- Step #2 **–** Calculate the right-of-use asset as at the commencement date (1 January 2016).
- Step #3 **–** Calculate the lease liability as at the date of initial application (1 January 2019).
- Step #4 **–** Roll the right-of-use asset forward to 1 January 2019 by amortising the asset.

Step #1: Lease Liability as at 1 January 2016

The lease liability as at 1 January 2016 must be calculated as it forms the basis for calculating the amount to bring on balance sheet for the right-of-use asset:



(1) The fixed payments are calculated at the present value of CU 1,500 per annum, 9 years of payments (the first payment was made at lease commencement) and applying a 5% discount rate, since the modified retrospective approach requires the incremental borrowing rate as at the date of initial application to be used in the calculation.

(2) The lease does not contain any variable lease payments that depend on a rate or index such as CPI/inflation.

(3) The lease does not include a residual value guarantee.

(4) The lease does not include any purchase options.

(5) The lease does not include any termination options.

Step #2 – Right-of-use asset as at 1 January 2016

Lease Liability	+	Initial Direct Costs	+	Costs of Removal and Restoring	+	Payments made at or prior to commencement	-	Lease incentives received	=	Right-of-Use Asset
CU 10,662 (1)	+	Nil (2)	+	Nil (3)	+	CU 1,500 (4)	-	Nil (5)	=	CU 12,162

(1) The lease liability component is equal to the value calculated in Step #1.

(2) Under the modified retrospective approach, a number of practical expedients are available to first-time adopters of IFRS 16 (see Section 10.1.). In this example, Entity A is electing to use the practical expedient that excludes initial direct costs from the measurement of right-of-use assets at the date of initial application. This simplifies Entity A's accounting process in that it is not necessary to analyse contracts for initial direct costs arising in the past. This practical expedient is not available to entities applying the full retrospective approach.

(3) The lease does not contain any costs of removal or costs to restore.

(4) The initial payment on the first day of the lease is capitalised into the right-of-use asset.

(5) The lessee has not received any lease incentives.

Step #3 – Lease Liability as at 1 January 2019

The lease liability under both versions of the modified retrospective approach is identical, therefore the calculation is identical to Step #1 described in Section 10.7.2., meaning the amount to recognise on the date of initial application is CU 9,114.

Step #4 – Right-of-use asset as at 1 January 2019

The right-of-use asset is calculated by amortising its cost at the lease commencement date that was calculated in Step #2 in accordance with IAS 16. The annual amortisation charge is therefore 10% of CU 12,162, i.e. CU 1,216.

The carrying value of the right-of-use asset at each period end is therefore as follows.

Year ended	Opening balance	Amortisation charge	Closing balance
31 December 2016	CU 12,162	CU 1,216	CU 10,946
31 December 2017	CU 10,946	CU 1,216	CU 9,730
31 December 2018	CU 9,730	CU 1,216	CU 8,514

The closing right-of-use asset as at 31 December 2018 is the opening figure as at 1 January 2019. Therefore CU 8,514 is the right-of-use asset's carrying value on the date of initial application.

Summary

The figures calculated for the date of initial application (1 January 2019), the comparative period (31 December 2018) and the beginning of the comparative period (1 January 2018) are therefore as follows:

	1 January 2019	31 December 2018	1 January 2018
Right-of-use asset	CU 8,514	-	-
Lease liability	CU 9,114	-	-
Adjustment to equity	(CU 600)	-	-

This version of the modified retrospective approach is more complex in that it requires retrospective calculation of the right-of-use asset. However, it is simpler than full retrospective application in that practical expedients can be used and the incremental borrowing rate as at the date of initial application must be used. The comparative period is not restated, so comparability will be reduced. However, compared to the first version of the modified retrospective approach, the right-of-use asset is recorded at a value closer to the amount which would have been calculated using the full retrospective approach.

The difference between the asset and liability recognised as at the date of initial application is recognised as an adjustment to opening equity (e.g. retained earnings).

10.7.4. Illustration of Transition – Comparison of Approaches

Date	Full Retrospective	Modified #1 (ROU = Lease Liability)	Modified #2 (ROU restated retrospectively)
ROU Asset – 31 December 2017	CU 9,419	-	-
Lease Liability – 31 December 2017	CU 9,584	-	-
ROU Asset – 31 December 2018	CU 8,242	-	-
Lease Liability – 31 December 2018	CU 8,650	-	-
ROU Asset – 1 January 2019	CU 8,242	CU 9,114	CU 8,514
Lease Liability – 1 January 2019	CU 8,650	CU 9,114	CU 9,114

Comparing the three approaches, a number of observations can be made:

- All three approaches produce different right-of-use asset figures as at 1 January 2019, which will have an impact on subsequent amortisation expense for a number of accounting periods.
- The only amount in common among the approaches are the lease liability for the modified retrospective approaches.
- The work effort required for the full retrospective approach and the modified retrospective approach #2 may be similar in that they both require retrospective calculations of both lease liability and right-of-use asset, despite the fact that the modified retrospective approach does not result in the restatement of comparative information. However, the work effort for the modified retrospective approach #2 may be reduced through the use of practical expedients that are not available under the full retrospective approach.
- Only with the full retrospective approach is the carrying amount of the right-of-use asset and lease liability at the end of the comparative period (31 December 2018) equal to the amount at which it is recognised at the date of initial application (1 January 2019).
- Only with modified retrospective approach #1 is there no impact to equity on first time application to IFRS 16 as the amount recognised for the right-of-use asset and lease liability are the same.

Note that the two versions of the modified retrospective approach can be adopted on a lease-by-lease basis, so a lessee may use one method for certain leases and another method for a different set of leases. For example, an entity may wish to use the second modified retrospective approach for its high-value leases (e.g. aircraft) as it reflects a figure for the right-of-use asset which is closer to that required by the full retrospective approach. The first modified retrospective approach could be used for portfolios of lower value leases to reduce the amount of work required (e.g. a company's small fleet of cars) for which there may be relatively small difference compared to the second modified retrospective approach.

BDO comment

The differences between the amounts recognised, the amount of work involved, the practical exemptions available, and the degree of comparability between current and comparative figures in the year of first-time adoption of IFRS 16 mean that entities will need to weigh up their options carefully early in the transition planning process in order to decide which is the most appropriate transition approach to follow for their circumstances.

Given that different entities will reach different conclusions about which is the most appropriate approach for their individual circumstances, total comparability across entities will not be achieved. However, the IASB decided to provide entities with these choices to make it as straightforward as possible to implement the new standard.

11. EFFECTS ON OTHER STANDARDS

IFRS 16 has resulted in several consequential amendments to other IFRSs. A summary of the more significant amendments are:

Standard	Effect of Amendments

IFRS 1 *First-time Adoption of IFRS*	– The option to use fair value as deemed cost in an entity's opening statement of financial position upon adopting IFRS has been extended to right-of-use assets.
	– If an entity elects not to apply IFRS 3 retrospectively to past business combinations upon adopting IFRS, it still must recognise the acquiree's lease contracts based on the requirements of IFRS 16.
	– An entity may elect to follow several simplifications for initial measurement:
	  – Measure the lease liability as the present value of remaining lease payments discounted using the lessee's incremental borrowing rate at the date of transition;
	  – Measure the right-of-use asset at either:
	    (1) The amount that would have been recognised had IFRS 16 applied on commencement of the lease except that it is discounted using the lessee's incremental borrowing rate at the date of transition; or
	    (2) An amount equal to the lease liability.
	– A right-of-use asset for a lease that meets the definition of investment property and is measured using the fair value model would be measured at fair value on adoption of IFRS.
	– A lessee may also use several other simplifications on a lease-by-lease basis:
	  – Use a single discount rate for a reasonably similar portfolio of leases;
	  – Elect not to measure leases that terminate within twelve months of the date of transition to IFRS;
	  – Elect not to measure leases where the underlying asset is of low-value;
	  – Exclude initial direct costs from the measurement of right-of-use assets;
	  – Elect to use hindsight (e.g. in determining the lease term if options exist).

IFRS 3 *Business Combinations*	– Clarifies that an acquirer recognises and measures an acquiree's lease liabilities and right-of-use assets using the principles in IFRS 16, and not at fair value, i.e. leases acquired are accounted for as if they were new leases as at the acquisition date. – As IFRS 16 recognises leases 'on balance sheet', separate intangible assets relating to off-market operating leases acquired in a business combination prior to the adoption of IFRS 16 will no longer be recognised. Instead, the acquirer adjusts the initial measurement of the right-of-use asset to reflect favourable or unfavourable terms when compared to market terms.
IFRS 7 *Financial Instruments: Disclosures*	– Extends the exemption from disclosure of fair values of financial instruments to lease liabilities.

Standard		Effect of Amendments
IFRS 9 *Financial Instruments*	–	Permits lessors to measure finance lease receivables using lifetime expected credit losses instead of the three-staged approach otherwise required by IFRS 9 for impairment of financial assets.
IFRS 13 *Fair Value Measurement*	–	Extends the scope exemption for the measurement and disclosure requirements to leasing transactions within the scope of IFRS 16.
IAS 21 *The Effects of Changes in Foreign Exchange Rates*	–	Clarifies that lease liabilities are monetary liabilities and right-of-use assets are non-monetary assets.
IAS 40 *Investment Property*	–	Significant editorial amendments to reflect that leased right-of-use assets may meet the definition of investment property.

APPENDIX A
ILLUSTRATIVE DISCLOSURE EXAMPLE

IAS 1:117(b)	Disclose accounting policies that are relevant to understanding the financial statements (i.e. those for material items).
IFRS 16:60	If a lessee accounts for short-term leases or leases of low-value assets applying Paragraph 6 of IFRS 16 (i.e. by not recognising a lease liability and corresponding right-of-use asset), disclose that fact.

Accounting Policy

All leases are accounted for by recognising a right-of-use asset and a lease liability except for:

– Leases of low-value assets; and
– Leases with a duration of twelve months or less.

Lease liabilities are measured at the present value of the contractual payments due to the lessor over the lease term, with the discount rate determined by reference to the rate inherent in the lease unless (as is typically the case) this is not readily determinable, in which case The Group's incremental borrowing rate on commencement of the lease is used. Variable lease payments are only included in the measurement of the lease liability if they depend on an index or rate. In such cases, the initial measurement of the lease liability assumes the variable element will remain unchanged throughout the lease term. Other variable lease payments are expensed in the period to which they relate.

On initial recognition, the carrying value of the lease liability also includes:

– Amounts expected to be payable under any residual value guarantee;
– The exercise price of any purchase option granted in favour of The Group if it is reasonable certain to assess that option;
– Any penalties payable for terminating the lease, if the term of the lease has been estimated on the basis of termination option being exercised.

Right-of-use assets are initially measured at the amount of the lease liability, reduced for any lease incentives received, and increased for:

– Lease payments made at or before commencement of the lease;
– Initial direct costs incurred; and
– The amount of any provision recognised where The Group is contractually required to dismantle, remove or restore the leased asset (typically leasehold dilapidations – see Note 29).

Subsequent to initial measurement lease liabilities increase as a result of interest charged at a constant rate on the balance outstanding and are reduced for lease payments made. Right-of-use assets are amortised on a straight-line basis over the remaining term of the lease or over the remaining economic life of the asset if, rarely, this is judged to be shorter than the lease term.

When The Group revises its estimate of the term of any lease (because, for example, it re-assesses the probability of a lessee extension or termination option being exercised), it adjusts the carrying amount of the lease liability to reflect the payments to make over the revised term, which are discounted at the same discount rate that applied on lease commencement. The carrying value of lease liabilities is similarly revised when the variable element of future lease payments dependent on a rate or index is revised. In both cases an equivalent adjustment is made to the carrying value of the right-of-use asset, with the revised carrying amount being amortised over the remaining (revised) lease term.

IFRS 16:52	Disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not 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.
IAS 16:59	Disclose qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in Paragraph 51 (as described in Paragraph B48). This additional information may include, but is not limited to, information that helps users of financial statements to assess: (a) The nature of the lessee's leasing activities; (b) Future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from: (i) Variable lease payments (as described in Paragraph B49); (ii) Extension options and termination options; (iii) Residual value guarantees; (iv) Leases not yet commenced to which the lessee is committed; (c) Restrictions or covenants imposed by leases; and (d) Sale-and-leaseback transactions.
IAS 16:B48	For the purposes of IFRS 16:59: (a) Only disclose information that is expected to be relevant to users of financial statements. This is likely to be the case if it helps those users to understand: (i) The flexibility provided by leases. Leases may provide flexibility if, for example, a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions; (ii) Restrictions imposed by leases. Leases may impose restrictions, for example, by requiring the lessee to maintain particular financial ratios; (iii) Sensitivity of reported information to key variables. Reported information may be sensitive to, for example, future variable lease payments; (iv) Exposure to other risks arising from leases; (v) Deviations from industry practice. Such deviations may include, for example, unusual or unique lease terms and conditions that affect a lessee's lease portfolio; (b) Whether information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.
IFRS 16:B49	Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in Paragraph 51 could include information that helps users of financial statements to assess, for example: (a) The lessee's reasons for using variable lease payments and the prevalence of those payments; (b) The relative magnitude of variable lease payments to fixed payments; (c) Key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and (d) Other operational and financial effects of variable lease payments.

When The Group renegotiates the contractual terms of a lease with the lessor, the accounting depends on the nature of the modification:

- If the renegotiation results in one or more additional assets being leased for an amount commensurate with the standalone price for the additional rights-of-use obtained, the modification is accounted for as a separate lease in accordance with the above policy;
- In all other cases where the renegotiated increases the scope of the lease (whether that is an extension to the lease term, or one or more additional assets being leased), the lease liability is remeasured using the discount rate applicable on the modification date, with the right-of-use asset being adjusted by the same amount;
- If the renegotiation results in a decrease in the scope of the lease, both the carrying amount of the lease liability and right-of-use asset are reduced by the same proportion to reflect the partial of full termination of the lease with any difference recognised in profit or loss. The lease liability is then further adjusted to ensure its carrying amount reflects the amount of the renegotiated payments over the renegotiated term, with the modified lease payments discounted at the rate applicable on the modification date. The right-of-use asset is adjusted by the same amount.

For contracts that both convey a right to The Group to use an identified asset and require services to be provided to The Group by the lessor, The Group has elected to account for the entire contract as a lease, i.e. it does allocate any amount of the contractual payments to, and account separately for, any services provided by the supplier as part of the contract.

Nature of leasing activities (in the capacity as lessee)

The Group leases a number of properties in the jurisdictions from which it operates. In some jurisdictions it is customary for lease contracts to provide for payments to increase each year by inflation or and in others to be reset periodically to market rental rates. In some jurisdictions property leases the periodic rent is fixed over the lease term.

The Group also leases certain items of plant and equipment. In some contracts for services with distributors, those contracts contain a lease of vehicles. Leases of plant, equipment and vehicles comprise only fixed payments over the lease terms.

The percentages in the table below reflect the current proportions of lease payments that are either fixed or variable. The sensitivity reflects the impact on the carrying amount of lease liabilities and right-of-use assets if there was an uplift of 5% on the balance sheet date to lease payments that are variable.

31 December 2019	***Lease Contracts Number***	***Fixed payments %***	***Variable payments %***	***Sensitivity CU'000***
Property leases with payments linked to inflation	3	-	25%	±495
Property leases with periodic uplifts to market rentals	6	-	40%	±791
Property leases with fixed payments	2	15%	-	-
Leases of plant and equipment	46	17%	-	-
Vehicle leases	3	3%	-	-
	60	**35%**	**65%**	**±1,286**

BDO Comment	***Entities that apply the modified retrospective approach for adopting IFRS 16 (i.e. do not restate comparatives retrospectively) are not required to provide comparatives on an IFRS 16 basis in the period of adoption. Instead, comparative disclosures would be made in accordance with IAS 18 and IAS 10 as appropriate.***
IFRS 16:B50	Additional information relating to extension options or termination options that, depending on the circumstances, may be needed to satisfy the disclosure objective in Paragraph 51 could include information that helps users of financial statements to assess, for example: (a) The lessee's reasons for using extension options or termination options and the prevalence of those options; (b) The relative magnitude of optional lease payments to lease payments; (c) The prevalence of the exercise of options that were not included in the measurement of lease liabilities; and (d) Other operational and financial effects of those options.
IFRS 16:B51	Additional information relating to residual value guarantees that, depending on the circumstances, may be needed to satisfy the disclosure objective in Paragraph 51 could include information that helps users of financial statements to assess, for example: (a) The lessee's reasons for providing residual value guarantees and the prevalence of those guarantees; (b) The magnitude of a lessee's exposure to residual value risk; (c) The nature of underlying assets for which those guarantees are provided; and (d) Other operational and financial effects of those guarantees.
IFRS 16:B52	Additional information relating to sale-and-leaseback transactions that, depending on the circumstances, may be needed to satisfy the disclosure objective in Paragraph 51 could include information that helps users of financial statements to assess, for example: (a) The lessee's reasons for sale-and-leaseback transactions and the prevalence of those transactions; (b) Key terms and conditions of individual sale-and-leaseback transactions; (c) Payments not included in the measurement of lease liabilities; and (d) The cash flow effect of sale-and-leaseback transactions in the reporting period.
BDO Comment	***A Layout (International) Group has not entered into any sale-and-leaseback transactions and so addition information required by IFRS 16:52 has not been given.***

31 December 2018	***Lease Contracts Number***	***Fixed payments %***	***Variable payments %***	***Sensitivity CU'000***
Property leases with payments linked to inflation	3	-	25%	±368
Property leases with payments linked to market rentals	5	-	38%	±558
Property leases with fixed payments	2	20%	-	-
Leases of plant and equipment	42	15%	-	-
Vehicle leases	3	2%	-	-
	55	**37%**	**63%**	**±926**

The Group sometimes negotiates break clauses in its property leases. On a case-by-case basis, The Group will consider whether the absence of a break clause exposes The Group to excessive risk. Typically factors considered in deciding to negotiate a break clause include:

– The length of the lease term;

– The economic stability of the environment in which the property is located; and

– Whether the location represents a new area of operations for The Group.

At both 31 December 2019 and 2018 the carrying amounts of lease liabilities are not reduced by the amount of payments that would be avoided from exercising break clauses because on both dates it was considered reasonably certain that The Group would not exercise its right to exercise any right to break the lease. Of the total lease payments of CU 7,327,000 (2018 – CU 6,878,000) is potentially avoidable were The Group to exercise break clauses at the earliest opportunity.

One of the contracts that The Group has with a distributor conveys to The Group the right to use certain vehicles for the contractual term. The Group agreed to the inclusion of a residual value guarantee in favour of the supplier. This because the pricing of the contract does not result in The Group having to pay full fair value of the vehicles, but as those vehicles are under The Group's control The Group is able to use the vehicles to such an extent that they would have little value to the supplier at the end of the lease term. The alternative would have been to restrict the mileage use of the vehicles over the lease term, but The Group did not wish to be operationally restricted on its ability to use the vehicles. The amount of the residual value guarantee, which has been included in the carrying value of lease liabilities, is CU 1,475,000 (2018 – CU 1,475,000).

IFRS 16:52	Disclose information about its leases for which the entity is a lessee in a single note or separate section in its financial statements. However, a lessee need not 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	Disclose the following amounts for the reporting period: (a) Depreciation charge for right-of-use assets by class of underlying asset; (b) Interest expense on lease liabilities; (c) The expense relating to short-term leases accounted for applying Paragraph 6. This expense need not include the expense relating to leases with a lease term of one month or less; (d) The expense relating to leases of low-value assets accounted for applying Paragraph 6. This expense shall not include the expense relating to short-term leases of low-value assets included in Paragraph 53(c); (e) The expense relating to variable lease payments not included in the measurement of lease liabilities; (f) Income from subleasing right-of-use assets; (g) Total cash outflow for leases; (h) Additions to right-of-use assets; (i) Gains or losses arising from sale-and-leaseback transactions; and (j) The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.
IFRS 16:54	Provide the disclosures specified in Paragraph 53 in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.
BDO Comment	***A Layout (international) Group has disclosed amounts in compliance with IFRS 16:53 (a), (b), (g), (h) and (j) in a reconciliation of both right-of-use assets and lease liabilities rather than as standalone amounts in a table. This is considered more appropriate as it facilitates a clearer picture of what has given rise to changes in the carrying amounts of these items as well as enables ease of cross reference to other parts of the financial statements. For example, the amounts in the reconciliation for right-of-use assets would equal the amount included on the face of the statement of financial position (if that presentation approach is chosen under IFRS 16), and the interest expense on lease liabilities would tie into that component of total finance cost included in Note 9. Providing the disclosures in the form of a reconciliation results in voluntary disclosures being given for the effect of lease modifications, adjustments from revising variable lease payments linked to an index or rate, and foreign exchange movements on the carrying amounts for both right-of-use assets and lease liabilities.***
IFRS 16:56	If right-of-use assets meet the definition of investment property, apply the disclosure requirements in IAS 40. In that case, a lessee is not required to provide the disclosures in Paragraph 53(a), (f), (h) or (j) for those right-of-use assets.

Right-of-Use Assets

	Land and buildings CU'000	*Plant, machinery and motor vehicles CU'000*	*Total CU'000*
At 1 January 2019	24,395	5,200	**29,595**
Additions	3,279	1,246	**4,525**
Amortisation	(1,626)	(1,200)	**(2,826)**
Modification to lease terms	1,500	(85)	**1,415**
Variable lease payment adjustment	3,772	-	**3,772**
Foreign exchange Movements	328	75	**403**
At 31 December 2019	**31,648**	**5,236**	**36,884**

At 1 January 2018	26,340	5,670	32,010
Additions	-	650	650
Amortisation	(2,196)	(1,085)	(3,281)
Variable lease payment adjustment	411	-	411
Foreign exchange Movements	(160)	(35)	(195)
At 31 December 2018	24,395	5,200	29,595

Lease liabilities

	Land and buildings CU'000	*Plant, machinery and motor vehicles CU'000*	*Total CU'000*
At 1 January 2019	28,700	6,500	**35,200**
Additions	3,349	1,246	**4,595**
Interest expense	2,010	390	**2,400**
Effect of modification to lease terms	1,500	(101)	**1,399**
Variable lease payment adjustment	3,772	-	**3,772**
Lease payments	(3,500)	(850)	**(4,350)**
Foreign exchange movements	287	85	**372**
At 31 December 2019	**36,118**	**7,270**	**43,388**

At 1 January 2018	29,890	6,065	35,955
Additions	-	650	650
Interest expense	1,794	650	2,444
Variable lease payment adjustment	411	-	411
Lease payments	(3,200)	(825)	(4,025)
Foreign exchange movements	(195)	(40)	(235)
At 31 December 2018	28,700	6,500	35,200

BDO Comment	***A Layout (international) Group has disclosed amounts in compliance with IFRS 16:53 (c), (d), (e), (f) and (i) in a table as required by Paragraph 54. Income from sub-leases is already disclosed in Note 5 and, in accordance with IFRS 16:53, the disclosure is not duplicated here. A Layout (International) Group has not entered into any sale-and-leaseback transactions in the current or prior period.***
IFRS 16:55	Disclose the amount of its lease commitments for short-term leases accounted for applying Paragraph 6 if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed applying Paragraph 53(c) relates.
IFRS 16:57	If a lessee measures right-of-use assets at revalued amounts applying IAS 16, disclose the information required by Paragraph 77 of IAS 16 for those right-of-use assets.
BDO Comment	***A Layout does not measure right-of-use assets at revalued amounts and hence these disclosures are not applicable.***
IFRS 16:58	Disclose a maturity analysis of lease liabilities applying Paragraphs 39 and B11 of IFRS 7 *Financial Instruments: Disclosures* separately from the maturity analyses of other financial liabilities.
BDO Comment	***The same format has been used for disclosing the maturity of other liabilities in Note 3 as the disclosure might more appropriately be included within the same table in Note 3 rather than separately within the separate lease note.***

	2019 CU'000	*2018 CU'000*
Short-term lease expense	1,313	1,200
Low-value lease expense	600	850
Expense relating to variable lease payments not included in the measurement of lease liabilities	65	24
Aggregate undiscounted commitments for short-term leases	410	865

At 31 December 2019	*Up to 3 months CU'000*	*Between 3 and 12 months CU'000*	*Between 1 and 2 year(s) CU'000*	*Between 2 and 5 years CU'000*	*Over 5 years CU'000*
Lease liabilities	**1,428**	**4,285**	**4,031**	**12,092**	**30,041**

At 31 December 2018	*Up to 3 months CU'000*	*Between 3 and 12 months CU'000*	*Between 1 and 2 year(s) CU'000*	*Between 2 and 5 years CU'000*	*Over 5 years CU'000*
Lease liabilities	**1,139**	**3,416**	**3,266**	**9,797**	**24,000**

Disclosures applicable only to entities not applying IFRS 16 on a fully retrospective basis	
IFRS 16:C13	If a lessee elects to apply this Standard using the modified retrospective approach, disclose: (a) The weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the statement of financial position at the date of initial application; and (b) An explanation of any difference between: (i) Operating lease commitments disclosed applying IAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application; and (ii) Lease liabilities recognised in the statement of financial position at the date of initial application.
BDO Comment	***A Layout (International) Group has chosen to provide this explanation by presenting a numerical reconciliation.*** ***The numerical reconciliation presents the adjustment to discount the total population of lease commitments as at 31 December 2018 first. An alternative approach would be to first subtract all leases that are to be excluded from recognition under IFRS 16 due to the short-term and low-value exemptions. A Layout (International) Group could then apply the discount rate and other adjustments to this modified population of leases that are to be recognised 'on balance sheet' under IFRS 16.***
IFRS 16:C14	If a lessee uses one or more of the specified practical expedients in Paragraph C10, it shall disclose that fact.

Disclosures applicable only to entities not applying IFRS 16 on a fully retrospective basis

The weighted average incremental borrowing rate applied to lease liabilities on 1 January 2019 was 6.24%.

The aggregate lease liability recognised in the statement of financial position at 1 January 2019 and The Group's operating lease commitment at 31 December 2018 can be reconciled as follows:

	CU'000
Operating lease commitment at 31 December 2018	40,000
Effect of discounting those lease commitments at an annual rate of 6.24%	(12,000)
Effect of estimating for the purposes of IFRS 16 that lease break clauses will not be exercised (i.e. present value of lease payments to be made after the break date)	7,400
Effect of electing to account for short-term and low-value leases off balance sheet	(200)
	35,200

In applying the modified retrospective approach, The Group has taken advantage of the following practical expedients *[delete as appropriate]*:

- A single discount rate has been applied to portfolios of leases with reasonably similar characteristics;
- Impairment losses on right-of-use assets as at 1 January 2019 have been measured by reference to the amount of any onerous lease provision recognised on 31 December 2018;
- Leases with a remaining term of twelve months or less from the date of application have been accounted for as short-term leases (i.e. not recognised on balance sheet) even though the initial term of the leases from lease commencement date may have been more than twelve months;
- Initial direct costs have not been included in the measurement of the right-of-use asset as at the date of initial application.

  [Note: This relief is only relevant if the modified retrospective approach is applied by measuring the right-of-use asset by reference to the amount of lease payments from lease commencement date. It is not relevant if the entity applies the modified retrospective approach by reference to the measurement of the lease liability recognised on the date of initial application.]

- For the purposes of measuring the right-of-use asset hindsight has been used. Therefore, it has been measured based on prevailing estimates at the date of initial application and not retrospectively by making estimates and judgements (such as the term of leases) based on circumstances on or after the lease commencement date.

  [Note: This relief is only relevant if the modified retrospective approach is applied by measuring the right-of-use asset by reference to the amount of lease payments from lease commencement date. It is not relevant if the entity applies the modified retrospective approach by reference to the measurement of the lease liability recognised on the date of initial application.]

APPENDIX B – DEFINITIONS

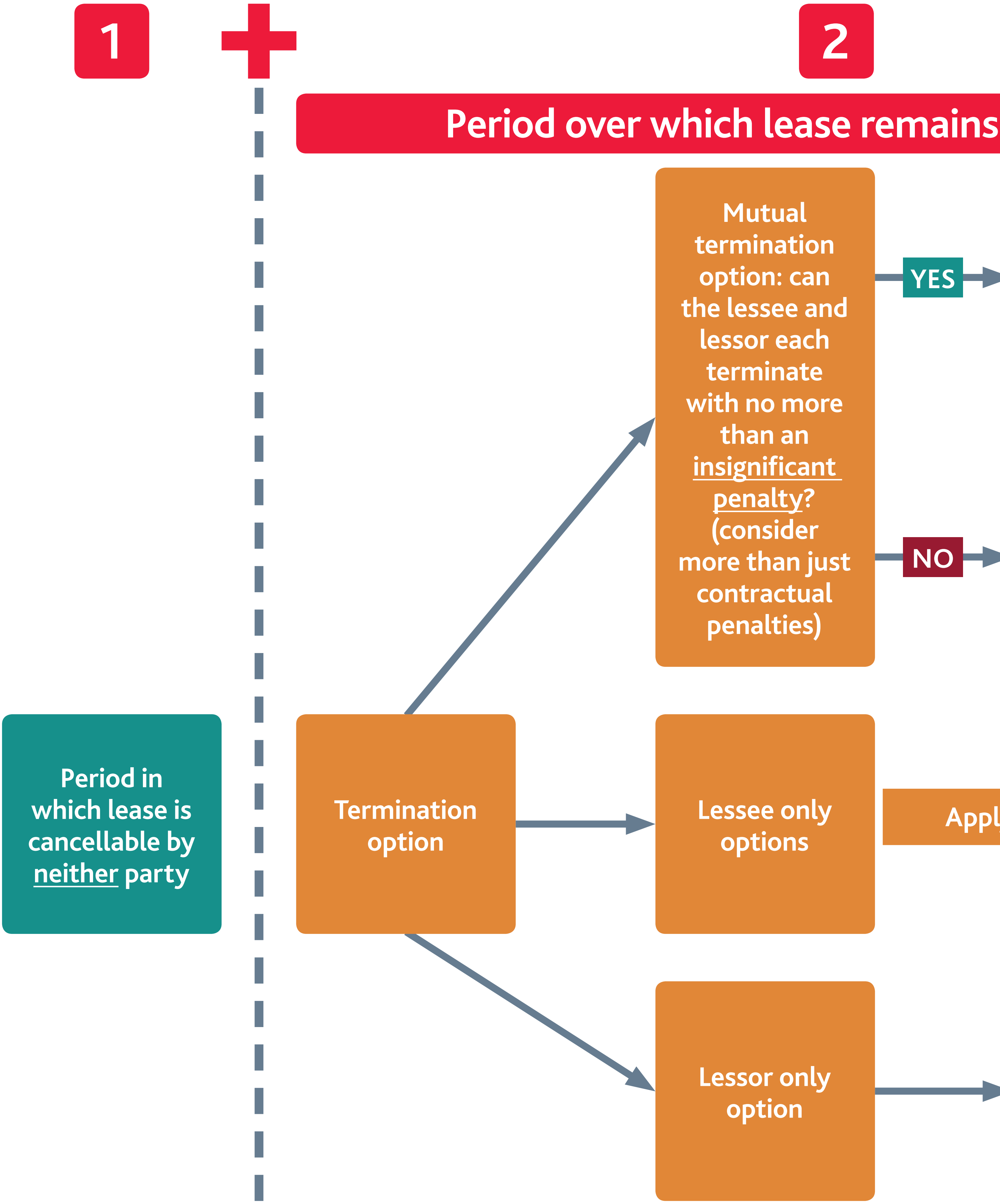
Commencement date of the lease (commencement date)	The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.
Contract	An agreement between two or more parties that creates enforceable rights and obligations.
Economic life	Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.
Effective date of the modification	The date when both parties agree to a **lease modification**.
Fair value	For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
Finance lease	A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.
Fixed payments	Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.
Gross investment in the lease	The sum of: (a) The **lease payments** receivable by a **lessor** under a **finance lease**; and (b) Any **unguaranteed residual value** accruing to the lessor.
Inception date of the lease (inception date)	The earlier of the date of a **lease** agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
Initial direct costs	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.
Interest rate implicit in the lease	The rate of interest that causes the present value of: (a) The **lease payments**; and (b) The **unguaranteed residual value** to equal the sum of: (i) The **fair value** of the **underlying asset**; and (ii) Any **initial direct costs** of the lessor.
Lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.

Lease incentives	Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.
Lease modification	A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).
Lease payments	Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, comprising the following: **(a) Fixed payments** (including in-substance fixed payments), less any **lease incentives**; **(b) Variable lease payments** that depend on an index or a rate; (c) The exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and (d) Payments of penalties for terminating the **lease**, if the lease term reflects the lessee exercising an option to terminate the lease. For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component. For the lessor, lease payments also include 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. Lease payments do not include payments allocated to non-lease components.
Lease term	The non-cancellable period for which a **lessee** has the right to use an **underlying asset**, together with both: (a) Periods covered by an option to extend the **lease** if the lessee is reasonably certain to exercise that option; and (b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.
Lessee	An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.
Lessee's incremental borrowing rate	The rate of interest that a **lessee** would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the **right-of-use asset** in a similar economic environment.

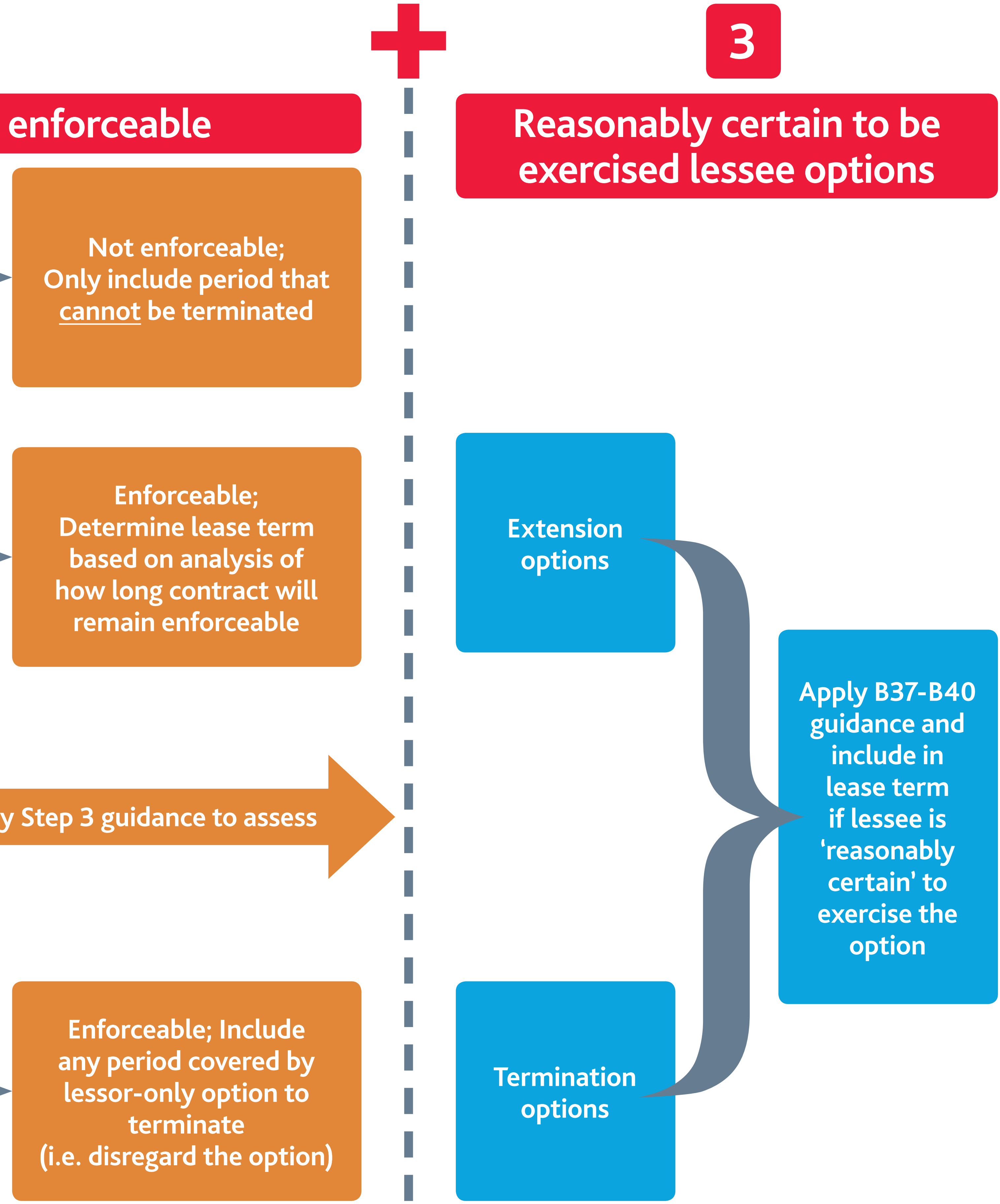
Lessor	An entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.
Net investment in the lease	The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.
Operating lease	A **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.
Optional lease payments	Payments to be made by a **lessee** to a **lessor** for the right to use an **underlying asset** during periods covered by an option to extend or terminate a **lease** that are not included in the **lease term**.
Period of use	The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).
Residual value guarantee	A guarantee made to a **lessor** by a party unrelated to the lessor that the value (or part of the value) of an **underlying asset** at the end of a **lease** will be at least a specified amount.
Right-of-use asset	An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.
Short-term lease	A **lease** that, at the **commencement date**, has a **lease term** of twelve months or less. A lease that contains a purchase option is not a short-term lease.
Sublease	A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.
Underlying asset	An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.
Unearned finance income	The difference between: (a) The **gross investment in the lease**; and (b) The **net investment in the lease**.
Unguaranteed residual value	That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.
Useful life	The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Variable lease payments	The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

APPENDIX C – LEASE TERM ASSESSMENT FLOW CHART



– DETERMINING LEASE TERM (sum of 1 + 2 + 3)



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