

IFRS 16: key points of the lease standard

in 80 questions & answers

forvis mazars

Introduction

IFRS 16 – Leases is mandatory for financial statements prepared under IFRS from 1 January 2019.

This standard was issued in January 2016 by the International Accounting Standards Board (IASB). It replaced IAS 17, the previous Standard on leases, and all related interpretations:

- IFRIC 4 – Determining whether an Arrangement contains a lease;
- SIC 15 – Operating leases-Incentives; and
- SIC 27 – Evaluating the substance of transactions involving the legal form of a lease.

IFRS 16 contains a single accounting model for lessees but proposes practical expedients. Unless an exemption offered by the Standard is used, a lease is recognised as an asset, referred to as a "right-of-use" asset, and as a liability for the lease payments over the term of the contract.

The main issue is thus now the distinction between a lease and a service contract. Any contract requiring the use of a specified asset and conveying the right to control the use of that asset for a specified period of time will be classified as a lease.

On this topic as on others (e.g. the determination of the lease term – a key parameter in measuring a lease liability), the apparent simplicity of a single model masks a significant use of judgement in the detailed implementation of the Standard.

For lessors, IFRS 16 has brought fewer changes to lease accounting. In particular, the distinction between operating and finance leases has been retained, creating an asymmetry between the lessee and lessor accounting models.

Although the transition to IFRS 16 for companies applying IFRSs seems to have gone smoothly in 2019, lease accounting has continued to evolve due to amendments to the Standards and agenda decisions reached by the IFRS Interpretations Committee (IFRS IC). At the time of publication of this handbook, several topics are under consideration by the IFRS Foundation and could, depending on the direction they take, contribute to changes in the accounting for leases.

This handbook in 80 questions and answers is meant to serve as a useful tool for as many stakeholders as possible, providing clarity and insight on the challenging issues at stake when applying IFRS 16. It does not aim to cover every possible situation that may be encountered in practice, but many topics are examined in detail.

This publication does not consider the consequences of IFRS 18, which is mandatory for financial years beginning on or after 1 January 2027.

10 Key points to remember

1. IFRS 16 defines a lease as a contract, or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration. This definition is common to lessees and lessors. The identification of a lease is based on an analysis of the substance of the transaction and may therefore require significant judgement.

2. IFRS 16 is consistent in many respects with IFRS 15 – *Revenue from Contracts with Customers*, in its treatment of “unit of account” issues. For example, the requirements of the two standards are broadly similar regarding the identification of separate components within a contract, the allocation of total consideration to each component, the grouping of contracts, and the ability to account on a portfolio basis.

3. Determination of the lease term requires an assessment of the period for which it is "enforceable" (enforceability being assessed by considering the broader economics of the lease). Within that period, the lease term represents the period that is reasonably certain from the lessee's point of view. Therefore, the lease term includes the period that the lessee cannot cancel, together with any optional period available to the lessee if it is reasonably certain that the lessee will make use of any such option. This assessment, which is common to lessees and lessors, will often require the exercise of significant judgement.

4. IFRS 16 is characterised by an asymmetry between the general accounting model applicable to lessees and that applicable to lessors. Whereas the lessee applies a single model resulting in the recognition of a right-of-use asset and a lease liability at the commencement date of the lease (unless an exemption is used), the lessor model distinguishes between "operating leases" and "finance leases". For leases classified as operating leases, the lessor continues to recognise the leased asset on its balance sheet and recognises rental income over the lease term. For leases classified as finance leases, the leased asset is replaced by a lease receivable (equal to the "net investment in the lease") which generates financial income over the lease term by unwinding the discount on the lease receivable.

5. The general accounting model for lessors is substantially the same as that in IAS 17 (the previous lease Standard). However, IFRS 16 introduces new requirements for lessors regarding subleases, lease modifications, sale and leaseback transactions, and disclosures.

6. The right-of-use asset recognised in the financial statements of a lessee is initially measured at its cost. The main component of this cost is the present value of the future lease payments over the lease term, being the initial measurement of the lease liability. Consistently with the accounting for owned assets under IAS 16 – *Property, Plant and Equipment,* the right-of-use asset is subsequently measured at either depreciated cost or, more rarely, revalued amount.

7. In the same way as a financial liability at amortised cost under IFRS 9 – *Financial Instruments*, the carrying amount of the lease liability of a lessee increases with the calculation of interest and decreases with the payments made by the lessee. However, unlike IFRS 9, the measurement of a lease liability under IFRS 16 only includes variable payments if they depend on an index or a rate. Therefore, when lease payments comprise only variable payments that do not depend on an index or a rate, no lease liability is recognised on the lessee's balance sheet.

8. Under IFRS 16, changes in the lease liability resulting from a reassessment of the lease liability or a lease modification are recognised as an adjustment to the-right-of-use asset (with some exceptions) rather than in profit or loss.

9. The interaction with the requirements of other IFRSs sometimes gives rise to complexity, particularly in the financial statements of a lessee. Examples include deferred tax relating to a lease (solving this issue required an amendment to IAS 12 – *Income Taxes* in May 2021), the application of the requirements of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets* on onerous contracts to leases, and determining the appropriate level at which to perform the impairment test under IAS 36 – *Impairment of assets* when there is an indication that a right-of-use asset may be impaired.

10. Since IFRS 16 became effective in 2019, lease accounting has continued to evolve due to amendments to the Standards and agenda decisions reached by the IFRS IC. It is therefore important to keep abreast of possible future developments, as certain application issues are still under discussion at the time of publication of this handbook.

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Overview

1. What is the definition of a lease?

[IFRS 16.9-10]

IFRS 16 defines a lease as a contract, or part of a contract, that conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

The Standard specifies that a period of time need not be expressed in units of time. It can also be expressed in terms of the amount of use of an identified asset (e.g. the number of production units that an item of equipment will be used to produce).

The IFRS 16 application guidance also provides details on the two main concepts within this definition:

- the existence of an identified asset (see questions **16** to **19**); and
- the right to control the use of an asset (see questions **20** to **23**).

As the definition of a lease does not depend on the legal form of a contract, identifying a lease requires an analysis of the substance of the transaction and may involve significant judgement.

2. Which leases are within the scope of IFRS 16?

[IFRS 16.3-4]

IFRS 16 applies to all contracts (or parts of contracts) that meet the definition of a lease (see question **1**), including subleases (see question **64**), except for:

- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

  IFRS 6 – *Exploration for and Measurement of Mineral Resources* applies to expenditure on exploration for and measurement of mineral resources.

  However, being a temporary Standard, it only requires certain improvements to existing accounting practices. Furthermore, it does not apply to expenditure incurred during the exploitation phase (after the technical feasibility and commercial viability of extracting a mineral resource have been demonstrated).

  Therefore, judgement may be required in determining an accounting policy for these contracts.

- contracts entered into by a lessee for the lease of biological assets within the scope of IAS 41 – Agriculture (e.g. live animals);

  The scope of IAS 41 excludes bearer plants (i.e. living plants used in the production or supply of agricultural products, likely to bear produce over more than one period and which have only a remote likelihood of being sold as agricultural produce) related to agricultural activity, e.g. vines or fruit trees.

  Therefore, leases entered by a lessee for bearer plants are within the scope of IFRS 16.

- public service concession arrangements that fall under IFRIC 12 – *Service Concession Arrangements*;
- intellectual property licences granted by a lessor that are within the scope of IFRS 15 – *Revenue from Contracts with Customers*; and
- rights held by a licensee under licence agreements within the scope of IAS 38 – *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

A lessee may elect to apply IFRS 16 (this is an accounting option) to leases of intangible assets other than those covered by the last exclusion above.

> The International Accounting Standards Board (IASB) considered it preferable not to require lessees to account for such contracts under IFRS 16, pending a comprehensive review of the accounting for intangible assets (see IFRS 16.BC71).

3. How can a lease be distinguished from a sale (from the perspective of the supplier/lessor) or a purchase (from the perspective of the customer/lessee) when the lease term approaches the economic life of the underlying asset?

[IFRS 15.31]

Under IFRS 16, a lease is defined as the transfer of the right to control the use of an identified asset for a specified period of time in exchange for consideration (see question **1**).

Under the requirements in IFRS 15 – Revenue from Contracts with Customers, a sale (or symmetrically, a purchase) can be defined as the transfer of control of an asset to a customer for consideration. In practice, the need to distinguish a lease from a sale (from the perspective of the supplier/lessor) or a purchase (from the perspective of the customer/lessee) could therefore arise when the term of the contract approaches the economic life of the underlying asset.

In such a case, judgement is required to determine which Standard applies to those transactions.

> The IASB did not wish to address this issue in the main text of the Standard, but clarified in the Basis for Conclusions (cf. IFRS 16.BC 138-140) that a transaction transferring control of the underlying asset is not covered by IFRS 16, but by other standards – such as, for example, IFRS 15 on the supplier side or IAS 16 – Property, Plant and Equipment on the customer side.

In the financial statements of a lessee, qualifying a transaction as a lease or an "in-substance purchase" may have consequences:

- on the recognition of variable payments;

> Whereas IFRS 16 requires variable payments that do not depend on an index or a rate not to be included in the measurement of the lease liability (see question **34**), there is no clear position in IFRS on the measurement of tangible or intangible assets that are acquired for a variable price – as the IFRS IC noted in March 2016 (two months after the publication of IFRS 16).
>
> In our view, in the absence of clarification from the texts, there is an accounting policy choice in this area. An entity either:
>
> - recognises variable payments in profit or loss as they fall due (by analogy with the requirements of IFRS 16); or
> - recognises a liability at inception for future variable payments (provided that the liability can be measured reliably).
>
> In the latter case, the accounting treatment of variable payments will thus differ depending on whether the transaction is classified as a lease or an "in-substance purchase".

- on the presentation of liabilities arising from the transaction.

> When an entity chooses to present lease liabilities and financial liabilities separately (see question **52**), judging the transaction to be an in-substance purchase leads to an increase in the amount of its liabilities presented as financial liabilities, which in turn may impact the calculation of certain debt ratios.

4. Should all leases within the scope of IFRS 16 be recognised on the lessee's balance sheet?

[IFRS 16.5-8; IFRS 16.53.c-d]

For practical reasons, the Standard provides lessees with two optional exemptions from the general accounting model (see question **31**):

- short-term leases (see question **5**): the choice to use this exemption is made by class of underlying assets (i.e. by class of assets of a similar nature and use in an entity's operations);
- leases for which the underlying asset is of a low value (see question **6**): the choice to use this exemption is made on a lease-by-lease basis.

If a lessee elects to use one of these exemptions, it does not recognise a right-of-use asset or lease liability on its balance sheet for the lease(s) in question, and instead recognises the lease payments as an expense over the lease term (see question **24**) on a straight-line basis, or on another systematic basis if more representative of the pattern of the lessee's benefit.

> When one of these exemptions is applied, lease expenses are recognised on a similar basis to that of operating leases under IAS 17 (the previous lease standard).

However, use of these optional exemptions entails certain disclosure requirements, namely:

- a lessee is required to indicate it has used them (see question **54**); and
- a lessee is required to provide the total amount of lease expense for each exemption (see question **53**.

Further, leases which only include variable payments that do not depend on an index or a rate and for which the lessee did not incur any initial direct costs (see question **43**) would in practice not be recognised on the lessee's balance sheet. This is because the initial measurement of both the right-of-use asset and the lease liability would be nil.

> However, in this case, lease expenses are recognised on a different basis from that used when one of the above exemptions is applied: lease payments are recognised as they fall due and not on a straight-line basis over the lease term (see question **34**).

5. Exemptions: what is a short-term lease under IFRS 16?

[IFRS 16.5-8; IFRS 16.Appendix A]

The first optional exemption from the general accounting model for lessees (see question **4**) concerns short-term leases.

IFRS 16 defines a short-term lease as a lease:

- for which the lease term, determined in accordance with the requirements of IFRS 16 (see question **24**), is twelve months or less; and

> Therefore, this exemption does not make it possible to be exempted from the analysis of the lease term.

- which does not contain a purchase option.

> The mere presence of a purchase option seems to have been considered by the IASB as an indication of the complexity of a lease, justifying their systematic recognition on the lessee's balance sheet.

When a lessee has applied the short-term lease exemption to a lease and the lease term is revised after the commencement date (i.e. the date on which a lessor makes the underlying asset available for use by the lessee) (see question **30**), IFRS 16 requires the lessee to consider the lease as a "new lease". In other words, to determine whether the lease is still within the scope of the exemption, a lessee only considers its remaining term (not the sum of the expired term and the remaining term of the lease).

However, it should not be inferred that the applicability of the exemption for short-term leases is reconsidered each time the lease term is revised: it is reconsidered only in the case of a lease previously subject to the exemption – as illustrated in the following example.

Illustration:

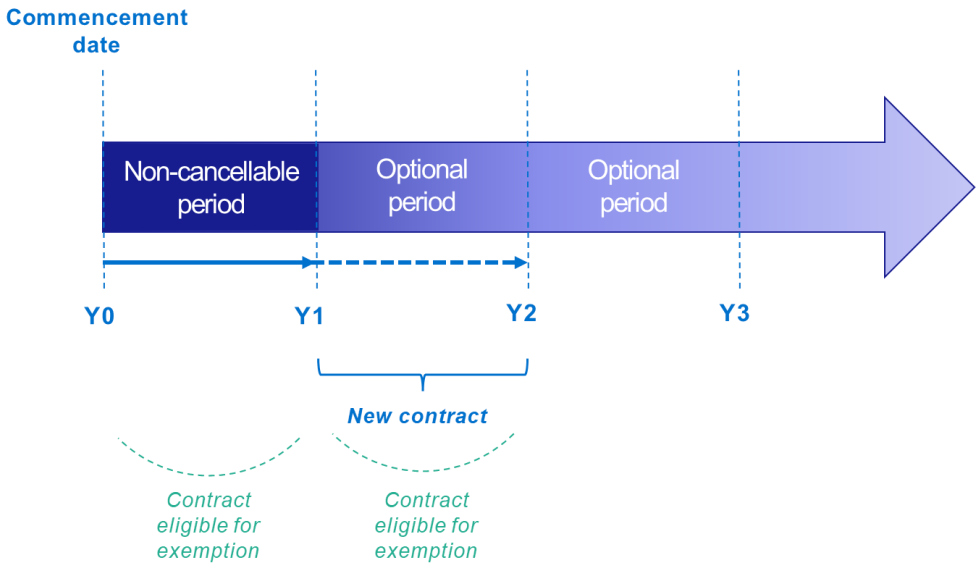
A lease contract includes a non-cancellable period of one year and two optional periods of one year that are available to the lessee. The contract does not include a purchase option.

The entity (lessee) has elected to apply the short-term lease exemption for this class of underlying asset.

Situation 1: at the commencement date, the entity considers, based on all the facts and circumstances, that it is not reasonably certain to extend the lease beyond the first year. Consequently, the lease term is initially estimated to be one year. Because the entity has elected to apply the exemption for short-term leases to this class of underlying asset, the exemption applies to this lease: the lease is not recognised on the entity's balance sheet.

At the end of the first year, the entity chooses to extend the lease by one year. As a result, the lease term needs to be revised (see question 30). In doing so, the entity considers all the facts and circumstances, including the reasons for extending the lease by one year. Because it does not expect the circumstances that led it to extend the contract to recur, the entity concludes that extending the contract beyond the next year is not reasonably certain. Therefore, the remaining lease term is estimated to be one year.

As the exemption for short-term leases has previously been applied to the lease, the entity only considers its residual term when assessing whether the lease is still within the scope of the exemption (as shown in the diagram below).

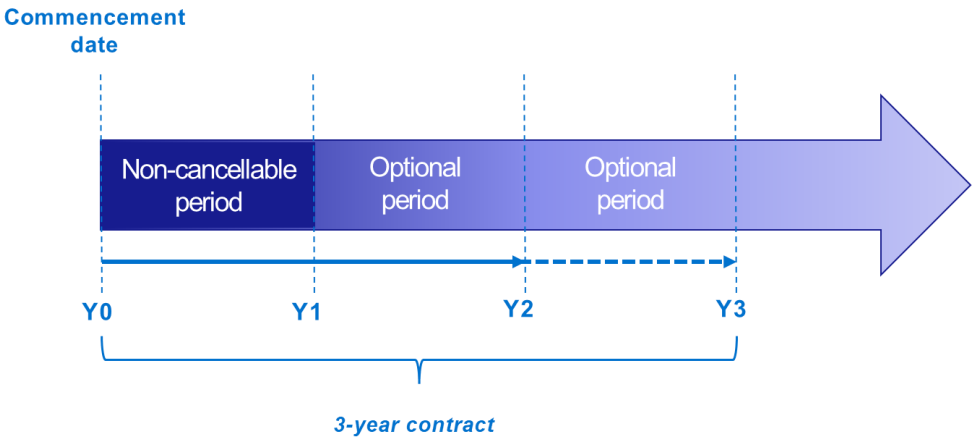


As this "new lease" is estimated to be one year, the exemption for short-term leases still applies: the contract remains off-balance sheet.

Situation 2: at the commencement date, the entity considers, based on all the facts and circumstances, that it is reasonably certain that the lease will be extended at the end of the first year, but it is not reasonably certain that a second extension will occur. Consequently, the lease term is initially estimated to be two years. As the lease does not fall within the scope of the exemption for short-term leases, it should be recognised on the entity's balance sheet.

At the end of the second year, the entity finally chooses to extend the contract by one year. As a result, the lease term needs to be revised (see question **30**): it is extended to three years, of which two years have already elapsed, the remaining term being one year.

As the contract has not previously been subject to the exemption for short-term leases, there is no basis for the entity to consider the remaining term as being related to a new contract. The lease term is thus now three years (as shown in the diagram below).



In other words, the contract does not fall within the scope of the exemption for short-term leases. More generally, this will be true of any lease for which the lease term, as initially assessed at the commencement date, is longer than one year.

6. Exemptions: what is an underlying asset of low value under IFRS 16?

[IFRS 16.5-6; IFRS 16.8; IFRS 16.B3-B8; IFRS 16.B32]

The second optional exemption from the general accounting model for lessees (see question **4**) concerns leases for which the underlying asset is of low value.

The IASB provided several clarifications on how the assessment of whether an underlying asset is of low value is performed:

- in terms of methodology, the IFRS 16 application guidance indicates that this assessment should be:
  - based on the value of the asset when it is new;
  - performed on an "absolute basis" – i.e. without regard to the significance of the underlying asset in relation to the size, nature or circumstances of the lessee;

  In other words: the assets considered to be of low value should in principle be the same for all lessees.

  This assessment is thus different from the assessment of materiality in relation to financial statements as a whole (which is an entity-specific assessment).

- in terms of magnitude, IFRS 16 does not specify any threshold below which an underlying asset would be of low value (thresholds are rare in IFRS), however:
  - the IFRS 16 application guidance indicates that the nature of some assets is such that, when new, they are typically not of low value (the Standard gives the example of cars), but conversely, examples of low value assets can include tablet and personal computers, small items of office furniture and telephones;

- the Basis for Conclusions indicates that the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US$5,000 or less during the discussions on this topic in 2015 (see IFRS 16.BC100).

Although the IASB did not wish to introduce a "bright line" threshold, it is the US$ 5,000 threshold mentioned in the Basis for Conclusions that has most often guided entities in practice when assessing whether a particular contract qualifies for the exemption for leases of low-value assets.

IFRS 16 also indicates that:

- the eligibility for this exemption must be analysed on a component-by-component basis, which therefore requires their prior identification in accordance with the rules set out in IFRS 16 (see questions **9** and **10**);

Without this restriction, it would have been possible for a lessee to circumvent the requirement to recognise leases on its balance sheet simply by componentising the underlying asset into items of sufficiently low value to benefit from the exemption.

Illustrations:

Consider a lease for 40 containers (of a fairly simple design) representing a total volume of 800 m^3: according to the rules set out in IFRS 16 for the identification of separate components, each container is a separate component which, given its value when new (generally a few thousand euros), is eligible for the exemption.

Now consider a lease for a movable metal structure (hangar) of 800 m^3. According to the rules set out in IFRS 16 for the identification of separate components, the lease contains a single component (the hangar) and cannot be considered, for example, to be a lease of 40 separate low-value components of 20 m^3 each. Since the value of the hangar, when new, is well over USD 5,000, the lease is not eligible for the low value exemption.

For a lessee, identifying the separate components of a leased asset properly is important to ensure appropriate application of the low value exemption.

- if a lessee subleases a low-value asset, or expects to sublease a low-value asset, then the headlease (i.e. the contract in which it is a lessee) does not qualify for the low-value lease exemption.

7. Can a lease result in the recognition of a provision for onerous contracts in the financial statements of a lessee under IAS 37?

[IAS 37.1; IAS 37.5; IFRS 16.24.d]

In principle, provisions covered by another standard are excluded from the scope of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*. Therefore, IAS 37 does not apply to liabilities of uncertain timing or amount that are covered by IFRS 16.

When the general accounting model for lessees is applied (see question **31**), a lease liability is recognised for the lease payments. As a consequence, the onerous nature of a lease is not dealt with through IAS 37 (whereas it would have been, prior IFRS 16, for a lease classified as an operating lease under IAS 17 – e.g. an operating lease of vacant premises with no possibility of subletting would usually have triggered the recognition of a provision for onerous contract), but rather through an impairment test of the right-of-use asset, in accordance with IAS 36 (see question **44**).

As confirmed in the Basis for Conclusions (see IFRS 16.BC72).

However, IAS 37 may apply to liabilities which are not recognised under IFRS 16. The paragraphs of IAS 37 relating to the scope of this Standard clarify that the following lease obligations remain within the scope of IAS 37:

- leases that become onerous before the commencement date of the lease (i.e. before their recognition on the lessee's balance sheet);
- leases that are not recognised on the lessee's balance sheet under either the short-term lease exemption (see question **5**) or the exemption for leases of low-value assets (see question **6**).

> In our view, the issue of recognising a provision for onerous contract under IAS 37 may validly arise for any lease that is not recognised on the lessee's balance sheet, provided that the lessee is committed to the lease. For example, although not explicitly mentioned in IAS 37, we believe that such an issue may arise for leases that only include variable payments that do not depend on an index or a rate and for which the lessee has not incurred any initial direct costs (see question **4**).

The above requirements do not prevent a lessee from having to recognise a provision in accordance with IAS 37 in situations where that Standard applies and the conditions for recognising a provision are met. Situations related to a lease contract in which the requirements of IAS 37 would still apply include:

- a lessee's obligations to the lessor in respect of separate service components that have become onerous, if the lessee has not opted for the practical expedient allowing it not to separate non-lease components from lease components (see question **11**);
- a lessee's obligations to dismantle or restore the underlying asset or the site on which it is located. IFRS 16 requires these obligations to be recognised and measured in accordance with IAS 37 requirements (see question **43**).

Identification of a lease

8. When is it necessary to assess whether a contract is (or contains) a lease?

[IFRS 16.9; IFRS 16.11; IFRS 16.B12]

An entity assesses whether a contract is a lease or contains a lease (see question **1**) at inception of the contract, i.e. the earlier of the date of the lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

> In practice, this assessment needs to be made on each part of a contract that could potentially represent a separate lease component (see question **10**).

This initial assessment is revised only if the terms and conditions of the contract are changed.

> On the accounting consequences of a lease modification in the financial statements of a lessee or a lessor: see questions **48** and **62** respectively.

9. In what situations does the Standard require separating a contract into different components?

[IFRS 16.12]

IFRS 16 requires separating a contract into different components in the following situations:

- the contract comprises several distinct lease components (see question **10**);
- the contract contains a lease component and one or more non-lease components to which other accounting Standards apply, for example a contract including the lease and maintenance of a car – unless, in the case of a lessee, the lessee elects to apply the practical expedient allowing a lessee not to separate non-lease components from lease components (see question **11**11).

10. How is it determined whether the components of a lease are distinct?

[IFRS 16. B32-B33]

The right to use an underlying asset is a separate lease component if both of the following conditions are met:

- the lessee can benefit from the use of the underlying asset either on its own or together with other resources that are readily available to the lessee (i.e. goods or services that are sold or leased separately by the lessor or other suppliers, or resources that the lessee has already obtained from the lessor or from other transactions or events); and
- the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that the lessee could decide not to lease the underlying asset without significantly affecting its rights to use other underlying assets in the contract might indicate that the underlying asset is not highly dependent on, or highly interrelated with, those other underlying assets.

Illustrations:

> A lease of commercial premises and parking spaces comprises two separate lease components.
>
> In contrast, a lease of an electric vehicle and its battery comprises only one lease component (considering the second condition above, the vehicle and the battery appear to be closely related and, for this reason, are not considered separate for the purposes of IFRS 16).

These two conditions are similar to those in IFRS 15 for identifying separate performance obligations within a contract with a customer.

> The IASB expects the above requirements to be applied in a similar way to those in IFRS 15 in the context of a contract for the sale to a customer (see IFRS 16.BC134)
>
> See also **Mazars Insight on IFRS 15**, question 18.

Therefore, in practice, the above provisions can be considered to apply equally to the determination of whether:

- several lease components are distinct from each other; or
- a lease component is distinct from one or more non-lease components within the scope of IFRS 15 (i.e. the sale of a good or service).

As a consequence, the fact:

- that a contract provides for the provision of several assets to the lessee over a period of time is not in itself sufficient to conclude that there are as many separate lease components;
- that a contract includes an amount payable by the lessee for activities performed or costs incurred by the lessor is not sufficient to conclude that those activities or costs represent a distinct non-lease component. If those activities or costs do not result in the transfer of a good or service to the lessee (e.g. administrative or other costs incurred by the lessor and charged to the lessee that do not result in the transfer of a good or service to the lessee), the amount payable by the lessee is considered to be part of the total consideration to be allocated between the lease components of the contract (see questions **12** and **13**).

The above principles apply to both lessees and lessors.

> For a lessee, identifying the separate components of a lease is of particular importance, as the eligibility for the exemption for leases of low-value assets is assessed on a component-by-component basis (see question **6**).

11. Are there practical expedients allowing an entity not to account for distinct components separately?

[IFRS 16.15; IFRS 16.17]

IFRS 16 provides a practical expedient allowing lessees not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease component (except for embedded derivatives that meet the criteria in paragraph 4.3.3 of IFRS 9 – *Financial Instruments*) as a single lease component.

> In practice, this means that the consideration for the non-lease components is included in the payments used to measure the lease liability (see question **34**).

As with the exemption on short-term leases (see questions **4** and **5**), this option is exercisable by class of underlying assets (i.e. assets of a similar nature and use in an entity's operations).

> According to the IASB, this option reduces the cost and complexity of applying IFRS 16 for some lessees, without creating significant comparability issues (see IFRS 16.BC135.b). The IASB believes that a lessee would have little incentive to use this option for significant service components because this would result in a significant increase in the lessee's lease liabilities.
>
> However, it can be observed that the use of this practical expedient also has a favourable effect on performance measures which exclude depreciation charges, such as EBITDA (since the cost of the service component is included in the depreciation charge of the right-of-use asset).

For lessors, no such practical expedient exists. They are always required to account for the lease components and non-lease components of a contract separately.

> The IASB considers that a lessor has the necessary elements to allocate the consideration in the contract to its distinct components, because it was able to gather the information necessary when pricing the contract.

12. In the financial statements of a lessee, how is the consideration in the contract allocated to the distinct components identified?

[IFRS 15.47; IFRS 16.13-14]

Where a contract contains a lease component and one or more additional lease or non-lease components (see questions **9** and **10**) and the lessee does not elect to apply the practical expedient regarding the non-separation of lease and non-lease components (see question **11**), IFRS 16 requires the consideration in the contract to be systematically allocated to the different components in proportion to their relative stand-alone prices (i.e. individual market prices or, failing that, an approximation thereof).

> If a contract assigns a price to each distinct component of the contract, these can only be used as the consideration for each such component if the contractual breakdown of prices reflects their relative stand-alone prices.

This is consistent with the approach in IFRS 15 for allocating the transaction price to performance obligations.

> By analogy to the requirements of IFRS 15, the consideration to be allocated to the distinct components should, in our view, not include amounts collected on behalf of third parties (e.g. certain taxes based on sales, such as VAT).
>
> In our view, since VAT is collected by the lessor on behalf of the government in most jurisdictions, it is also appropriate for non-refundable VAT (i.e. VAT charged by a lessor to a lessee which, under applicable law, cannot fully recover it) to be excluded from the consideration allocated to components. Such non- refundable VAT should instead be recognised as an expense when it is due, in accordance with IFRIC 21 – *Levies*. Asked whether or not non-refundable VAT on lease payments formed part of these lease payments, the IFRS IC, in October 2021, decided not to provide any clarification on this issue because there was insufficient evidence that the matter had widespread and significant effect.

Under IFRS 16, the stand-alone price of a distinct component is the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available for one or more components of the contract, the lessee needs to estimate it by maximising the use of observable inputs.

Illustration:

A lumber manufacturing company enters into a contract that includes the lease of a sawing machine and a planing machine for five years, as well as the maintenance of both machines for the same period.

The contract provides for a fixed annual payment of €10k (i.e. a total of €50k over the lease term) and a variable payment based on the number of hours of maintenance performed.

As these are standard facilities and services, the lessee can determine the stand-alone price of each lease and non-lease component (considering similar payment schedules to that of the contract):

- lease of a sawing machine: €24k (for a period of five years);
- lease of a planing machine: €17k (for a period of five years);
- maintenance of the sawing machine: €7k (for a period of five years) and a variable payment according to the number of hours of maintenance performed;
- maintenance of the planing machine: €5k (for a period of five years) and a variable payment according to the number of hours of maintenance performed.

As a first step, the different components of the contract should be identified (see questions 9 and 10):

- maintenance services, being within the scope of IFRS 15, must be distinguished from the lease components of the contract, unless the lessee elects to apply the practical expedient regarding the non-separation of lease and non-lease components (see question 11);
- the lessee can benefit from the right to use each machine, either on its own or together with other readily available resources (e.g. by renting another type of sawing machine or another type of planing machine, or by subcontracting either of them). Moreover, even if the lessee uses these machines for the same purpose (the manufacture of lumber), they are neither highly dependent on, nor highly interrelated with, each other.

Therefore, the contract consists of two distinct lease components (a lease of a sawing machine and a lease of a planing machine) and a non-lease component (maintenance services).

Once the different components of the contract have been identified, the second step is to allocate the consideration in the contract to its different components.

The fixed consideration is allocated to each component in proportion to their relative stand-alone prices:

- lease of a sawing machine: [24/(24+17+12)]*50 = €22.7k;
- lease of a planing machine: [17/(24+17+12)]*50 = €16k;
- maintenance services: [12/(24+17+12)]*50 = €11.3k.

Any variable consideration that the entity is charged over and above the annual €10k fixed lease payment is allocated to the non-lease maintenance component because such an allocation is consistent with the principle of allocating the consideration in the contract to its various components in proportion to their relative stand-alone prices. The amounts allocated to the non-lease maintenance component are recognised as an expense by the lumber manufacturing company when it receives the maintenance services.

The amounts allocated to each of the lease components (lease of a sawing machine and lease of a planing machine) are the lease payments used to initially measure the lease liability (see question 34). Note that in practice, it may not be necessary to distinguish the amounts allocated to each of these lease components if the amortisation period and amortisation method are the same for both right-of-use assets and if these right-of-use assets are not presented separately on the balance sheet or disclosed separately in the notes.

13. In the financial statements of a lessor, how is the consideration in the contract allocated to distinct components?

[IFRS 16.17]

On that matter, IFRS 16 refers directly to the requirements of IFRS 15 to perform the allocation of the transaction price to the different performance obligations (including subsequent changes in the transaction price).

See **Mazars Insight on IFRS 15**, questions 41 to 49.

14. When is an entity required to combine lease contracts?

[IFRS 16.B2]

The circumstances under which an entity is required to combine lease contracts under IFRS 16 are similar to those under which an entity is required to combine contracts with customers under IFRS 15.

> The similarity of the two standards in this respect is explicitly mentioned in the Basis for Conclusions: see IFRS 16.BC132.

Specifically, an entity (lessee or lessor) is required to combine two (or more) leases if they are negotiated:

- on the same date (or close to it);
- with the same counterparty (or related parties of the counterparty); and
- if at least one of the following conditions is met:
  - the contracts are negotiated as a package with an overall commercial objective that cannot be understood without considering the contracts together; or
  - the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
  - 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 (see question **10**).

Illustration:

A lessee enters into a one-year lease for an asset with certain characteristics, while at the same time entering into:

- a one-year lease for an asset with the same characteristics, starting in one year;
- two similar contracts, one starting in two years, the other in three years.

The terms and conditions of these four contracts are clearly negotiated in relation to each other, so that the overall economic effect cannot be understood without considering the four contracts together. In other words, accounting for each contract independently of the others may not give a true representation of the overall transaction.

It should be concluded that the four transactions form a single lease contract with a lease term of four years, and not four separate lease contracts to which the short-lease exemption could be applied.

The requirements on combining lease contracts is to be distinguished from a portfolio approach (see question **15**).

15. Under what conditions can an entity apply the Standard to a portfolio of leases?

[IFRS 16.B1]

IFRS 16 requires an entity to apply its requirements to each lease individually.

However, as a practical expedient, an entity (lessee or lessor) is allowed to apply the requirements of the Standard to a portfolio of leases when the following conditions are met:

- the contracts in the portfolio have similar characteristics; and
- the entity expects that the effects of applying the Standard to the portfolio of leases would not differ materially from applying them individually.

The practical expedient may be useful for companies that conclude master framework agreements for the leasing of (say) vehicles for use by their employees. Individual lease contracts often have the same characteristics (e.g. in terms of duration and type of vehicle). In this case, the company may decide to apply IFRS 16 to groups of contracts starting on approximately the same date (e.g. over a quarter).

The conditions for applying a portfolio approach differs from those for combining lease contracts (see question **14**). In addition, it is important to note that accounting for leases on a portfolio basis is optional, whereas combining leases is mandatory when the required conditions are met.

16. Identified asset: what is an identified asset?

[IFRS 16.B13; IFRS 16.Appendix A]

Under IFRS 16, an identified asset is:

- an asset that is either:
  - explicitly specified in the contract (e.g. a flat in a building, identified by its floor and its location on the floor); or
  - implicitly specified when it is made available for use by the customer (e.g. in the case of a short-term car lease, the contract usually only specifies a type of car, but a car is implicitly specified when the lessee takes possession of the vehicle; in the case of a lease for a construction crane, it is possible that the contract specifies only the characteristics of the crane, however a crane is implicitly specified once brought on site); and

The key question here is whether a specified asset is necessary to satisfy the contract (in this regard, see IFRS 16.BC111).

- for which the supplier has no substantive right to substitute the asset (see question **18**) throughout the period of use.

A lease can therefore be distinguished from a service contract by the supplier having the obligation to make a specified asset available to its customer (or to use a specified asset to perform the contract) and not simply to supply the output resulting from the use of assets (e.g. an electricity supply contract in which the electricity could come from different sources of production, at the supplier's discretion, is a service contract because the electricity does not have to be supplied from a contractually specified asset).

Consequently, whenever an asset is identified in a service contract, special attention should be paid to the possibility that this contract, whatever its legal form (given the definition of a lease in IFRS 16: see question **1**), might contain a lease.

Determining whether the underlying asset is an identified asset, as defined in IFRS 16, may require significant judgement.

17. Identified asset: under what conditions is a capacity or other portion of an asset considered an identified asset?

[IFRS 16.B11; IFRS 16.B20; IFRS 11.20; IFRS 11.24]

A capacity or other portion of an asset may meet the definition of an identified asset (see question **16**) provided:

- it is "physically distinct" (the example given in the application guidance is a floor of a building);

Usually, determining whether a capacity or other portion of an asset is "physically distinct" is obvious.

However, this may not always be the case. For example, in a contract for subsurface rights, asserting that the underground space specified in the contract is "physically distinct" first requires considering that underground space is distinct from the surface above. In this regard, a decision of the IFRS IC in June 2019 regarding underground space leased by a pipeline operator supported the view that it was possible to consider surface and underground space as two physically distinct assets.

- it represents substantially all of the asset's capacity – so that the customer has the right to obtain substantially all the economic benefits arising from the use of the asset (see question **21**).

IFRS 16 does not specify the threshold beyond which a capacity or other portion of an asset represents substantially all of the asset's capacity. An entity is thus required to consider the asset's characteristics and use judgement. With no further guidance in the Standard, this analysis may seem difficult at first.

In our opinion:

- this analysis is ultimately aimed at determining whether the contract (or a component of the contract) provides the customer with a right to control the use of the asset; and
- control in IFRS 16 is intended to be consistent with the definition of control under IFRS 15 (which states, *inter alia*, that control includes the ability to prevent others from directing the use of an asset and obtaining benefits from it).

Therefore, it should be possible to follow the following reasoning, based on the residual capacity of the asset:

- if the residual capacity appears too low for the supplier to obtain any benefit by directing it to another customer, then the capacity which has been allocated to the customer represents substantially all of the asset's capacity;
- if, on the contrary, there seems to be enough residual capacity for the supplier to obtain economic benefits by directing it to another customer, then the capacity which has been allocated to the customer does not represent substantially all of the asset's capacity.

A contract may provide the customer with the right to use an asset and an option or an obligation to return any part of its capacity that exceeds its needs. In our view, this does not prevent the customer from being able to direct the use of the asset (since the customer can restrict its use by third parties by saturating its capacity). Therefore, to determine whether the asset qualifies as an identified asset, we believe that it is appropriate to consider the capacity which has been allocated to the customer before any mechanism for returning excess capacity.

Leases entered into by a joint arrangement, or on behalf of a joint arrangement, as defined in IFRS 11 Joint Arrangement

In the case of a contract entered into by a joint arrangement, or on behalf of a joint arrangement, as defined in IFRS 11, the IFRS 16 application guidance specifies that the joint arrangement (and not each party to the joint arrangement) is considered to be the customer in the contract. Therefore, the asset (or, where applicable, the capacity or other portion of the asset) over which the parties to the joint arrangement collectively have rights should be considered to determine whether the underlying asset in the contract qualifies as an identified asset.

To determine whether a contract entered into by a joint arrangement, or on behalf of a joint arrangement, relates to an identified asset, as defined in IFRS 16, it is thus not permitted to consider that there are as many portions of asset to analyse as there are parties to the joint arrangement.

This applies to both types of joint arrangement:

- a joint operation for which a joint operator recognises its share of the assets, liabilities, income and expenses of the joint operation in its financial statements; or

Accounting for a joint operation in a joint operator's financial statements under IFRS 11 is sometimes complex.

As pointed out by the Interpretations Committee in March 2019, notwithstanding the above general principle, a joint operator fully recognises the liability arising from a lease for which it is the sole signatory (to the extent that it has primary responsibility for this liability), even if the underlying asset is operated jointly as part of the joint operation's activity and the cost of the lease is ultimately shared between the joint operators.

- a joint venture accounted for in a joint venturer's financial statements in accordance with IAS 28, i.e. using the equity method.

18. Identified asset: what does the notion of substantive substitution rights of a supplier cover?

[IFRS 16.B14-B15; IFRS 16.B17-B19]

As previously mentioned (see question **16**), the fact that a supplier has substantive substitution rights throughout the period of use is sufficient to conclude there is no identified asset (and, therefore, the contract is not a lease).

The Basis for Conclusions (see IFRS 16.BC112) specifies that in this case, the supplier – not the customer – controls the use of the asset.

Therefore, assessing whether a supplier's substitution rights are substantive is often a critical step when analysing whether a contract is, or contains, a lease.

Substitution clauses that are not substantive do not affect this assessment (see IFRS 16.BC113).

Definition of substantive substitution rights

As a principle, the rights (or obligations) of a supplier to replace the asset due to repairs, maintenance, fixes or upgrades are not considered substantive substitution rights.

In practice, such substitutions are indeed common, both in the context of lease contracts and service contracts. They are generally linked to the supplier's obligation to provide its customer with an asset in good working order throughout the contract. It thus seems reasonable to consider that the rights (or obligations) of a supplier to make such substitutions have no bearing on the distinction between leases and other service contracts.

In all other cases, a substitution right is considered substantive under IFRS 16 when, throughout the period of use, the supplier both:

- has the practical ability to substitute alternative assets (e.g. the customer cannot prevent the supplier from substituting the asset and the supplier can easily find alternative assets); and
- would benefit economically from doing so (i.e. the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

Illustration:

A beverage retailer enters into a contract with an airport concessionaire for the right to use a designated area within the airport lobby to install and operate a removable take-away beverage stand for three years.

The contract allows the airport to change this location within the airport lobby, with no other condition than to give the retailer 48-hour notice. The airport has an interest in exercising this right for various reasons, e.g. to facilitate the management of the flow of people in the airport lobby, to comply with new security constraints, to reorganise the layout of the space inside the airport lobby for a specific promotional event, etc.

In this case, the airport both:

- has the practical ability to substitute locations within the airport lobby because the customer cannot prevent this decision and can be moved to alternative locations in the lobby; and
- would benefit economically from doing so (since the airport may regularly have an interest in making such a substitution and the cost is virtually nil).

As the airport's substitution rights are substantive, the asset (i.e. the location within the airport lobby) does not meet the definition of an identified asset under IFRS 16.

Therefore, the contract is not a lease, as defined in IFRS 16.

Detailed analysis of the criteria for defining a substantive substitution right

In practice, it is sometimes necessary to analyse in detail each of the criteria that defines a substantive substitution right to determine whether a supplier has such a right.

Practical ability to substitute alternative assets

In assessing the first criterion, an entity will usually have objective evidence on which to base its assessment, such as:

- the rights and obligations of the customer and the supplier (as these rights and obligations may sometimes restrict the supplier's ability to substitute the asset);

In the case of housing rentals, legal provisions usually protect the tenant against eviction by the landlord, so that the landlord usually does not have the practical ability to substitute the leased premises.

- the non-specific nature of the underlying asset (which often ensures that the supplier can easily find alternative assets; this will usually be the case for mass-produced goods: computers, copiers, transport containers, etc.).

Economic benefit of substituting alternative assets

The second criterion may be more complex for the customer to assess than for the supplier because the customer may not have information on the economic impacts of a substitution for the supplier, in particular the substitution costs that the supplier would incur.

However, there are many situations where the economic benefit – or the lack of economic benefit – to the supplier in making a substitution is clear. Consider:

- a contract providing a customer with the use of a construction crane for a period a time. It is unlikely that the supplier would have an economic benefit in dismantling the crane during the contract (the supplier would then have to find another available crane to replace it), with the sole aim of reassigning it to another customer (installing an already available crane at the other customer's premises would certainly be faster);
- a contract providing a customer with the right to use rail cars for a period of time, the rail cars being made available at the point of departure of the journey the customer wishes to make and returned to the supplier at the point of arrival. To optimise the use of its fleet, the supplier has every interest in substituting, whenever necessary, the rail cars made available in such a way so as to minimise the required number of journeys without breaching its obligations to the customer.

For its part, the IASB seems to consider that in many cases it will be clear that the supplier would not benefit from the exercise of a substitution right because of the costs associated with substituting an asset (see IFRS 16.BC113).

In practice, the assessment of the economic impacts of a substitution for the supplier amounts to asking in which scenarios the supplier would reasonably wish to substitute the asset.

The fact that a customer has difficulty determining the economic benefit of substitution for the supplier does not rule out the existence of a lease, as defined in IFRS 16. Indeed, when a customer cannot readily determine whether a supplier has a substantive substitution right, IFRS 16 requires the customer to presume that any substitution right is not substantive.

According to the IASB, a customer is not expected to exert “undue efforts” to provide evidence that a substitution right is not substantive. The IASB also clarified that, if substitution rights are substantive, this would be relatively clear from the facts and circumstances (see IFRS 16.BC115).

A right that can be exercised throughout the period of use

Finally, for the substitution right to be substantive, it must be exercisable throughout the period of use, i.e. the total period of time that an asset is used to fulfil a contract with a customer, including any non-consecutive periods.

The period of use may be shorter than the lease term (see question **24**) if non-consecutive periods of use are required to fulfil the contract.

Illustration:

A company leases a small plane for two years for the business trips of its managers. The contract specifies that the company can use the plane only from Monday to Friday. In practice, this means that the owner can freely lease the plane to other customers on weekends.

The period of use are the weekdays during which the company may use the plane and therefore excludes the weekends (whereas the lease term would include the weekends). What needs to be assessed is whether the supplier's substitution rights are substantive on weekdays.

A right to substitute the asset that could only be exercised on or after either a certain date, or the occurrence of a specified event, would also not be substantive (and hence would be insufficient to refute the existence of an identified asset) because it is not exercisable throughout the period of use.

Illustration:

A company enters into a three-year contract for the use of five hundred square metres of office space on an intermediate floor of a building. The owner of the building can require the company to relocate within the building, provided that the new location is of equivalent size and located on the same or a higher floor. On the date the contract is concluded, the building is fully occupied.

The practical ability of the supplier (i.e. the building owner) to substitute the asset is contractually limited because a substitution will only be possible when equivalent space becomes available on the same floor or a higher floor. The owner cannot exercise its substitution right throughout the period of use.

Therefore, the supplier’s substitution right is not substantive, and the intermediate floor of the building is an identified asset.

As confirmed by the IFRS IC in its April 2023 agenda decision, judgement is required to determine whether a supplier's right to substitute an asset is substantive *throughout* the period of use. This is because the term 'throughout the period of use' does not mean at all times within that period.

The IFRS IC illustrated this by pointing out that, according to IFRS 16 (par. B14(a)), a supplier has the practical ability to substitute alternative assets throughout the period of use even if the supplier does not already have alternative assets but could source those assets within a reasonable period of time.

19. Identified asset: when is it necessary to assess whether a supplier's substitution rights are substantive?

[IFRS 16.9; IFRS 16.B16]

As part of the analysis for identifying a lease (see question **8**), the assessment of whether a supplier's substitution rights are substantive must be carried out (i) at inception of the contract and (ii) whenever the terms and conditions of the contract are modified, on the basis of the facts and circumstances existing at each of these dates.

According to the IFRS 16 application guidance, future events are considered in this analysis if they are considered likely to occur at inception of the contract.

> This analysis may require assumptions to be made about future conditions during the period of use, for example the future availability of alternative assets and whether there will be an economic benefit for the supplier in substituting the asset in the future.

However, the IFRS 16 application guidance specifies that the following hypothetically possible future events would be excluded from the determination of whether a supplier's substitution right is substantive as they are not considered likely to occur at inception of the contract:

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

Illustration:

> Customer enters into a three-year contract for commercial premises within a shopping centre. The owner of the shopping centre can require the customer to relocate within the shopping centre, subject to compensation for the customer's relocation costs. At inception of the contract, it is likely that there will be vacant premises within the shopping centre throughout the period of use, as expansion work is planned and all the corresponding space has not yet been assigned to future customers. However, given the expected evolution of market prices over the next three years, it is not likely that the owner will obtain a sufficiently higher price from a new customer to cover the compensation due to the first customer.
>
> The supplier (i.e. the owner of the shopping centre) only has an economic advantage to make a substitution if certain market conditions arise which are not likely at inception of the contract.
>
> Therefore, the supplier has no substantive substitution right.

20. Control over the use of an asset: what does the right to control the use of an asset mean?

[IFRS 16.B9-B10]

According to IFRS 16, an entity has the right to control the use of an identified asset if, throughout the period of use (see question **18**), it has:

- the right to obtain substantially all the economic benefits arising from its use (see question **21**); and
- the right to direct the use of that asset (see questions **22** and **23**).

In most cases, this assessment is relatively straightforward since the customer takes possession of an asset and uses it under an exclusive right for the duration of the contract.

However, there are some more complex cases where judgement is required (typically, contracts in which a supplier undertakes to provide goods or services to a customer by making use of a specified asset in the provision of those goods and services). In such cases, the guidance below may be helpful.

21. Control over the use of an asset: how should it be determined whether an entity has the right to obtain substantially all the economic benefits arising from the use of an asset throughout its period of use?

[IFRS 16.B21-B23]

What economic benefits should be considered?

IFRS 16 specifies that the economic benefits from the use of an asset include its primary output and by-products, as well as other economic benefits from using the asset in a commercial transaction with a third party (e.g. a sublease).

The economic benefits to be considered are those resulting from using the asset within the defined scope of a customer's right to use the asset, which may be subject to restrictions (e.g. a car lease in which the use of the car is restricted to a certain mileage or geographical area). The existence of such contractual restrictions – which are common in leases – do not impact the assessment of whether a customer controls the use of the asset within the defined scope of its right to use the asset (see question **22**).

> As discussed in the Basis for Conclusions (see IFRS 16.BC22.c), such restrictions are also common in asset acquisition contracts, without necessarily affecting the control that will be exercised by the future acquirer (e.g. when a company acquires an asset from a competitor with certain limitations on the use or resale of that asset; or when a government restricts the use and transfer of certain assets for safety or environmental reasons). The outright purchase of a tangible or intangible asset with such restrictions would nonetheless result in the purchaser recognising that asset on its balance sheet.

Finally, economic benefits arising from the ownership rather than use of an identified asset are not included in determining whether the entity has a right to substantially all the economic benefits (see IFRS 16.BC118).

> The Standard provides an example to illustrate this point (Example 9A). In this example, a distinction is made between economic benefits associated with the use of a solar farm (in the form of renewable energy credits, the amount of which increases with the use of the asset) and those associated with the ownership of the asset (in the form of tax credits relating to the construction and ownership of an infrastructure). Only the former are considered when assessing control over the use of the asset. Therefore, although the customer does not benefit from the tax credits, the contract might nonetheless be a lease of the solar farm.

Is there a threshold beyond which an entity would be considered entitled to substantially all the economic benefits arising from the use of an asset?

IFRS 16 does not set a quantitative threshold beyond which an entity would be considered entitled to substantially all the economic benefits arising from the use of an asset.

> The absence of a quantitative threshold is customary under IFRS, but not under US GAAP.
>
> For entities applying the US Standard on leases (ASC Topic 842), the notion of "substantially all the economic benefits" should, in practice, correspond to a threshold of 90% (though this notion is not used in assessing whether a customer has the right to control the use of an asset, it is frequently used in other parts of the US Standard and the 90% threshold is mentioned in the Standard's application guidance and Basis for Conclusions). This threshold could therefore constitute a relevant indicator under IFRS (given the proximity of the two accounting frameworks).
>
> This issue is also related to the question of whether the underlying asset qualifies as an identified asset, as defined in IFRS 16, when the right-of-use asset relates to a capacity or other portion of an asset (see question **17**).

Would the linking of contractual payments to the performance of the underlying asset mean there is no substantial right to obtain the economic benefits from its use?

According to the IFRS 16 application guidance, a contractual requirement for the customer to pay the supplier (or a third party) an amount equivalent to a portion of the cash flows from the use of the asset does not preclude the customer from being entitled to the economic benefits arising from the use of the asset.

Illustration:

> A customer has the exclusive right to use specified retail space for a period of time in return for a percentage of sales payable to the supplier.
>
> In this example:
>
> - the customer initially obtains the full economic benefits from the use of the retail space; and
> - the customer uses part of the cash flows from the sales to pay the supplier for the right to use the retail space.

The fact that contractual payments are linked to the performance of the asset does not, in and of itself, mean the purchaser cannot obtain the economic benefits resulting from use of the asset.

22. Control of the use of the asset: how is it determined who directs the use of an asset?

[IFRS 16.B24-B27; IFRS 16.B30]

The analysis of the right to direct the use of an identified asset, like the analysis of the right to obtain substantially all the economic benefits arising from its use, is to be carried out within the defined scope of a customer's right to use the asset (see question **21**).

Deciding whether it is the supplier or customer who directs the use of the asset generally involves determining which one decides how and for what purpose the asset is used throughout the period of use. However, in situations where the relevant decisions about how and for what purpose the asset is used are predetermined (i.e. neither the customer nor the supplier can modify how and for what purpose the asset is used throughout the period of use), specific requirements apply (see question **23**).

> The IASB expects those situations to be rare (see IFRS 16.BC121).

Which decisions-making rights give the customer the right to direct how and for what purpose the asset is used?

Decisions made by supplier, customer, or either, before (or at the beginning of) the period of use are relevant only if the customer designed the asset (or specific aspects of it) in a way that predetermines how and for what purpose the asset will be used throughout the period of use (see question **23**).

> The IASB considers that a customer whose decision-making rights are limited to determining the output from an asset at or before the beginning of the period of use has no more decision-making rights than any customer in a typical supply or service contract (see IFRS 16.BC123).

Consistently with the concept of control under IFRS 10 – *Consolidated Financial Statements*:

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use if it has the power to make the "relevant" decisions, i.e. those affecting the economic benefits arising from the use of the asset;
- rights of the supplier which are "protective" in nature (i.e. those which primarily protect the supplier's interest in the residual value of the asset or in the value of other assets, to protect its personnel, or to ensure compliance with laws or regulations) do not affect the analysis. According to the IFRS 16 application guidance, protective rights typically define the scope of the customer's right to use the asset in a contract but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

Under IFRS 16, the decision-making rights that are considered most relevant are likely to vary from contract to contract, depending on the nature of the asset and the terms and conditions of the contract.

Examples of decision-making rights that are generally considered “relevant” decisions

The application guidance of the Standard provides the following examples of decision-making rights that, depending on the circumstances, grant the customer the right to change how and for what purpose the asset is used:

- rights to change the type of output that results from the use of the asset (e.g. to decide whether to use a shipping container to transport goods or for storage, or to decide upon the mix of products sold from a retail space);
- rights to change when the output is produced (e.g. to decide when an item of machinery or a power plant is used);
- rights to change where the output is produced (e.g. to decide upon the destination of a truck or a ship, or to decide where an item of equipment is used);
- rights to change whether the output is produced, and the quantity of that output (e.g. to decide whether to produce energy from a power plant and how much energy to produce from that power plant).

Examples of decision-making rights that are generally considered protective

The IFRS 16 application guidance also provides the following examples of supplier rights that would generally be considered protective:

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

Does it matter whether the customer or the supplier operates and maintains the asset?

IFRS 16 considers that, except in situations where the relevant decisions about how and for what purpose the asset is used are predetermined (see question **23**), operating and maintaining an asset does not, in itself, confer a right to make relevant decisions about how and for what purpose the asset is used. This is because these activities are often dependent on decisions that have already been made about how and for what purpose the asset is used (in a way, they implement those decisions).

Therefore, whether it is the customer or supplier who operates and maintains the asset generally has no bearing on the analysis.

Illustration:

A shipping company enters into a five-year contract for the exclusive use of a specified ship in a specific territory. The shipowner is responsible for repairing and maintaining the ship, which are the only times it has the right to substitute the ship. The shipowner provides the crew to operate the ship. During the entire period of use, the shipping company decides on the routes to be taken, the dates of departure and arrival and the cargo to be transported (subject to certain restrictions related to the safety of the ship and its crew).

In this example, the contract is for the use of an identified asset, as the ship is specified in the contract and the owner has no substantive substitution right (see questions **16** and **18**).

The shipping company decides where, when and for what purpose (i.e. what cargo is transported) the ship is used, and therefore has the right to direct the use of the ship throughout its period of use. The fact that the shipowner operates the ship does not impact the conclusion because this activity depends on the decisions made by the shipping company regarding the use of the ship. The shipping company is also entitled to obtain substantially all the economic benefits arising from the use of the ship since it has exclusive use of the ship (see question **21**).

Therefore, the contract includes a lease component, being a lease of the ship.

In addition, ship operation and maintenance services are non-lease components (see question **10**) that should be accounted for separately, unless the shipping company has elected not to separate lease and non-lease components for this class of underlying assets (see question **11**).

23. Control over the use of an asset: how do you deal with situations where the relevant decisions about how and for what purpose the asset is used are predetermined?

[IFRS 16.B24.b: IFRS 16.B28-B29]

In situations where the relevant decisions about how and for what purpose the asset is used are predetermined and cannot be changed by the customer or the supplier throughout the period of use (which, according to IFRS 16, may be as a result of the design of the asset or contractual restrictions on the use of the asset), IFRS 16 indicates that the customer has the right to direct the use of an identified asset if:

- it has the right to operate the asset (or to direct the manner the asset is operated by others) throughout the period of use, without the supplier having the right to change its instructions; or

  The IASB considers that, in this case, a customer has decision-making rights that extend beyond those available to a customer under a typical supply or service contract (see IFRS 16.BC122).

- it designed the asset (or specific aspects of it) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

  In our view, this is typically the case where the underlying asset, once commissioned, produces economic benefits with no outside intervention other than that required for repairs and maintenance and almost operates on “autopilot” (e.g. a solar farm designed by the customer so that there is no longer any decision to be made throughout its period of use on what the solar farm produces (electricity), in what quantity and when).

To decide whether to analyse who controls the use of an asset by reference to the general requirements (see question **22**) or by reference to the above requirements, it is generally necessary to assess whether all relevant decisions about how and for what purpose the asset will be used are predetermined.

However, in practice, it is not always clear whether all relevant decisions are predetermined or, in other words, whether the decisions to be made by the customer or supplier throughout the period of use give either of them the power to change how and for what purpose the asset will be used.

The judgement reached in this area is important because it will impact the analysis that is undertaken to determine if the contract is, or contains, a lease.

Illustration:

The IFRS IC considered an issue in which a customer enters into a five-year contract with the owner-operator of a specified ship. The ship is assumed to qualify as an identified asset, as defined in IFRS 16, and was not designed by the customer. The contract specifies the type and quantity of cargo to be transported by the ship, the loading ports (there are multiple points of departure) and the discharging port (there is only one point of arrival) and the number of voyages. During the period of use, the customer sends regular instructions (annual and quarterly shipment plans) to the owner-operator of the ship specifying the order of the voyages (however, the customer cannot change either the total number of voyages or the total quantities transported as provided for in the contract).

Because the customer did not design the ship, IFRS 16 requires the customer to disregard any decisions that are predetermined in concluding whether it can direct the use of the ship throughout its period of use. Therefore, if the customer has relevant decision-making rights, it will direct how and for what purpose the asset is used, and hence conclude that it has the right to direct the use of the ship.

Without describing in detail the above background, the agenda decision reached by the IFRS IC in January 2020 considered that the relevant decisions about how and for what purpose the ship would be used were held by the customer during the period of use. The agenda decision did not, however, identify which relevant decisions were not pre-determined and could be made by the customer during the period of use. The IFRS IC perhaps viewed the customer's right to decide on the order of voyages as enabling it to optimise its upstream costs, thus affecting the economic benefits to be derived from use of the ship.

If, by contrast, it had been concluded that the decision making rights retained by the customer were not relevant decisions (i.e. the decisions did not affect the economic benefits to be derived from use of the ship), then it would likely have been concluded the customer did not have the right to direct the use of the ship throughout the period of use because it had neither the right to operate the ship nor the right to instruct the ship owner how to operate the ship.

Lease term

24. How is the lease term defined?

[IFRS 16.18; IFRS 16.Appendix A; IFRS 16.B35-B36]

The definition of the lease term in IFRS 16 is common to lessees and lessors.

The lease term begins at the commencement date (i.e. the date on which a lessor makes the underlying asset available for use by the lessee). Beyond that date it includes:

- the non-cancellable period during which a lessee has the right to use the underlying asset;
- optional periods that the lessee is reasonably certain to use on the commencement date (see question **25**), i.e.:
  - periods covered by an extension option that a lessee is reasonably certain to exercise; and
  - periods covered by a termination option that a lessee is reasonably certain not to exercise.

IFRS 16 clarifies that the non-cancellable period does not include periods covered by a lessee's termination option but does include periods covered by a lessor's termination option (regardless of the likelihood of the lessor exercising that option).

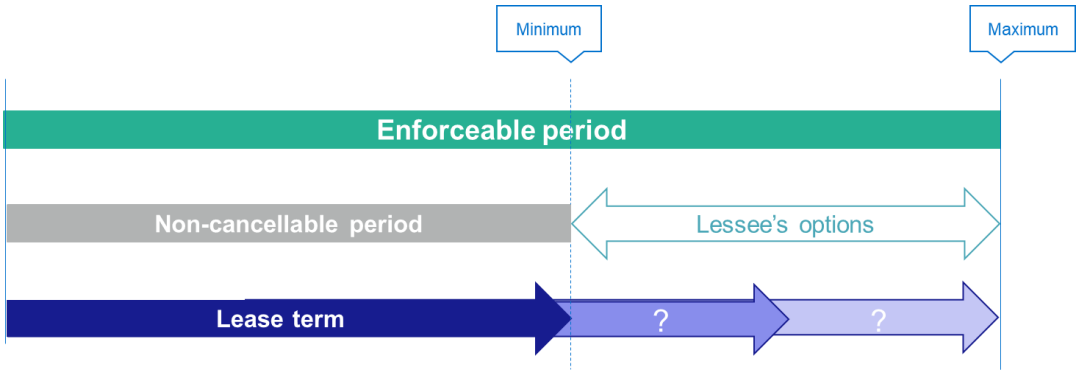
> It may seem surprising that a period covered by a lessor's termination option should be included in the "non-cancellable" period of a lease. In addition, including a period for which the lessee's right is only conditional (on the lessor not exercising its termination option) in the lease term, and therefore, in the lessee's right-of-use asset (see question **43**), could be considered not to adequately reflect the lessee's right to use the underlying asset.
>
> However, during that period, the lessee has an unconditional payment obligation as long as the lessor has not exercised its termination option. The lease term must include the period covered by the lessor's termination option for this unconditional payment obligation to be reflected in the lease liability (see question **32**). In view of the Basis for Conclusions of the Standard (see IFRS 16.BC128), it seems that it was this consideration on the need to reflect an unconditional payment obligation in the lease liability that prevailed over other considerations when the IASB chose how to define the non-cancellable period.

The lease term, as defined above, cannot be longer than the period during which the contract exists. According to IFRS 16, this is the period during which the contract creates enforceable rights and obligations, often referred to as the "enforceable period".

> The notion of enforceable rights and obligations is also found in the definition of a contract in IFRS 15 (the revenue recognition Standard): *"an agreement between two or more parties that creates enforceable rights and obligations"* (see IFRS 15.Appendix A). This Standard also specifies that the existence of enforceable rights and obligations is a matter of law. This has led to the term "enforceable" being considered, for the purposes of this Standard, as the characteristic of a right (or obligation) that could, for example, be enforced by a court (see **Mazars Insight on IFRS 15**, question 9).
>
> In IFRS 16, however, the IASB's approach regarding the assessment of whether a contract is enforceable appears to be different, being based more on the economic rather than the legal position of the parties to the contract (see question **26**).

In summary:

The articulation between these different concepts can be represented by the following diagram:



The lease term is one of the key variables for initially measuring the lease liability of a lessee (see question **32**).

25. How is it determined whether a lessee is reasonably certain to exercise an extension option, or reasonably certain not to exercise a termination option?

[IFRS 16.19; IFRS 16.B37-B40]

At the commencement date of the lease, an entity – whether a lessee or a lessor – assesses the lease term that is reasonably certain (see question **24**), taking into account lessee's options that may affect the duration of the lease (such as an extension or termination option).

IFRS 16 specifies that, in making this assessment, an entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise or not to exercise the option (including any expected changes in facts and circumstances from the commencement date until the exercise date of the option – e.g. changes in the market price of an asset up to the date of exercise of a purchase option).

The notion of "reasonably certain" is neither defined in IFRS 16 nor in IAS 17 (the previous lease Standard).

In our view, given the Basis for Conclusions (see IFRS 16.BC156-157) and the use of these terms in other IFRSs, the notion of "reasonably certain" in IFRS 16 refers not so much to a quantitative probability threshold (such as "more likely than not") but to a qualitative assessment, based on:

- reasonable application of judgement; and;
- objective elements from the fact pattern, rather than information produced by management only (estimates or intentions).

In practice, it may be appropriate to start by identifying the reasons that might lead a lessee to reduce the lease term (by not exercising an extension option or by exercising a termination option). In the absence of reasons that would seem both economically relevant and plausible, then it should be assumed it is reasonably certain that the lessee will exercise the extension option (or not exercise the termination option) in question.

This assessment represents a key judgement area (with potentially significant consequences on an entity's balance sheet, particularly for a lessee).

To help an entity apply judgement, the Standard provides a non-exhaustive list of examples of factors to consider (see table below).

Factors to consider (judgement)	
Contractual terms and conditions for optional periods compared to market conditions	• Payments for the lease in optional periods • Other payments in optional periods (variable payments, other contingent payments such as termination penalties or a residual value guarantee) • Terms and conditions of options that are exercisable after initial optional periods (e.g. a purchase option exercisable at the end of the extension period at a price already fixed)
Significant leasehold improvements undertaken (or expected to be undertaken)	• Economic benefit associated with these leasehold improvements when the option becomes exercisable
Costs relating to the termination of the lease	• Negotiation costs • Relocation costs • Costs of identifying another asset suitable for the lessee's needs • Costs of integrating a new asset into the lessee's operations • Termination penalties and similar costs • Costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location
Importance of the underlying asset to the lessee's operation	• Underlying asset of a specific (or non-specific) nature • Location of the underlying asset • Availability of suitable alternatives
Conditions for the option to be exercisable	• Likelihood of these conditions being met

The Standard further indicates that:

- if the lessor is guaranteed to receive at least the same amount of cash regardless of whether the option to extend or terminate a lease is exercised, then it must be it assumed that the lease term includes the period covered by the option;
- the shorter the non-cancellable period, the more likely a lessee is to exercise an option to extend the lease (or not to exercise an option to terminate the lease), as the costs associated with finding an alternative asset are likely to be higher the shorter the non-cancellable period;
- an entity's past practice regarding the period over which it has typically used similar assets, and the economic rationale for this practice, may provide information that is useful in assessing whether the lessee is reasonably certain to exercise an extension option or not to exercise a termination option.

26. Under what conditions does a lease cease to be enforceable under IFRS 16?

[IFRS 16.B34]

The IFRS 16 application guidance (in paragraph B34) states that *"a lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty."*

This principle was clarified by a decision of the IFRS IC in November 2019.

> In our view, although the request submitted to the Interpretations Committee relates to contracts with an indefinite term or indefinitely renewable contracts (see question **27**), the clarifications provided by the Interpretations Committee apply to all contracts falling within the scope of IFRS 16.

To understand the concept of enforceable period, it is necessary to analyse the interactions between:

- the enforceable period and penalties; and
- the enforceable period and the right of a lessor to object to the extension of the contract.

Enforceable period and penalties

As per the text of the Standard

The relevance of penalties when assessing the lease term is mentioned in IFRS 16 on two occasions:

- when assessing the reasonable certainty of the lessee exercising (or not exercising) an option beyond the non-cancellable period (see question **25**);
- when determining the enforceable period in which the lease term falls (see principle quoted at the beginning of the question).

In the first case, IFRS 16 makes it clear that an entity considers not only contractual penalties (or other payments provided for in the contract), but also all facts and circumstances that may be economically unfavourable to the lessee, contractual penalties being only one example among others (see question **25**).

In the second case, in the absence of any clarification in IFRS 16, some stakeholders questioned whether an entity should consider only contractual penalties (or other payments provided for in the contract) or the broader economics of the contract (the term "penalty" then also including any other negative economic consequences resulting from termination of the contract, such as the lessee abandoning leasehold improvements).

IFRS IC decision in November 2019

In November 2019, the Interpretations Committee clarified that the broader economics of the contract – and not only the contractual penalties – should be considered when determining the enforceable period of a lease: *"in applying paragraph B34 and determining the enforceable period of the lease described in the request, an entity considers the broader economics of the contract, and not only contractual termination payments"*.

As indicated by the IFRS IC in its November 2019 decision, this approach is consistent with the IASB's objective that lease accounting should reflect an entity's reasonable expectation of the period during which the underlying asset will be used (see IFRS 16.BC156).

Indeed, considering only contractual penalties (or other contractual payments) to determine the enforceable period would have led, in the case of a contract with one or several optional periods available to the lessee beyond the non-cancellable period and without any contractual termination payment, to only include the non-cancellable period in the lease term (whereas the use by the lessee of one or more optional periods might have been reasonably certain – or even more than reasonably certain).

In doing so, the Interpretations Committee confirms clarifications that were already included in some educational material issued in 2017 (a webcast called: *"Lease Term Q&A"*).

Enforceable period and the right of a lessor to object to the extension of the contract

As per the text of the Standard

The principle set out in the application guidance of the Standard (in paragraph B34) sets the end of the enforceable period of a lease at the point at which *"the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty"*.

In the absence of any clarification in IFRS 16, the question of whether a contract could cease to be enforceable in other situations – in particular, because of the right of a lessor to object to the extension of the contract – was left open.

> Certain considerations in the Basis for Conclusions relating to the enforceability of a lessee's options could indeed suggest that the right of a lessor to object to the extension of the contract could, in itself, render the contract unenforceable (cf. IFRS 16.BC127: *"to be part of a contract, any options to extend or terminate the lease that are included in the lease term must also be enforceable; [...]. If optional periods are not enforceable, for example, if the lessee cannot enforce the extension of the lease without the agreement of the lessor, the lessee does not have the right to use the asset beyond the non-cancellable period. [...] In assessing the enforceability of a contract, an entity should consider whether the lessor can refuse to agree to a request from the lessee to extend the lease"*).

IFRS IC decision in November 2019

In its November 2019 decision, the Interpretations Committee clarified that a lease is no longer enforceable only when both parties have such a right, as set out in the application guidance of the Standard (*"Applying paragraph B34, a lease is no longer enforceable only when both parties have such a right"*).

In other words, the principle set out in paragraph B34 of the IFRS 16 application guidance is a necessary and sufficient condition for a lease to cease to be enforceable.

Thus, a lease ceases to be enforceable if and only if each party has the right to terminate the agreement without permission from the other party and without incurring a more than insignificant penalty. Therefore, the right of a single party (lessee or lessor) to terminate the agreement, considered in isolation, is never sufficient to limit the enforceable period of a lease.

> The Interpretations Committee's decision in November 2019 thus confirmed the primacy of the principle set out in paragraph B34 of the IFRS 16 application guidance over certain considerations in paragraph BC127 of the Basis for Conclusions (see comment above).

In summary

Considering the clarifications provided by the IFRS IC in November 2019, a lease appears to be enforceable only in one of the following three situations:

- neither party has the right to terminate the contract without permission from the other party; or

> In practice, this case seems to be rather rare, as unilateral termination is usually always possible, subject to payment of compensation to the other party (in application of legal provisions, if not specified in the contract).

- only one of the two parties has a right to terminate the contract without the other party's permission; or
- both parties have a right to terminate the contract without permission from the other party, but (at least) one of them incurs a more than insignificant penalty if it exercises this right (the term “penalty” then representing any negative economic consequences resulting from termination of the contract and not only contractual penalties).

27. How do you determine the lease term of a contract with an indefinite term or an indefinitely renewable contract?

[IFRS 16.18; IFRS 16.B34; IFRS 16.BC156]

This question focuses on specific types of contracts:

- a contract with an indefinite term is generally a contract that the lessee and lessor can unilaterally terminate at any time (or, sometimes, after an initial defined period), subject to notice being given by either party;

- an indefinitely renewable contract is generally a contract with a fixed initial term (e.g. one year), which is then automatically renewed at the end of each period unless notice of termination is given by one of the parties.

Determining the enforceable period – which represents the maximum duration of the lease term (see question **24**) – for these specific types of contracts may seem difficult at first.

In fact, the approach to determining the lease term here is not different from that applicable to any type of lease comprising one or more optional periods beyond the non-cancellable period (see question **26**).

In these situations, an entity:

- first determines the enforceable period considering the broader economics of the contract;
- then determines the reasonably certain duration of the lease, taking into account options available to the lessee that may affect the duration of the lease.

In our view, it is also possible in practice to proceed "more directly" in these situations:

- by considering, beyond the non-cancellable period (which, for a lease with an indefinite term, generally corresponds to the termination notice period and, for a an indefinitely renewable lease, generally corresponds to the first firmly committed period), the optional periods that are available to the lessee (in practice, these contracts typically comprise one or more optional periods that a lessee may use beyond the non-cancellable period);
- by then identifying which of these optional periods are reasonably certain – the contract is then necessarily enforceable at least until the end of the optional periods that the lessee is reasonably certain to use (see question **25**).

28. How does the depreciation period for non-removable leasehold improvements interact with the lease term?

[IAS 16.6; IAS 16.50; IAS 16.56-57; IFRS 16.B34; IFRS 16.B37]

When applying the general accounting model to a lease (see question **31**), a lessee recognises a right-of-use asset which is then depreciated over a period that cannot exceed the lease term (see question **24**), except in certain specific situations (see question **45**).

In the absence of any clarification in IFRS 16, leasehold improvements recognised as assets by a lessee in accordance with IAS 16 – *Property, Plant and Equipment* must be depreciated over their useful life, i.e. the period over which the lessee expects to use them. Under IAS 16, a lessee determines this period by considering, *inter alia*, *"legal or similar limits on the use of the asset, such as the expiry dates of related leases"*.

However, when these leasehold improvements cannot be removed from the underlying asset (i.e. a lessee can only use and benefit from them for as long as it leases the underlying asset), their useful life cannot exceed the useful life of the right-of-use asset. The question which then arises is whether the useful life of the leasehold improvements for the purposes of IAS 16 should be limited to the lease term (as determined in accordance with IFRS 16).

Clarifications provided by the IFRS IC

The IFRS IC's decision in November 2019 referred to in question **26** also provided useful clarification on this issue:

In our view, although the request submitted to the IFRS IC relates to a particular type of contract, i.e. contracts with an indefinite term or indefinitely renewable contracts (see question **27**), the clarifications provided apply to all contracts falling within the scope of IFRS 16.

- the IFRS IC's decision first confirmed that there is no requirement for the depreciation period of non-removable leasehold improvements to be limited to the lease term and that these assets are, therefore, depreciated over their useful life in accordance with IAS 16;

- furthermore, the IFRS IC considered that:
  - under the requirements of IAS 16, an entity would often conclude that it does not expect to use the non-removable leasehold improvements beyond the lease term;
  - if an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur a more than insignificant penalty when exercising any option it has to terminate the lease before the end of the useful life of the leasehold improvements. Consequently, an entity then considers whether the lease is enforceable for at least the useful life of those leasehold improvements.

A lessee, acting rationally, should conclude that it expects to use non-removable leasehold improvements over a particular period if it is in its interest to do so (a fortiori, if it has made a significant investment to build them or have them built). Part of the economic benefit of leasehold improvements would thus be lost if the lessee were to terminate a lease whilst they still provided economic benefits. If this "loss" is deemed to be more than insignificant, then:

- in accordance with the principle set out in paragraph B34 of the IFRS 16 application guidance (see question **26**), the lease is enforceable for at least the useful life of those leasehold improvements;
- when assessing whether it is “reasonably certain” to use any optional period beyond the non-cancellable period, a lessee must in particular take into account the negative economic consequences of abandoning non-removable leasehold improvements before the end of their useful life.

The Interpretation Committee thus introduces a presumption of consistency between the depreciation period of non-removable leasehold improvements and the lease term of the corresponding lease.

In our view, however, there may be situations in which it is justified to depreciate leasehold improvements beyond the lease term – in particular, in situations where the lessee expects to renew the lease and use the leasehold improvements over an additional period, but without being reasonably certain it will do so.

29. Can the enforceable period of commercial leases in France exceed the legal term of the initial contract?

Issue

In France, a commercial lease (known as *"bail 3-6-9"*) is a contract for the lease of premises in which a business is operated. Its main characteristics are defined by law. They are summarised below:

- in general, the initial lease is for nine years, with the possibility for the lessee to terminate the contract after the third and sixth year without penalty;
- at the end of the nine-year term of the initial (or renewed) lease, the lessee may apply for renewal (legally constituting a new lease), which the lessor may either:
  - accept, in which case the lessee benefits from rental conditions that are generally favourable compared to market conditions (due to mechanisms provided for by law to regulate the evolution of rents between the old and the new lease); or
  - reject, in which case the lessor must pay compensation to the lessee (called "indemnité d’éviction") covering the loss of its business;
- the number of renewals is not limited;

In practice, it is not uncommon for lessees to remain in the premises well beyond the initial nine-year period.

- if the lessee does not apply for a renewal and the lessor does not notify the end of the lease, the lease tacitly continues for an indefinite period, but the lessee loses some of the advantages attached to the initial contract, in particular the possibility to transfer the lease to a third party and the benefit of the rent control mechanisms provided for by law, after the first three-year period of the extended lease.

Discussions and consensus in France

In the context of the transition to IFRS 16 in France, the question arose as to whether, in the case of a French commercial lease, the enforceable period (see question **24**) could exceed the legal term of the initial contract (generally nine years).

Considering the IFRS IC's decision in November 2019 (see question **26**), both the French accounting standard-setter (*l'Autorité des Normes Comptables* or ANC) and the French organisation of chartered accountants (*la Compagnie Nationale des Commissaires aux Comptes* or CNCC) clarified that the enforceable period of a French commercial lease could exceed the legal term of the initial contract (according to the CNCC, whatever the legal form of the extension of the contract between the lessor and lessee).

In our opinion

In the case of a French commercial lease:

- as with any lease, the lease term under IFRS 16 reflects the period for which the lessee is reasonably certain to continue the lease;
- it is not necessarily limited by the legal term of the initial contract.

> As clarified by the IFRS IC in November 2019, an entity determines the enforceable period of a lease considering the broader economics of the lease (see question **26**).

30. When should the lease term be revised?

[IFRS 16.20-21; IFRS 16.45.b; IFRS 16.Appendix A; IFRS 16.B41]

The lease term is not revised at the end of each reporting period, but only when required by IFRS 16.

> The IASB considered that requiring reassessment of the lease term at the end of each reporting period would result in excessive costs for entities (see IFRS 16.BC185).

IFRS 16 requires a distinction to be made between:

- situations in which the terms and conditions of the contract remain unchanged;
- situations in which the terms and conditions of the contract are modified.

Contractual terms and conditions remain unchanged

The lease term, determined in accordance with the requirements of IFRS 16, incorporates certain assumptions about the lessee's and lessor's future options (see question **24**). The lease term may thus evolve, even if the terms and conditions of the lease remain unchanged, because of either:

- a reassessment of the reasonable certainty that the lessee will exercise (or will not exercise) a future option affecting the duration of the contract; or
- a change in the non-cancellable period following the exercise (or non-exercise) of an option by the lessee if the original estimate of the lease term included a different assumption about whether it would be exercised.

Specific requirements of IFRS 16 apply in each of these two situations, sometimes differently depending on whether the entity is a lessee or lessor:

- only lessees are required, in certain circumstances, to reassess the reasonable certainty of exercising (or not exercising) its options affecting the duration of the contract;

  In practice, after the commencement date of the lease, a lessor thus does not reassess the reasonable certainty that the lessee will exercise (or will not exercise) future options affecting the duration of the contract.

- on the other hand, if there is a change in the non-cancellable period of a lease, both lessee and lessor are required to revise the lease term.

When should the lease term be revised by a lessee to reflect a reassessment of the lessee's future choice of options?

IFRS 16 requires a lessee to reassess the reasonable certainty of exercising (or not exercising) its options when a significant event or a significant change in circumstances occurs that:

- is within the control of the lessee; and

  This is to avoid requiring a lessee to systematically reassess its future option choices every time market conditions change (see IFRS 16.BC185).

- affects whether the lessee is reasonably certain to exercise (or not to exercise) its options.

The identification of such events or changes in circumstances thus requires judgement.

In practice, a significant action or decision by the lessee (e.g. a decision formally approved by the board of directors, entering into other contracts requiring the use of the asset underlying the lease, etc.) is usually required to characterise such an event or change in circumstances (a change in the lessee's intent in response to new market conditions is not, in itself, sufficient).

The IFRS 16 application guidance provides some examples of such events or changes in circumstances:

- significant leasehold improvements that are expected to have significant economic benefit for the lessee when the option becomes exercisable;
- a significant modification to, or customisation of, the underlying asset;
- the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- a business decision of the lessee that is directly relevant to exercising, or not exercising, an option (for example, a decision to extend the lease of a complementary asset, to dispose of an alternative asset or to dispose of a business unit within which the right-of-use asset is employed).

In the lessee's financial statements, the lease liability is remeasured (see question **46**) at the date of the event or change in circumstances to reflect the revised lease term.

When should the lease term be revised by an entity (lessee or lessor) to reflect a change in the non-cancellable period?

When there is a change in the non-cancellable period, both lessee and lessor revise the lease term.

IFRS 16 provides examples of such changes:

- the exercise or non-exercise of an option by the lessee (if the original estimate of the lease term included a different assumption);

- the occurrence of an event that will oblige or prohibit the exercise of a future option by the lessee (if the original estimate of the lease term included a different assumption about the exercise of such options).

In our view, the exercise of a termination option by the lessor should be included in these changes, because it:

- leads to a change in the non-cancellable period – as, by definition, the non-cancellable period includes periods covered by a lessor's termination option (see question **24**);
- effectively prohibits the lessee from exercising options for future periods (which the lease may, in some cases, contain).

At the date of the change in the non-cancellable period:

- in the lessee's financial statements: the lease liability is remeasured (see question **46**) to reflect the revised lease term;
- in the lessor's financial statements: the accounting consequences differ depending on the classification of the lease (see question **56**).

Contractual terms and conditions have been modified

The lease term may also need to be revised by an entity (lessee or lessor) when the lease is modified, as defined in IFRS 16, i.e. when the terms and conditions of the lease are modified to introduce a change in either:

- its scope (e.g. adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term); or

The phrase "contractual lease term" is not defined in IFRS 16 and is only used in the definition of a lease modification. In our view, it means all the terms and conditions relating to the duration of the lease as specified in the contract, whether they relate to firm commitment periods or optional periods.

- its price.

At the date both parties agree to the modification (i.e. the effective date of the lease modification) and when required by IFRS 16 (i.e. in all cases where the modification does not result solely in the recognition of a separate lease), the lease term is revised to reflect the contract modification:

- in the lessee's financial statements, with different accounting consequences depending on whether the revised lease term reflects a scope reduction (see question **48**);
- in the lessor's financial statements, with different accounting consequences depending on the classification of the lease (see question **56**).

In summary

Situation		Date on which a LESSEE revises the lease term	Accounting by a LESSEE
Contractual terms and conditions unchanged	**Reassessment by a lessee of its future options affecting the duration of the contract**	When the event or change in circumstances triggering the lessee's reassessment of his future option choices occurs	See question **46**
	Change in the non-cancellable period	When the change in the non-cancellable period occurs	
Lease modification (not resulting solely in the recognition of a separate lease)		On the effective date of the lease modification	See question **48**

Situation	Date on which a LESSOR revises the lease term	Accounting by a LESSOR
Change in the non-cancellable period, with the contractual terms and conditions remaining unchanged	When the change in the non-cancellable period occurs	Different accounting consequences depending on the classification of the contract (see question **56**)
Lease modification (not resulting solely in the recognition of a separate lease)	On the effective date of the lease modification	

Accounting for a lease in the financial statements of a lessee

31. What is the general accounting model for lessees?

[IFRS 16.22-60]

When applying the general accounting model to a lease, a lessee recognises an asset – called a right-of-use asset – and a lease liability.

Recognition of the right-of-use asset and lease liability occurs on the commencement date, defined in IFRS 16 as "the date on which a lessor makes the underlying asset available for use by the lessee". This may be later than the date on which the lessee and lessor contract with each other (referred to in IFRS 16 as the inception date).

> The IASB considered that, for a lessee, a lease typically creates (see IFRS 16.BC22-27):
>
> - a right to use the underlying asset similar to that of an entity which has acquired an asset in exchange for instalment payments and has not made all the agreed payments (i.e. the right to use the underlying asset remains conditional on the payment of the remaining agreed payments);
> - an obligation to make lease payments once the underlying asset has been made available.

A right-of-use asset is measured at cost. Therefore, its initial measurement (see question **43**) includes the present value of future lease payments, i.e. the initial measurement of the lease liability (see question **32**).

> In the IASB's view, this measurement basis is relevant because it is consistent with that used for underlying assets when they are accounted for in accordance with IAS 16 – *Property, Plant and Equipment* and IAS 38 – *Intangible Assets* (see IFRS 16.BC148), thus allowing for the comparability of amounts reported for leased and owned assets.

This general accounting model does not always apply, as the Standard provides for certain exemptions from applying this model (see question **4**) and some exceptions to the inclusion of lease payments in the measurement of the lease liability (see question **34**). When a lease is not recognised on the balance sheet, or when certain lease payments are not included in the measurement of a lease liability, information provided in the notes should enable users to assess their effect on the financial statements (see questions **53** and **54**).

32. How is the lease liability initially measured?

[IFRS 16.26-28; IFRS 16.Appendix A]

At the commencement date of the lease, a lessee applying the general accounting model (see question **31**) recognises a lease liability.

> As the IASB considers that a lessee generally has no obligation to pay before the underlying asset is made available (see IFRS 16.BC142), IFRS 16 does not require a lease liability to be recognised before that date.
>
> However, the same paragraph in the Basis for Conclusions states that a liability may need to be recognised before the commencement date if the contract meets the definition of an onerous contract under IAS 37, i.e. when the unavoidable costs of meeting the contractual obligations exceed the economic benefits expected to be received under it (see IAS 37.10). If this is the case, a provision must be recognised in accordance with IAS 37, as for any onerous contract (see question **7**).

The lease liability is initially measured at the present value of future lease payments between the lessee and lessor.

In practice, the initial measurement of the lease liability is the result of three variables:

- lease term (see questions **24** to **30**);
- lease payments (see questions **34** to **38**);
- discount rate (see questions **39** to **42**).

The last two variables are determined consistently with the first, as explained in more detail below.

33. How is the lease liability subsequently measured?

[IFRS 9.3.3.1; IFRS 16.36-46]

Once the calculation variables (lease term, lease payments, discount rate) have been determined at initial recognition, the carrying amount of the lease liability is adjusted for:

- the recognition of interest using the lease liability discount rate (which increases the carrying amount of the liability), this being the rate used for the initial measurement of the lease liability (see question **39**) or, where applicable, a revised rate (see question **42**);

  The resulting interest is recognised in profit or loss unless another Standard requires its inclusion in the carrying amount of another asset.

- cash-flows included in the measurement of the lease liability (see question **34**). These reduce the carrying amount of the lease liability for payments made by the lessee to the lessor.

It is thus similar to the subsequent measurement model of a financial liability at amortised cost under IFRS 9.

Illustration:

A lessee enters into a lease agreement for a period of three years, commencing on 1 January 20X0.

For each year of the contract, a fixed rent of €100k is payable on 1 January of the following year. Therefore, the first payment of the contract is due on 1 January 20X1.

As the interest rate implicit in the contract is not readily determinable, the lessee determines its incremental borrowing rate for this contract at the commencement date (see question 39). This rate is 5%.

In its statement of cash flows, the lessee has elected to present cash flows from interest payments within financing activities.

At the commencement date, on 1 January 20X0, the lease liability is measured as follows:

$$V_{1/01/20X0} = \sum_{t=1}^{3} \frac{€100k}{(1+5\%)^t} = €272k$$

Subsequently, the lease liability evolves as follows:

At 31 December 20X0:

- on the balance sheet, the lease liability is measured as follows:

$$V_{31/12/20X0} = V_{1/01/20X0} - payments\ made + interest$$

$$V_{31/12/20X0} = €272k - 0 + 5\% \times €272k = €286k$$

- in the statement of profit or loss: an interest expense of €14k (= 5% x €272k) is recognised.
- in the statement of cash flows: no impact (no cash flow has occurred yet).

At 31 December 20X1:

- on the balance sheet, the lease liability is measured as follows:

$$V_{31/12/20X1} = V_{31/12/20X0} - payments\ made + interest$$

$$V_{31/12/20X1} = (€286k - €100k) \times (1 + 5\%) = €195k$$

- in the statement of profit or loss: an interest expense of €9k (= 5% x €186k) is booked.
- in the statement of cash flows: the €100k disbursed on 1 January 20X1 is presented as a financing cash flow (€14k as interest paid and €86k as debt repayment).

At 31 December 20X2:

- on the balance sheet, the lease liability is measured as follows:

$$V_{31/12/20X2} = V_{31/12/20X1} - payments\ made + interest$$

$$V_{31/12/20X2} = (€195k - €100k) \times (1 + 5\%) = €100k$$

- in the statement of profit or loss: an interest expense of €5k (= 5% x €95k) is booked.
- in the statement of cash flows: the €100k disbursed on 1 January 20X2 is presented as a financing cash flow (€9k as interest paid and €91k as debt repayment).

At 31 December 20X3:

- on the balance sheet, there is no longer a lease liability since it was fully repaid on 1 January 20X3 (the calculation formula which was used previously remains valid):

$$V_{31/12/20X3} = V_{31/12/20X2} - payments\ made + interest$$

$$V_{31/12/20X3} = €100k - €100k + €0k = €0k$$

- in the statement of cash flows: the €100k disbursed on 1 January 20X3 is presented as a financing cash flow (€5k as interest paid and €95k as debt repayment).

The evolution of the lease liability can be summarised as follows:

Year	Opening (k€)	Payments (k€)	Accrued interest (k€)	Closing (k€)
20X0	272	0	14	286
20X1	286	-100	9	195
20X2	195	-100	5	100
20X3	100	-100	0	0

Furthermore, the lease liability may need to be adjusted for reasons other than the accrual of interest and the subsequent recognition of lease payments. Specific requirements in IFRS 16 apply depending on whether an entity has:

- re-estimated variables (lease term, lease payments, discount rate) (see question 46); or

> This may be the case, for example, when the index or rate on which a variable payment is indexed or when the expectation of exercising (or not exercising) a lessee option changes, thus impacting the lease payments.

- agreed with the lessor to modify the lease (see question **48**).

Finally, a lease liability is derecognised when it is extinguished – i.e. (as clarified in paragraph 3.3.1 of IFRS 9, which applies to lease liabilities recognised under IFRS 16): "*when the obligation specified in the contract is discharged or cancelled or expires*".

> For a discussion on the accounting for rent concessions: see question **50**.

34. Lease payments: what payments should be included in the measurement of the lease liability?

[IFRS 16.27-28; IFRS 16.Appendix A]

Under IFRS 16, the payments included in the measurement of the lease liability are those that:

- have not yet been paid at the measurement date;
- relate to the right to use the underlying asset during the lease term. In other words, they are payments:
  - relating to the lease; and

> Identifying lease payments may require careful analysis of the context and of the terms and conditions of the contract. In principle, it is first necessary to determine whether the contract contains a lease and a non-lease component (see question **10**). If it does, it may be necessary to allocate the consideration in the contract to these different components in order to identify the portion of this consideration that relates to the lease (see question **12**).

  - due in respect of the right to use the underlying asset over the lease term;

> Payments that are contractually due for optional periods are included in the measurement of the lease liability to the extent that the lease term (see question **24**) includes these optional periods.

- are not variable payments, unless they depend on an index or a rate (e.g. a consumer price index, a benchmark interest rate or a variable reflecting changes in market rental prices).

Payments that do not depend on an index or a rate are not included in the measurement of the lease liability but are recognised in profit or loss (unless another Standard requires their inclusion in the carrying amount of another asset) as they fall due.

> The IASB considered on balance that the expected benefits of including all variable payments in the measurement of the lease liability, in terms of the quality of the financial statements, did not justify the costs of introducing such a requirement (see IFRS 16.BC169).

IFRS 16 also specifies that the payments included in the measurement of the lease liability comprise the following types of payment:

- fixed payments (including so-called "in-substance fixed" payments – see question **36**), less any lease incentives (see question **35**);
- variable payments that depend on an index or a rate, measured using the index or rate prevailing at the measurement date;

- amount expected to be payable under residual value guarantees (i.e. guarantees to the lessor that the value of the underlying asset will not fall below a specified value at the end of the lease term);

  The Basis for Conclusions (see IFRS 16.BC171) states that their measurement should reflect an entity's reasonable expectation of the amount that will be paid.

- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (this assessment being performed in a similar way to the approach used to assess whether the lessee is reasonably certain to exercise, or not to exercise, an option affecting the duration of the contract: see question **25**);

- penalties for terminating the lease, if the lease term (see question **24**) reflects the lessee exercising a termination option.

35. Lease payments: what are lease incentives?

[IFRS 16.27; IFRS 16.Appendix A]

Under IFRS 16, lease incentives are defined as:

- payments made by the lessor to the lessee associated with a lease; or
- reimbursement or assumption of costs of the lessee by the lessor (e.g. payment of penalties owed by the lessee to a third party due to the termination of the previous lease).

However, the Standard does not specify how to determine whether:

- a payment made by the lessor to the lessee is associated with a lease;

  It is thus appropriate to consider all the facts and circumstances of the transaction and, as a first step, to rely on the requirements of IFRS 16 (that are similar to those of IFRS 15) relating to:

  - the identification of distinct components (see question **10**): e.g. a payment made by the lessor to the lessee in consideration for the transfer of control of an asset or a service to the lessor may have to be analysed as a separate transaction from the lease;
  - the combination of contracts (see question **14**): if the benefit received by the lessee results from an agreement concluded with the lessor at a date that is distant from the inception date of the lease, the two transactions should in principle not be combined.

- any costs reimbursed or borne by the lessor are costs of the lessee or the lessor.

  This difficulty especially arises when the lessee makes improvements to the underlying asset, the cost of which is reimbursed or borne by the lessor. Such costs may represent economic benefits to the lessee (e.g. if the lessee benefits from the improvements during the lease term) or to the lessor (e.g. if the improvements significantly increase the residual value of the underlying asset at the end of the lease).

  In our view, it is necessary to determine which of the lessee or the lessor controls the leasehold improvements and should therefore recognise them as an asset (i.e. property, plant and equipment) on its balance sheet:

  - if the lessee controls the leasehold improvements on the underlying asset (i.e. the lessee controls the use of the leasehold improvements until the end of their economic life), their reimbursement or assumption by the lessor is a lease incentive (the leasehold improvements being a cost of the lessee);
  - if the economic value of the leasehold improvements are likely to be significant at the end of the lease, their reimbursement or assumption by the lessor may be considered to be consideration for their acquisition by the lessor, with the lessee carrying out the work on behalf of the lessor: the lease will then be deemed to relate to an underlying asset including the leasehold improvements and the lease liability will be calculated on the basis of the lease payments, without deducing the reimbursement or assumption of the cost of the works by the lessor.

Consequently, the identification of lease incentives may sometimes require significant judgement.

Under IFRS 16, lease incentives are part of the lease payments. As such if they are paid by the lessor:

- before (or at) the commencement date of the lease: they reduce the initial measurement of the right-of-use asset (see question **43**);

Illustration:

In a lease agreement, a lessor agrees to contribute to the lessee's removal costs and pays a lump sum to the lessee on the commencement date of the lease.

As this payment is a lease incentive, no revenue is recognised in the lessee's financial statements (besides, the lessee recognises its removal costs as an expense when incurred). The lump sum received from the lessor reduces the carrying amount of the lessee's right-of-use asset (it forms part of the "net" cost for acquiring the right-of-use asset).

- after the commencement date of the lease: they are included, at their present value, in the measurement of the lease liability (see question **32**).

Regardless of when they are paid or assumed by the lessor, lease incentives are in practice recognised over time in profit or loss, through depreciation of the right-of-use asset, following a similar approach to that set out in SIC 15 – *Operating Lease Benefits*.

However, this principle is not explicitly stated in IFRS 16.

When a lease does not result in the recognition of a right-of-use asset on the lessee's balance sheet (see question 4), a question arises as to when to recognise the lease incentive as income. A similar question arises when the amount of the lease incentive exceeds the carrying amount of the right-of-use asset, which could arise if lease payments are predominantly comprised of variable payments that do not depend on an index or rate.

In our view, it is generally appropriate to recognise lease incentives in profit or loss in a manner that is consistent with the requirements of IFRS 16 regarding lease payments (i.e. as a deduction from the lease expense which is generally recognised over time in profit or loss).

Illustration:

A company enters into a contract to lease laptops for three years. The commencement date is 1 January 20X0.

The contract provides for a fixed annual rent of €120k, payable on 31 December.

In return for the company's firm commitment over a period of three years, the lessor agrees to assume the cost of initial IT security training for the company's employees, ordered by the company from an external service provider. In this respect, the contract stipulates that the lessor pays the company €12k on 1 January 20X0.

The company decides to apply the exemption offered by IFRS 16 for leases of low-value assets as each laptop lease within the contract represents a separate component of low value.

The payment received from the lessor at the commencement date of the lease meets the definition of a lease incentive. In our view, this lease incentive should be recognised over the lease term as a deduction from the lease expense.

The annual lease expense is thus: €120k - €12k / 3 = €116k.

The lessee books the following entries:

On 1 January 20X0 (payment received from the lessor):

(k€)	Debit	Credit
Cash	12	
Deferred income		12

Then, each year, the lessee should recognise a net lease expense, after deduction of the lease incentive, over the lease term:

(k€)	Debit	Credit
Lease expense	116	
Deferred income	4	
Cash		120

NB: the company recognises the cost of the training as an expense for its gross amount (i.e. without deducing the payment received from the lessor), when it receives the training service (i.e. in year 20X0). Indeed, for accounting purposes, the lease incentive is not a component of the cost of the training, but a component of the cost of the right to use the laptops.

36. Lease payments: how do you distinguish between fixed and variable payments?

[IFRS 16.B42]

Principles

The distinction between fixed and variable payments is especially important for lessees, since only certain types of variable payments are included in the measurement of the lease liability under IFRS 16. Otherwise, they are recognised in profit or loss as they fall due: see question **34**.

The Standard provides little detail on the distinction between fixed and variable payments.

For a debt instrument, interest can in practice result from:

- a payment schedule in which all payments (including interest) are fixed at the outset of the contract (i.e. a "fixed-rate" instrument): the nominal value of all the contractual cash flows is known when the contract is concluded; or
- the periodical reset of an interest rate according to a benchmark rate or another variable (i.e. a "variable-rate" instrument): the nominal value of all the contractual cash flows is not known when the contract is concluded, since the nominal value of each interest cash flow will be defined on the date when the reference variable is reset.

A parallel can thus be drawn with a debt instrument:

- a lease liability consisting of fixed payments is economically similar to a fixed-rate debt, in that the nominal value of all contractual flows is known when the contract is concluded;
- a lease liability consisting of variable payments is economically similar to a variable-rate debt, in that the nominal value of all contractual flows is not known when the contract is concluded.

It should be noted that IFRSs do not define the concepts of fixed-rate and variable-rate debt instruments.

However, the existence of the concept of “in-substance fixed” lease payments in the IFRS 16 application guidance makes it clear that, in all cases, an in-substance analysis is necessary to distinguish between fixed and variable payments.

IFRS 16 defines “in-substance fixed” payments as payments that may have variability in form but are, in substance, unavoidable.

The IFRS 16 application guidance further clarifies that:

- the analysis may lead to the identification of part of a payment stream as being an in-substance fixed payment, while the remainder of the payment stream is considered a variable payment. E.g. in the case of a rent based on the lessee's annual sales with a guaranteed minimum, the portion of the rent corresponding to the guaranteed minimum represents an in-substance fixed payment;
- a variable payment may become in-substance fixed at a given time due to context change. The distinction between fixed and variable payments may, therefore, need to be reconsidered over the course of the contract.

Application

To illustrate these principles, the IFRS 16 application guidance specifies that in-substance fixed payments exist in the following situations:

- payments that are variable in form, but the clauses giving them a variable character do not have real economic substance, for example:
  - payments conditional on the underlying asset being capable of being operated during the lease;
  - payments conditional on the occurrence of an event that has no genuine possibility of not occurring (e.g. in a lease agreement for shop premises in a busy shopping centre, the payment of a fixed annual rent is conditional on the lessee achieving at least one euro of revenue);
  - payments vary depending on the use of the underlying asset, but cease to vary at some point after the commencement date of the lease, at which point, these payments then become in-substance fixed payments;

Illustration:

> A six-year lease for retail space within an airport provides for the payment by the lessee of an annual rent corresponding to 10% of the lessee's sales, with a guaranteed minimum for the fourth, fifth and sixth years corresponding to the average annual rent over the first three years of the agreement.
>
> At the commencement date, lease payments are fully variable.
>
> However, during the first three years of the contract, the amount of the guaranteed minimum gradually increases as the lessee is making sales. As a consequence, at the end of first year, the lessee recognises a lease liability corresponding to the present value of the payment, over three years (for the fourth, fifth and sixth years), of an annual rent equal to one third of the annual rent due for the first year.

- among several sets of payments that a lessee could make, only one of these sets is realistic (IFRS 16 specifies that, in this case, it is this set of payments that must be considered for measuring the lease liability);
- among several realistic sets of payments, the lessee must make at least one (IFRS 16 specifies that, in this case, the set of payments with the lowest present value must be considered for measuring the lease liability).

37. Lease payments: does a rent review clause necessarily lead to lease payments being considered variable?

The pricing conditions of a lease may comprise a fixed amount for the first payment term and a periodic review clause for subsequent payment terms. Depending on the contractual terms, a rent review clause might include an element of variability in the lease payments.

For example, if a lease agreement provides for a 2% increase in annual rent over the lease term, these are not variable payments but fixed payments.

To use a previous analogy (see question 36): the cash flows of such a contract are economically similar to those of a fixed-rate debt instrument (in the sense that the nominal value of all contractual cash flows is known when the contract is concluded).

In other words, a "fixed payment" under IFRS 16 does not necessarily correspond to the payment of a constant amount over the lease term.

38. Lease payments: should taxes borne by the lessor and recharged to the lessee be included in the measurement of the lease liability?

In situations where a contract provides for a payment from the lessee in respect of costs incurred by the lessor, it is necessary to consider whether this recharge represents consideration for a good or a service over which control is transferred to the lessee. If it does, this could lead to the identification of a separate non-lease component (see question **10**). In the case of taxes borne by the lessor and recharged to the lessee, it is generally easy to conclude that this recharge does not represent consideration for a good or a service transferred to the lessee and, therefore, that it should be part of the lease payments (except, in our view, when it is collected on behalf of third parties: see comment to question **12**).

Taxes borne by the lessor and recharged to the lessee that form part of the lease payments should be analysed to determine whether they are (in-substance) fixed or variable payments. If they are variable payments, it is also necessary to determine whether they depend on an index or a rate to determine whether they should be included in the measurement of the lease liability (see question **34**).

This analysis must be carried out on a case-by-case basis, considering the recharge provided for in the contract and, possibly, the tax calculation method:

- if the recharge takes the form of a lump sum (e.g. reimbursement of a tax that the lessor paid before the contract took effect): then it is clearly a fixed payment, to be included in the measurement of the lease liability;
- if the recharge corresponds to the amount paid each year by the lessor in respect of an identified tax, then it is necessary to analyse the tax calculation method to determine whether it should be included in the measurement of the lease liability.

In France, it has been considered that the reimbursement by the lessee of the property tax paid each year by the lessor should not be included in the measurement of the lease liability, because although this reimbursement is a variable payment (the variables used to calculate the tax are likely to change over time), the method for calculating the tax and the process for resetting the variables (base and rate) are such that the payments are not considered to depend on an index or a rate.

39. Discount rate: what discount rate is to be used for the initial measurement of the lease liability?

[IFRS 16.26; IFRS 16. Appendix A]

The discount rate to be used for the initial measurement of the lease liability (see question **32**) is determined at the commencement date of the lease.

It corresponds to:

- the interest rate implicit in the lease if it can be readily determined (see question **40**);
- otherwise, the lessee's incremental borrowing rate.

The Basis for Conclusions indicates that the IASB's objective was to define a discount rate that reflects how the contract was priced (see IFRS 16.BC160). In our view, this objective applies to both methods described above.

In its approach, the IASB seems to have considered that:

- using the interest rate implicit in the lease as a discount rate was the method that most directly reflected how a lease was priced;
- when the interest rate implicit in the lease was not readily determinable, a similar result could be achieved by taking an observable interest rate as a "starting point" and applying adjustments to it to reflect the specifics of the lease (see IFRS 16.BC162).

The IASB notes that the implicit interest rate in the lease and the lessee's incremental borrowing rate, as defined in IFRS 16, are likely to be similar in many cases (see IFRS 16.BC161).

Interest rate implicit in the lease

The interest rate implicit in the lease is the interest rate that equalises the two parts of the following equation which we have established on the basis of IFRS 16 (in practice, solving the equation requires using a "goal seek" function on a spreadsheet), in which each term is measured at present value at the commencement date of the lease:

$$\sum_{t=1}^{n} \frac{Lease\ payments\ (see\ question\ 34)}{(1+interest\ rate)^{t}} + \frac{Unguaranteed\ residual\ value\ (see\ question\ 34)}{(1+interest\ rate)^{lease\ term}}$$

$$= Fair\ value\ of\ the\ underlying\ asset + Initial\ direct\ costs\ of\ the\ lessor (see\ question\ 59)$$

Lessee's incremental borrowing rate

The lessee's incremental borrowing rate is the interest rate the lessee would have to pay to borrow:

- over a similar term,
- with a similar security,
- the funds necessary to obtain an asset of similar value to the right-of-use asset,
- in a similar economic environment.

As reiterated by the IFRS IC in September 2019, the discount rate resulting from these provisions is specific to a given lease (like the interest rate implicit in the lease).

This does not preclude using the same discount rate for multiple leases if applying the requirements of IFRS 16 leads to the same value.

If an entity accounts for leases on a portfolio basis (see question **15**), the use of a single incremental borrowing rate to measure the lease liability arising from all leases within a portfolio is *a priori* still consistent with these requirements (since accounting for leases on a portfolio basis requires that those leases have similar characteristics).

In practice, the lessee's incremental borrowing rate for a lease is determined using an observable interest rate and adjusting it to reflect the specifics of the lease (see question **41**).

This approach seems to be in line with the IASB's intentions when drafting the Standard (in this regard: see IFRS 16.BC162).

40. Discount rate: how do you assess whether the interest rate implicit in the lease is "readily determinable"?

IFRS 16 does not specify how to assess whether the interest rate implicit in the lease is “readily determinable”.

In the Basis for Conclusion (see IFRS 16.BC161), the IASB notes that the interest rate implicit in the lease is usually affected by the lessor's estimate of several parameters (including the residual value of the underlying asset at the end of the lease), some of which may not be known to the lessee (such as the initial direct costs incurred by the lessor). The IASB concludes that it is likely that, in many cases, the interest rate implicit in the lease is not readily determinable by the lessee, particularly when the residual value of the underlying asset at the end of the lease is significant.

> This seems to have been confirmed in practice: the discount rate used by lessees for measuring lease liabilities is most often their incremental borrowing rate.

In view of the above, we believe that it is legitimate for a lessee to use its incremental borrowing rate if one or more of the variables that are necessary and significant for determining the interest rate implicit in the lease (see question **39**), such as the lessor’s direct costs, cannot be easily estimated from observable data.

> In practice, caution is called for when, in the context of their business relationship, the lessor provides the lessee with a rate that the lessor presents as the interest rate implicit in the lease. Without any explanation concerning the calculation methodology and evidence to substantiate the source data used by the lessor, it will not be possible to conclude that this rate is the same as the rate implicit in the lease as defined in IFRS 16.

As a result:

- in practice, the interest rate implicit in the lease will rarely be “readily determinable” for real estate leases, given that the residual value of the underlying asset is usually unguaranteed and significant at the end of the lease (the interest rate implicit in the lease will be all the more difficult to determine as the lease term will be long and market prices for this type of asset will fluctuate);
- if a lease comprises significant variable payments (see question 36) that do not depend on an index or a rate, the interest rate implicit in the lease should generally not be considered “readily determinable”;

> Indeed, estimating these payments generally requires significant assumptions and judgement. It thus seems reasonable to consider that they tend to complicate the search for a discount rate that reflects how the contract was priced (which was the general objective followed by the IASB in specifying the discount rate to apply to a lease).

- in situations where it is difficult to distinguish between lease payments and payments for non-lease components (such as a service component), the interest rate implicit in the lease should generally not be considered “readily determinable”.

> Unless one considers that all payments should be included when calculating the interest rate implicit in the lease, which is not specified in IFRS 16 (even though the Standard provides a practical expedient consisting in including all payments in the recognised liability, as discussed in question **11**), such a situation makes it *de facto* difficult to determine the rate implicit in the lease.
>
> In our view, payments for non-lease components (such as a service component) should be excluded when calculating the interest rate implicit in the lease, for the following reasons:
>
> - unless there is a significant delay between the transfer of the good or the service by the lessor to the lessee and its payment, these non-lease components should generally have little impact when a lessor discounts contractual payments to establish contract prices;
> - if payments for non-lease components were to be included when calculating the interest rate implicit in the lease, then the fair value of those other components should also be included for consistency. Otherwise, the rate that would result from this calculation might not be consistent with the lessee's incremental borrowing rate and hence might not reflect the way the contract was priced.

In contrast, when a lease provides for fixed payments and an option to purchase the underlying asset for a fixed price, and the initial direct costs incurred by the lessor are estimated to be negligible and the fair value of the underlying asset is known, the interest rate implicit in the lease is usually readily determinable: it is the discount rate that makes the present value of contractual payments, including the exercise price of the purchase option, equal to the fair value of the underlying asset (e.g. this may be the case for car leases with a purchase option at a fixed price).

In this case, the total lease payments, comprising the rent payments and the exercise price of the purchase option, represent the consideration for which the lessor agrees to transfer the underlying asset. The sum of these payments is thus representative of the price at which the lessee could purchase the asset, plus the interest on the credit that a seller would grant to the lessee to make the purchase.

41. Discount rate: what factors are taken into account when determining the lessee's incremental borrowing rate?

[IFRS 16. Appendix A]

In light of the clarifications provided in the Basis for Conclusions (see comment to question **39**), the lessee's incremental borrowing rate can, in our view, be expressed as the interest rate on a loan that replicates the terms and conditions of the lease liability.

In practice, this rate is usually constructed from an observable interest rate (which may be a non-entity-specific interest rate – such as a corporate bond yield or a risk-free rate), adjusted for the specifics of the lease.

A lessee rarely has borrowing transactions comparable to all its lease liabilities for all the factors that IFRS 16 requires a lessee to consider when determining its incremental borrowing rate.

Adjustments made to an observable rate to determine the incremental borrowing rate for a specific lease may require the use of quantitative financial techniques (use of yield curves, finding specific risk premiums, etc.).

The definition of the lessee's incremental borrowing rate in IFRS 16 mentions several factors: economic environment, lessee's characteristics, lease term, amount of capital borrowed, security. Therefore, a lessee should consider these factors to identify the adjustments needed to the observable interest rate used as a "starting point".

However, the Standard does not specify how to assess these factors or how to adapt an interest rate to the specifics of the lease.

Unfortunately, it is not possible to rely on similar provisions contained in other Standards. Firstly, there is a general lack of precision on the use of discount rates in IFRSs (the IASB conducted a research project on discount rates between 2014 and 2017, which did not lead to specific proposals to amend existing Standards). Secondly, by its definition, the lessee's incremental borrowing rate obviously differs from:

- the Weighted Average Cost of Capital (WACC), which is often used to discount cash flows in the calculation of an asset's value in use for IAS 36 purposes, because it includes the cost of equity;
- the rate used for capitalising borrowing costs under IAS 23 since this rate, which generally reflects an entity's average borrowing costs over a past period, may differ from the entity's current incremental borrowing cost;
- the rate used for discounting employee post-employment benefit obligations under IAS 19 since the credit quality of the lessee is not necessarily the same as that of a "high quality corporate bond", and employee post-employment benefit obligations generally have longer maturities than leases.

Determining the lessee's incremental borrowing rate for a given lease therefore requires significant judgement.

For example:

Factors	Matters to consider (in our opinion) when adapting a rate to the specifics of a lease
Economic environment	• Date on which the rate is measured • Currency of settlement of lease payments • Risks specific to the economic environment in which the underlying asset is located and to its intended use, as these may affect the residual value of the underlying asset
Characteristics of the lessee	• Credit quality of the lessee including, if material, the impact of the additional lease liability on the lessee's indebtedness (*)
Lease term	• Lease term • Possibly: payment profile over the lease term (**)
Amount of capital borrowed	• Approximate value of the right-of-use asset (necessarily an approximation as its value, generally being cost on initial recognition, is a function of the measurement of the lease liability, not vice versa)
Security	• Guarantees in the lease: o value of the underlying asset (regaining control of the asset in the event of a default by the lessee on lease payments is, in itself, a guarantee mechanism) o where applicable, residual value guarantee granted to the lessor o where applicable, other guarantees given to the lessor by the lessee or parties related to the lessee • Restrictions and covenants imposed on the lessee by the lease (to the extent that such restrictions and covenants would affect the determination of the interest rate for a loan containing such provisions)

*: as the credit quality of entities within a group may vary from one entity to another, it is necessary to take into account the credit quality of the lessee and to adjust it for implicit or explicit intra-group guarantees

**: in September 2019, the IFRS IC clarified that IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the payment profile of the lease. The IFRS IC noted however that given the IASB's objective for the rate to reflect the terms and conditions of the lease liability (see IFRS 16.BC162), it would be appropriate, as a starting point, to refer to an observable rate for a loan with a similar payment profile to that of the lease.

42. Discount rate: when, during the course of the lease, should the discount rate be revised?

[IFRS 16.40-43 and IFRS 16.45]

Once determined as part of the initial measurement of the lease liability (see question **32**), the discount rate is not subsequently revised, except in certain specific situations.

This approach is generally consistent with the one used for financial instruments measured using the effective interest method (see IFRS 16.BC193).

In certain situations where the lease liability is reassessed (see question **46**), the discount rate must be revised at the same time. The table below summarises whether the discount rate is revised in different situations:

Situations where a reassessment of the lease liability is required	Revised discount rate (for the remaining term of the lease)	Discount rate not revised
Revision of the lease term (*) (**) (see question **30**)	X	
Change in the assessment of whether it is reasonably certain the lessee will exercise an option to buy the underlying asset (*)	X	
Change in the estimate of the amount payable under a residual value guarantee		X
Change in lease payments resulting from: • changes in the index or rate (other than a variable interest rate) used to calculate variable lease payments • a change in the variable interest rate used to calculate variable lease payments	X	X

(*): if a significant event or change in circumstances occurs within the lessee's control affects whether the lessee is reasonably certain to exercise extension (or termination) options

(**): or if there is a change in the non-cancellable period of the lease

The IASB's rationale for requiring the discount to be revised is the following (see IFRS 16.BC194-195):

- in the first two situations presented above the economics of the contract have changed, which justifies the revision of the discount rate;
- in the last situation presented above, the use of a revised discount rate is consistent with the requirements in IFRS 9 for measuring variable-rate financial liabilities subsequently measured at depreciated cost.

Furthermore, the discount rate also has to be revised if a lease is modified (see question **48**) and the modification does not result solely in the recognition of a separate lease. Indeed, in such a case, the lease term must be revised, resulting in a mandatory reassessment of the lease liability where the discount rate must also be revised (as shown in the table above).

43. How is the right-of-use asset initially measured?

[IFRS 16.23-25; IFRS 16.B43-44]

At the commencement date of the lease, a lessee applying the general accounting model (see question **31**) recognises a right-of-use asset which is initially measured as:

- the sum of the following elements:
  - the initial measurement of the lease liability (see question **32**);
  - lease payments made before (or on) the commencement date;
  - the initial direct costs incurred by the lessee (i.e. costs of obtaining a lease that the lessee would not have incurred if the lease had not been obtained).

Like the incremental costs of obtaining a contract, as defined in IFRS 15 (see **Mazars Insight on IFRS 15**, question 62), the notion of "initial direct cost" in IFRS 16 corresponds to a notion of incremental cost. The Basis for Conclusions in IFRS 16 highlights that these concepts are consistent between the two Standards (see IFRS 16.BC150).

The Basis for Conclusions in IFRS 16 also draws a parallel with costs associated with acquiring items of property, plant and equipment and intangible assets (see IFRS 16.BC149). Under IAS 16 and IAS 38, costs that are directly attributable to preparing the asset for its intended use are capitalised (such costs may include, for example, installation costs for an item of property, plant and equipment and are not restricted to costs of obtaining an asset). The main text of IFRS 16 does not confirm whether a valid analogy could be drawn with IAS 16 and justify capitalising the costs that are directly attributable to preparing a right-of-use asset for its intended use. In practice, some of these costs may be part of the cost of leasehold improvements controlled by the lessee and as such should be capitalised anyway in accordance with IAS 16.

Illustration:

In some countries, the lessee of a commercial lease may be required to pay an amount to the previous lessee for the acquisition of its rights (such as the "*droit au bail*" in France). For the new lessee, this amount meets the definition of an initial direct cost and is included in the initial measurement of the right-of-use asset (therefore, it can no longer be recognised separately as an asset on the lessee's balance sheet, as was the case in France, in practice, before the application of IFRS 16).

This accounting treatment seems to be confirmed by an illustrative example in the Standard (Example 13).

- an estimate of the costs to be incurred by the lessee in dismantling or restoring the underlying asset or the site on which that asset is located, unless those costs are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories during that period (in which case the lessee applies IAS 2 – Inventories to those costs);

In both cases, IFRS 16 specifies that these costs are provisioned and measured in accordance with IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*.

- less any lease incentives received by the lessee before (or at) the commencement date (see question **35**).

Illustration:

A company enters into a contract for the lease of warehouses. As part of this contract, the company has an obligation to restore the warehouses to their original condition at the end of the lease (it is assumed the company incurs this obligation at the commencement of the lease). At the commencement date of the lease, the company's lease liability is measured at €200k and the liability for restoring the site at the end of the lease is measured at €50k.

Furthermore, on the commencement date, the company:

- pays the lessor an advance rent of €5k;
- pays commission of €10k to the real estate agent (consideration due for the conclusion of the contract), which meets the definition of an initial direct cost;
- receives a payment from the lessor of €2k (lessor's contribution to the agency costs incurred by the company), which meets the definition of a lease incentive.

The impacts on the company's balance sheet at the commencement date of the lease are as follows:

Assets (k€)		Liabilities (k€)	
Right-of-use asset (1)	263	Lease liability	200
Cash (2)	(13)	Provision for site restoration obligation	50
Total	250	Total	250

(1): the initial measurement of the right-of-use asset is calculated as follows:

Lease liability		200
+	Provision for site restoration obligation	50
+	Prepaid lease payment	5
+	Initial direct cost	10
-	Lease incentive	-2
=	Right-of-use asset	263

(2): cash impacts include prepaid lease payment (-€5k), real estate agent fee (-€10k) and payment received from the lessor (€2k).

Finally, the IFRS 16 application guidance specifies that costs relating to the construction or design of the underlying asset that are incurred before the commencement date (in some cases, the underlying asset may indeed need to be constructed or redesigned for the lessee's intended use) are not covered by IFRS 16. These costs are to be accounted for according to other applicable Standards (such as IAS 16 – *Property, Plant and Equipment* or IAS 38 – *Intangible Assets*).

In our view, if such costs are initially capitalised under IAS 16 or IAS 38 (e.g. the cost of a design study for a building that forms part of an investment project that could be the object of a purchase), they should then be reclassified within the right-of-use asset at the commencement date of the lease, as they are inseparable from the right-of-use asset.

44. How is the right-of-use asset subsequently measured?

[IAS 16.29-30; IAS 16.43-62A; IAS 36;9-10; IAS 40.30; IFRS 5.5; IFRS 5.25; IFRS 16.30-35]

IFRS 16 generally requires a right-of-use asset to be subsequently measured using the cost model. However:

- if the lessee applies the fair value model under IAS 40 – Investment Property to investment property that is owned, it must also apply IAS 40's fair value model to right-of-use assets that meet the definition of investment property;
- if the lessee applies the revaluation model under IAS 16 – Property, Plant and Equipment to a class of property, plant and equipment, it may choose, but is not required, to apply IAS 16's revaluation model to right-of-use assets that relate to the same class of property, plant and equipment.

The subsequent measurement of the right-of-use asset is therefore intended to be consistent with the way many non-financial assets are accounted for when controlled by an entity (see IFRS 16.BC148).

In practice, the revaluation model of IAS 16 is rarely used.

Subject to some specific guidance in IFRS 16 on the depreciation period of a right-of-use asset (see question **45**), the cost model to be applied to a right-of-use asset after the commencement date is the same as that set out in IAS 16.

Therefore:

- after the commencement date, the initial measurement of the right-of-use asset (see question **43**), less any residual value, is depreciated on a systematic basis;

IFRS 16 explicitly sets the start date for depreciation at the commencement date of the lease:

- even if this date falls within a period for which no rent is contractually charged, e.g. the fact that a lessor grants the lessee a rent-free period for the first few months of the lease does not lead to the deferral of depreciation; and
- regardless of the lessee's actual use of the underlying asset from that date, e.g. if leasehold improvements need to be completed before the lessee occupies a leased building, depreciation is not deferred until after completion of the leasehold improvements if the lessee already has the right to control the use of the building. However, in our view, if the lessee needs to have the right to control the use of the building to complete the leasehold improvements, the depreciation charge on the right-of-use asset during the period of completion of the leasehold improvements – provided that this period represents a normal period – would appropriately be added to the cost of the leasehold improvements.

Thereafter, as depreciation is recognised systematically (as for any item of property, plant and equipment), the amount of depreciation recognised is not further affected by:

- the absence or reduction of contractual payment cash flows (e.g. a rent-free period or a discount);
- a reduction in the use by the lessee of the underlying asset (e.g. due to a period of economic slowdown), as depreciation methods leading to a depreciation charge that is proportionate to the level of use of the asset, such as the units of production method, are rarely used in practice for right-of-use assets.

Finally, as for property, plant and equipment and intangible assets, depreciation of right-of-use assets ceases on the earlier of the date the right-of-use asset is derecognised and the date the right-of-use asset is classified as an "asset held for sale" in accordance with IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations*.

- the residual value and useful life of the right-of-use asset should be reviewed at least annually, with any changes accounted for as a change in estimate, in accordance with the provisions of IAS 8 – Accounting Policies, Changes in Estimates and Error Corrections;

In some countries, the lessee of a commercial lease may be required to pay an amount to the previous lessee for the acquisition of its rights under the lease (such as the *"droit au bail"* in France). This amount is an initial direct cost of the lessee and is included in the initial measurement of the right-of-use asset (see question **43**). In addition, the existence of such a mechanism in the relevant jurisdiction is an indicator that the right-of-use asset may have a positive residual value, which should be considered in determining its depreciable amount.

In France, given that this right carries specific economic benefits that could be consumed by the lessee at a different rate from that of the right-of-use asset, it is considered that two approaches are acceptable for taking into account the *"droit au bail"* in the subsequent measurement of the right-of-use asset:

- as the residual value of the right-of-use asset (in practice, the value of the "*droit au bail"* can then vary upwards or downwards), being our preferred approach; or
- as a significant component of the right-of-use asset (as defined in IAS 16.43), with its own residual value and depreciation rate (in which case, the carrying amount of the "*droit au bail"* component cannot subsequently be revised upwards).

- a right-of-use asset is subject to the provisions of IAS 36 – *Impairment of Assets* for the identification and measurement of impairment losses.

As a result, a right-of-use asset must be tested for impairment in accordance with the requirements of IAS 36:

- whenever there is an indication that the right-of-use asset may be impaired (e.g. if a lessee intends to abandon leased premises before the end of the lease – see question **49**); and
- at least once a year, when the right-of-use asset is part of a Cash Generating Unit (CGU), or a group of CGUs, comprising a non-depreciable intangible asset (i.e. with an indefinite useful life or not yet ready for use) or goodwill.

As right-of-use assets, with rare exceptions (e.g. a sublease), do not generate cash inflows that are largely independent of those from other assets, they are usually tested for impairment as part of a CGU.

Finally, a right-of-use asset may need to be remeasured (upwards or downwards) after its initial recognition due to a reassessment of the lease liability (see question **46**) or a lease modification (see question **48**).

45. What is the specific guidance in IFRS 16 on the depreciation period of a right-of-use asset?

[IAS 16.51; IFRS 16.32]

Where the cost model is applied to the subsequent measurement of a right-of-use asset (see question **44**), IFRS 16 requires the right-of-use asset to be depreciated:

- over the useful life of the underlying asset when:
  - the lease agreement provides for the transfer of ownership of the underlying asset to the lessee at the end of the lease; or
  - the lease liability includes the lessee's exercise price of an option to purchase the underlying asset (see question **32**);

> In such cases, if the transaction results in the transfer of control of the underlying asset to the lessee, the transaction should be classified as an " in-substance purchase" (see comment to question **3**). However, transferring ownership of an asset is not necessarily equivalent to transferring its control, though it is an indicator to consider when assessing whether control has been transferred (see **Mazars Insight on IFRS 15**, question 61).

- over the shorter of the useful life of the right-of-use asset and the lease (see question **24**), in all other cases.

> This provision particularly addresses the situation where the useful life of the right-of-use asset is shorter than the lease term. It would be rare for such a judgement to be appropriate at the beginning of a lease (an exception being when standard duration conditions are imposed on the lessee and go beyond its needs). However, if the economic environment changes, or new technologies are developed, it might become an appropriate judgement subsequently (see question **49**).

46. What is a "reassessment of the lease liability" and how is it accounted for?

[IFRS 16.39-43; IFRS 16.B42]

What is meant by a "reassessment of the lease liability"?

When the estimate of future lease payments changes (without any change to the terms and conditions of the lease), the lease liability may need to be remeasured to reflect these changes: in practice, these situations and the associated accounting treatment are referred to as a "reassessment of the lease liability".

> The terms "reassessment of the lease liability" and "lease modification" describe distinct situations with their own accounting treatment. However, in the event of a lease modification, the lease liability must also be remeasured unless the lease modification results solely in the recognition of a separate lease (see question **48**).

When does such a reassessment occur?

A lease liability must be reassessed when the inputs to the calculation of the lease liability are required to be revised, i.e. in the following circumstances:

- due to a revision of the lease term (see question 30);

IFRS 16 does not require the lease term to be revised at the end of each reporting period, but only in certain specific circumstances:

- for a lessee: if a significant event or change in circumstances within its control occurs and affects whether the lessee is reasonably certain to exercise (or not to exercise) its options affecting the duration of the contract; or
- for a lessee or a lessor: if there is a change in the non-cancellable period of the contract.

- due to a change in the assessment of whether the lessee is reasonably certain to exercise a purchase option held over the underlying asset. IFRS 16 only requires such a reassessment if a significant event or change in circumstances occurs that is within the lessee's control and affects whether the lessee is reasonably certain to exercise the purchase option.;

At the latest, such reassessment will be required when the purchase option is used or expires, if the initial measurement of the lease liability was based on a different assumption.

- due to a change in an index or a rate upon which future variable lease payments depend, when such a change affects the contractual cash flows;

The IASB considered this approach to be less complex and costly than revising the variable payments included in the measurement of the lease liability at the end of each reporting period, as an entity is typically required to publish financial statements more frequently than the frequency of change of a variable payment that depends on an index or a rate (see IFRS 16.BC190).

Besides, if the contract provides that a variable rent is revised less frequently than the index or the rate on which it is based, this also avoids the need to revise the lease liability each time the index or rate is reset. E.g. if a variable rent is revised annually based on the last published value of an index which is published quarterly, the lease liability is revised annually, not quarterly.

- due to a change in expected payments under a residual value guarantee;

IFRS 16 does not specify when payments under a residual value guarantee should be revised. However, the Basis for Conclusions suggests that a revision is required at the end of the period whenever a change in economic conditions significantly affects the measurement of a residual value guarantee (see IFRS 16.BC191).

- due to variable lease payments previously excluded from the measurement of the lease liability (because they do not depend on an index or a rate) being re-categorised as fixed (or in-substance fixed) lease payments, or vice versa.

IFRS 16 does not explicitly address these situations which may arise in practice, for example when:

- a variable payment (not dependent on an index or a rate) becomes in-substance fixed over the course of the contract, due to context change (see question **36**);
- a payment that was initially considered in-substance fixed despite a variability clause (the activation of which was considered extremely unlikely) varies over the course of the contract (e.g. in the context of the COVID-19 pandemic, certain contractual clauses triggering rent relief in exceptional circumstances – *force majeure*, administrative closure, etc. – may have been activated, creating variability in payments; in this regard: see question **50**).

What discount rate should be used when the lease liability is remeasured?

Depending on the situation, the lease liability is remeasured using either the original discount rate or a revised discount rate.

A revised discount rate is only used when the lease liability is remeasured to reflect (see question **42**):

- a change in the economics of the lease, i.e. when the lease term is revised or when the reasonable certainty of a lessee exercising an option to purchase the underlying asset is reassessed; or
- variable payments that depend on an interest rate are revised.

How to account for a reassessment of the lease liability?

General case

IFRS 16 requires the amount of the remeasurement of the lease liability to be recognised as an adjustment to the right-of-use asset. An important consequence is that the remeasurement of the lease liability is therefore recognised over time in profit or loss in the future depreciation of the adjusted right-of-use asset. Should the carrying amount of the right-of-use asset be reduced to zero, any further reduction in the measurement of the lease liability is recognised immediately in profit or loss.

Illustration:

A lessee enters into an agreement for the lease of commercial premises for a period of five years, with a commencement date on 1 January 20X0.

The contract provides for a fixed annual rent of €40k, payable on 1 January.

The contract also provides for an annual revision of the rent according to changes in the commercial rent index of the jurisdiction which is published quarterly. The annual revision of the rent results from a comparison of the index values published in the fourth quarter of each year. Therefore, the annual change in the index, measured in the fourth quarter of a given year, makes it possible to determine the rent to be paid on 1 January of the following year.

As the interest rate implicit in the contract is not readily determinable, the lessee determines its incremental borrowing rate for this contract at the commencement date. This rate is 5%.

The useful life of the right-of-use asset is estimated by the lessee to be five years (same duration as the lease term). The right-of-use asset is depreciated on a straight-line basis in the lessee's financial statements.

On the commencement date:

On 1 January 20X0, the lessee books the following entries:

(k€)	Debit	Credit
Right-of-use asset (1)	182	
Cash		40
Lease liability (2)		142

(1): the initial measurement of the right-of-use asset corresponds to the sum of the prepaid lease payment (€40k) and the initial measurement of the lease liability (€142k)

(2): the initial measurement of the lease liability is the present value of the lease payments discounted at 5%:

(k€)	1 January 20X1	1 January 20X2	1 January 20X3	1 January 20X4	Total
Rent	40	40	40	40	160
Present value (discounted at 5%)	38	36	35	33	142

Reminder: variable payments that depend on an index or a rate are measured using the index or rate prevailing at the measurement date (see question **34**).

Immediately prior to the reassessment of the lease liability:

For the first three quarters of year 20X0, the lessee has booked the following entries (cumulatively):

(k€)	Debit	Credit
Depreciation charge [3]	27	
Right-of-use asset		27
Interest expense [4]	5	
Lease liability		5

(3): €182k (initial measurement of the right-of-use asset) x 0.75 / 5 = €27k

(4): €142k (initial measurement of the lease liability) x 5% x 0.75 = €5k

Thus, as of 30 September 20X0:

- the right-of-use asset amounts to €155k (= €182k - €27k);
- the lease liability amounts to €147k (= €142k + €5k).

Reassessment of the lease liability:

On 1 October 20X0, a new index value is published, which is 10% higher than the reference value used to assess the initial rent.

As this new index value affects the contractual cash flows (the amount of rent to be paid on 1 January 20X1 is calculated from this value), the lease liability must be remeasured to reflect the revised lease payments:

(k€)	1 January 20X1	1 January 20X2	1 January 20X3	1 January 20X4	Total
Rent	44	44	44	44	176
Present value (discounted at 5%)	44	41	39	38	162

Reminder: in this situation, the discount rate remains unchanged (see question 42).

Compared to its carrying amount immediately before the remeasurement, the lease liability therefore increases by €15k (= €162k - €147k).

The lease liability is remeasured against the right-of-use asset:

(k€)	Debit	Credit
Right-of-use asset	15	
Lease liability		15

Therefore, as of 1 October 20X0:

- the right-of-use asset amounts to €170k (= €155k + €15k);
- the lease liability amounts to €162k (= €147k + €15k).

At the end of year 20X0:

In the fourth quarter of year 20X0, the depreciation of the right-of-use asset and the interest on the lease liability are calculated on the basis of the reassessed values as of 1 October 20X0:

(k€)	Debit	Credit
Depreciation charge (5)	9	
Right-of-use asset		9
Interest expense (6)	2	
Lease liability		2

(5): €170k (reassessed value of the right-of-use asset on 1 October 20X0) x 0.25 / 5 = €9K

(6): €162k (reassessed value of the lease liability as of 1 October 20X0) x 5% x 0.25 = €2K

Thus, as of 31 December 20X0:

- the right-of-use asset amounts to €161k (= €170k - €9k);
- the lease liability amounts to €164k (= €162k + €2k).

Rent concession

If a lessee receives a rent concession which does not result from a lease modification (see question **48**), the remeasurement of the lessee's lease liability should generally be recognised in profit or loss and not against the right-of-use asset.

This accounting treatment is mentioned by the IASB in educational material published in April 2020 ("IFRS 16 and covid-19, Accounting for covid-19-related rent concessions applying IFRS 16 *Leases*"): *"if a change in lease payments does not result from a lease modification, that change would generally be accounted for as a variable lease payment. In this case, a lessee applies paragraph 38 of IFRS 16 and generally recognises the effect of the rent concession in profit or loss".*

NB: as ESMA submitted questions to the IFRS IC relating to the accounting for rent concessions by lessors and lessees, positions may evolve on this issue.

47. How to deal with exchange rate differences related to a lease liability denominated in a foreign currency?

[IAS 21.8; IAS 21.16; IAS 21.23]

A lease liability, like other financial liabilities, is a monetary item.

> As confirmed in the Basis for Conclusions of IFRS 16 (see IFRS 16.BC196).

Consequently, in accordance with IAS 21 – *The Effects of Changes in Foreign Exchange Rates:*

- a lease liability denominated in a foreign currency (i.e. denominated in a currency other than the entity's functional currency) should be translated at the end of each reporting period using the closing rate;
- the remeasurement of the lease liability at the new closing rate is recognised in profit or loss.

> The IASB did not wish to adopt the view, suggested by some stakeholders, that a lessee should recognise the effect of remeasuring a foreign currency lease liability for changes in the exchange rate as an adjustment to the right-of-use asset.

48. What is a lease modification under IFRS 16 and how is it accounted for?

[IFRS 16.44-46; IFRS 16.Appendix A]

IFRS 16 defines a lease modification as a modification of the original terms and conditions of a lease, resulting in a change in either:

- the scope of a lease (e.g. adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term); or
- the consideration for a lease.

> A revision of judgements previously made on the likelihood of a lessee exercising options, and which impacts the estimate of the lease term and/or lease payments, is not a lease modification as defined in IFRS 16, since the option was part of the original terms and conditions of the contract. Rather, it results in a reassessment of the lease liability (see question **46**).

Determining whether a change in lease payments meets the definition of a lease modification according to IFRS 16 may require significant judgement.

> This is particularly the case in situations where the lessor grants the lessee a rent concession (see question **50**).

In our view, it is also important to pay attention to questions that may arise regarding:

- whether the modification leads to a change in the number of distinct components in the contract (see questions **9** and **10**);
- which Standard(s) to apply, e.g.:
  - if new distinct components have been added, which Standard(s) they fall under (see questions **1** and **2**);
  - if the components initially identified as lease components still meet the definition of a lease (see question **8**).

When a lease is modified, IFRS 16 requires to consider whether the modification leads to an additional underlying asset being leased for additional consideration that is commensurate with its stand-alone price (see question **12**):

- if it does, the lease modification is treated as a separate lease contract and the lessee recognises a separate right-of-use asset and lease liability on the commencement date (i.e. when the additional right-of-use asset is made available to the lessee). No adjustment is made to the previously recognised lease liability or right-of-use asset;

- otherwise, on the effective date of the modification of the contract (being the date on which both parties agree to the modification), a lessee:
  - allocates the consideration in the contract to the different lease components (see question **12**); and
  - remeasures the lease liability (both the lease term and discount rate must be revised: see questions **30** and **42**). If the lease modification decreases the scope of the lease (i.e. reduces the lease term or terminates the right to use one or more underlying assets) the remeasurement of the lease liability is accounted for by decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the original lease. A gain or loss is recognised for the partial or full termination of the lease. If the lease modification does not decrease the scope of the lease, the remeasurement of the lease liability is fully adjusted against the right-of use asset.

Although not explicitly stated in the main text of the Standard, the illustrative examples in the Standard (Examples 17 and 18) make it clear that, to reflect the partial or full termination of the original lease, a portion of the right-of-use asset, as well as a portion of the lease liability of the original lease, are derecognised (in a proportion that reflects the reduction in scope of the contract).

Illustration (scope reduction affecting the lease term):

A lessee enters into a six-year lease agreement for 1,000 m^2 of office space, commencing on 1 January 20X0.

The contract provides for a fixed annual rent of €120k, payable on 31 December.

As the interest rate implicit in the contract is not readily determinable, the lessee determines its incremental borrowing rate for this contract at the commencement date. This rate is 10%.

The useful life of the right-of-use asset is estimated by the lessee to be six years (same duration as the lease term). The right-of-use asset is depreciated on a straight-line basis in the lessee's financial statements.

At the commencement date, the payment schedule of the lease liability and the depreciation schedule of the right-of-use asset, measured in accordance with IFRS 16, are as follows:

Year	Lease liability (k€)				Right-of-use asset (k€)		
	Opening	Accrued interest	Payments	Closing	Opening	Depreciation	Closing
20X0	523	52	-120	455	523	-87	436
20X1	455	45	-120	380	436	-87	348
20X2	380	38	-120	298	348	-87	261
20X3	298	30	-120	208	261	-87	174
20X4	208	21	-120	109	174	-87	87
20X5	109	11	-120	0	87	-87	0

On 1 January 20X3, the lessee and the lessor conclude an amendment to the initial contract reducing the lease term from six to four years, without changing the rent for the year 20X3.

The lessee's incremental borrowing rate for this contract, reassessed as of 1 January 20X3 (effective date of the lease modification), is 7%.

On the effective date of the lease modification, the lessee accounts for the modification as follows:

First, a reduction in the scope of the contract (lease term reduced from six to four years):

At 1 January 20X3, before taking into account the lease modification:

- the carrying amount of the right-of-use asset is €261k, representing three remaining years of use;
- the carrying amount of the lease liability is €298k, corresponding to the three remaining lease payments of €120k discounted at the initial rate of 10% (i.e. €109k, €99k and €90k for years 20X3, 20X4 and 20X5 respectively).

To reflect the reduction in the scope of the contract, the lessee derecognises:

- a portion of the original right-of-use asset: €261k x 2/3 = €174k (reducing the right-of-use asset to €87k);
- a portion of the original lease liability: €99k + €90k = €189k (reducing the lease liability to €109k);

and recognises a net gain in profit or loss corresponding to €189k - €174k = €15k.

The lessee books the following entries:

(k€)	Debit	Credit
Lease liability	189	
Right-of-use asset		174
Gain		15

Then, a reassessment of the lease liability to reflect the revised discount rate at the effective date of the lease modification:

On 1 January 20X3, the lease liability remeasured on the basis of the new discount rate amounts to €112k (payment flow of €120k due on 31 December 20X3, discounted at 7%).

After the previous accounting entries reflecting the reduction in scope of the original lease, the lease liability therefore increases by €3k (=€112k - €109k).

The lease liability is remeasured against the right-of-use asset (bringing the value of the right-of-use asset to €87k + €3k = €90k):

(k€)	Debit	Credit
Right-of-use asset	3	
Lease liability		3

Illustration (scope reduction affecting the underlying asset):

The original lease agreement is the same as in the previous example.

On 1 January 20X4, the lessee and lessor conclude an amendment to the original lease reducing the leased area by half and reducing the annual rent to €90k as of year 20X4.

The lessee's incremental borrowing rate for this contract, reassessed as of 1 January 20X4 (effective date of the lease modification), is 8%.

At the date of the lease modification, the lessee accounts for the modification as follows:

First, a reduction in the scope of the contract (leased area reduced by half):

To reflect the reduction in the scope of the contract, the lessee derecognises:

- half of the original right-of-use asset: €174K / 2 = €87k;
- half of the original lease liability: €208k / 2 = €104k;

and recognises a net gain of: €104k - €87k = €17k.

The lessee books the following entries:

(k€)	Debit	Credit
Lease liability	104	
Right-of-use asset		87
Gain		17

Then, a reassessment of the lease liability to reflect the change in lease payments and the revised discount rate at the effective date of the lease modification:

As of 1 January 20X4, the lease liability remeasured on the basis of the new discount rate amounts to €160k (two payments of €90k, on 31 December 20X4 and 31 December 20X5, discounted at 8%).

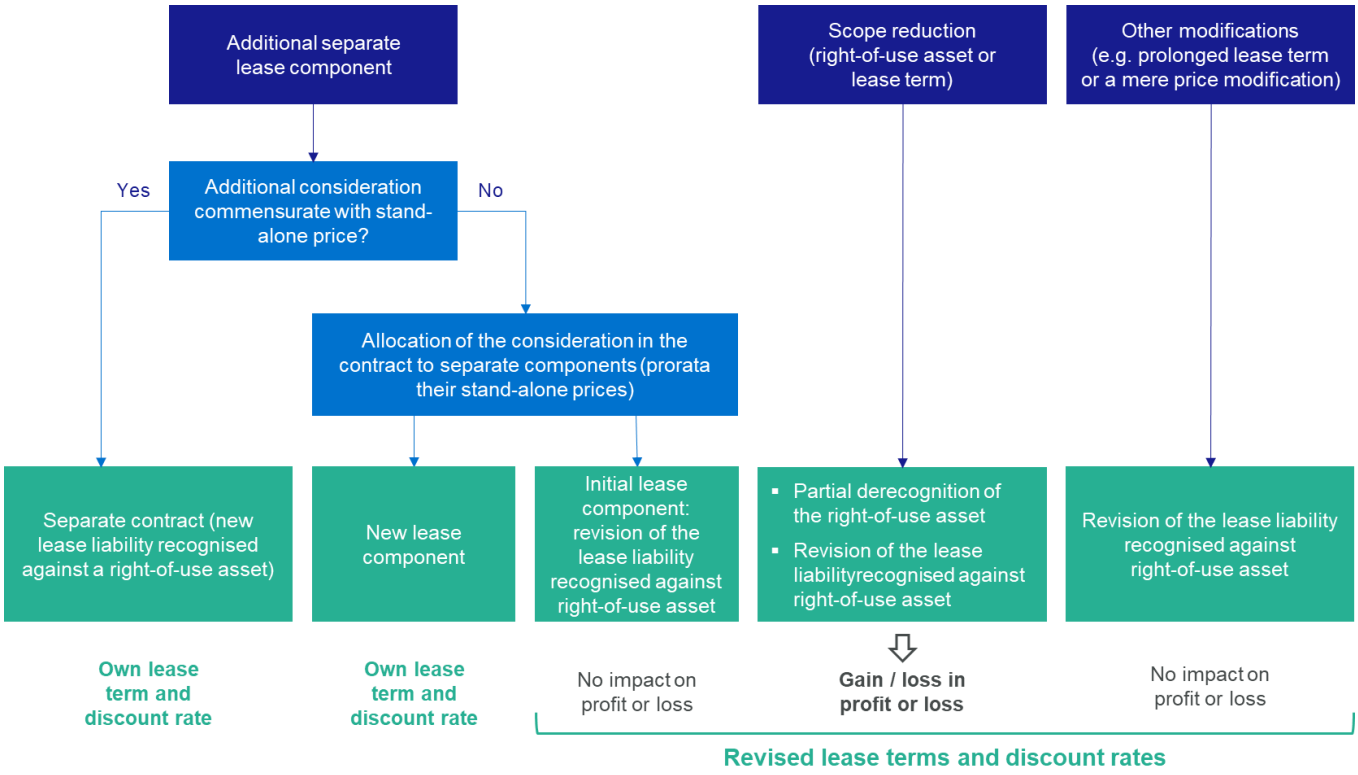
After the previous accounting entries reflecting the reduction in scope of the original lease, the lease liability therefore increases by €56k (=€160k - €104k).

The lease liability is remeasured against the right-of-use asset (bringing the value of the right-of-use asset to €87k + €56k = €143k):

(k€)	Debit	Credit
Right-of-use asset	56	
Lease liability		56

In summary

The different accounting treatments applicable on a lease modification can be summarised using the following decision tree:



49. How to deal with an abandonment of leased premises?

[IAS 16.51; IAS 36.12.f; IAS 37.5.c]

When does an abandonment of leased premises affect lease accounting under IFRS 16?

In various situations (cessation of activity, relocation, etc.), a lessee may consider leaving the leased premises before the date initially envisaged. In this case, it may be important to distinguish two situations:

- if the lessee has options affecting the duration of the contract:
  - prior to any change in the terms and conditions of the lease, the lease term may need to be revised, e.g. if a significant event or change in circumstances occurs that is within the lessee's control and affects whether the lessee is reasonably certain to exercise (or not to exercise) options affecting the duration of the contract (see question 30);

> A change in the lessee's intent in response to new market conditions is not, in itself, sufficient to characterise such an event or change in circumstances.

  - on the occurrence of such an event or change in circumstances, the lease liability is remeasured to reflect the revised lease term and discount rate (see question **46**);

Illustration:

> A company has entered into a fixed term lease for its head office, which includes an early termination option that the company was initially reasonably certain not to exercise. At the end of 20X0 (while the lease is in force), a relocation project is authorised by the company's board of directors (including the early termination of the current lease and the signing of a lease for other premises).
>
> At the beginning of 20X1, a notice of early termination is sent by the company to its lessor.
>
> In this case, the lease liability is remeasured at the end of 20X0 to reflect a revised lease term and discount rate.

- if the lessee has no such option, the lease term is revised only in the event of a lease modification, on the effective date of the modification (see question **48**).

Illustration:

> A company has entered into a fixed term lease for its head office, with no option affecting the duration of the contract. At the end of 20X0 (while the lease is in force), a relocation project is authorised by the company's board of directors. Discussions immediately begin with the lessor on the terms of a shortening of the lease (no commitment is made at this stage).
>
> At the beginning of 20X1, an amendment to the contract is concluded shortening the lease.
>
> In this case, the lease modification is only recognised in 20X1 (but interactions with other Standards may need to be considered at the end of 20X0: see details below).

In summary:

- the accounting for the abandonment of leased premises depends on whether the lessee has options affecting the duration of the contract (such as a termination or extension option);
- in the absence of such an option, the shortening of the lessee's commitment period can only result from amending the contract and is recognised on the effective date of the lease modification, without any possibility of anticipation;
- in any case, a change in the lessee's intent is never, in itself, sufficient.

What interactions with other Standards should be considered?

In addition, if at the end of the period a lessee expects to abandon premises and shorten the lease term via a lease modification that is not yet effective, attention should be paid to the following interactions with other Standards:

Standards / Issues	Interactions to consider
IAS 16 / Depreciation periods of assets (including right-of-use assets under IFRS 16)	The depreciation period is reviewed (prospectively) at least annually (see question **44**). Therefore, in the above example, at the end of 20X0 the depreciation period of the right-of-use asset should be revised (prospectively) and aligned with its useful life, if it has become shorter than the lease term.
IAS 36 / Impairment test of non-financial assets (including right-of-use assets under IFRS 16)	An impairment test must be performed if there is an indication of impairment, such as planning to dispose of an asset early (see question **44**). Therefore, in the above example: at the end of 20X0, an impairment test of the right-of-use asset must be performed (if, as is likely to be the case, the right-of-use asset does not generate cash inflows that are largely independent of those from other assets, this test is performed at CGU level).
IAS 37 / Provision for onerous contracts	In principle, leases recognised on the lessee's balance sheet are not covered by the provisions of this Standard, as the potentially onerous nature of a lease is not dealt with through IAS 37, but rather through an impairment test of the right-of-use asset, in accordance with IAS 36 (see question **7**). However, if a lessee recognises lease and non-lease components separately (see question **11**), separate service components that have become loss-making may lead to the recognition of a provision for onerous contract under IAS 37.

50. How to account for a rent concession?

[IFRS 16.2; IFRS 16.46A-46B]

In April 2020, the IASB published educational material on how to analyse rent concessions under IFRS 16 in the context of the COVID-19 pandemic (*"IFRS 16 and covid-19, Accounting for covid-19-related rent concessions applying IFRS 16* Leases*"*). In particular, the IASB provided guidance on how to determine whether a rent concession is a lease modification.

A lease modification, as defined in IFRS 16, requires a change in the terms and conditions of the contract affecting either the scope of the lease or the consideration for the lease (see question **48**). The IASB stated in this document that in assessing whether a rent concession:

- is a change in the consideration for a lease, the overall effect on lease payments should be considered (in other words, whether the rent concession substantially affects the present value of lease payments). According to the IASB, a rent-free period of three months may, for example, be offset by a proportionate increase in rent over a future period, so that the overall consideration for the lease is unchanged;
- results from a change in the terms and conditions of the contract, the contract and any applicable law and regulation should be considered together (in other words, the "terms and conditions of the contract" are the contract itself and any law and regulation that applies to the contract). Therefore, an entity should account for a rent concession in the same way, regardless of whether it results from a change in the text of the contract itself or from a change in applicable law or regulation.

  This was particularly important in the context of the COVID-19 pandemic, given the changes governments sometimes made to lease regulation to support economic activity.

These clarifications, based on an in-substance analysis of transactions and events, apply in our view to any rent concession granted by a lessor (including those granted outside the context of the COVID-19 pandemic).

General case

When accounting for rent concessions without applying the practical expedient provided by the amendments to IFRS 16 on COVID-19 related rent concessions, it is necessary to first determine whether it is a lease modification, as defined in IFRS 16:

- if a rent concession is a lease modification and no other substantive change has been made to the terms and conditions of the contract, then it is analysed as a price modification. Consequently, the lease liability is remeasured at the effective date of the modification (the discount rate and the lease term must also be revised) and the resulting remeasurement is recognised as an adjustment to the right-of-use asset (see question **48**);

  In our view, this is the case when a rent concession is granted by a lessor under a lease agreement which, in the event of *force majeure*, provides for negotiation in good faith between the parties to determine the terms of continuation of the agreement. The fact that the lessor grants such a rent concession does not *a priori* result from the terms and conditions of the initial agreement.

- if a rent concession is not a lease modification, the lease liability should be reassessed according to applicable requirements (see question **46**).

  In our view, this is the case when a rent concession results from the activation of a clause inducing a specified reduction in lease payments in cases of *force majeure*.

Application of the COVID-19 related rent concessions amendments to IFRS 16

Amendments to IFRS 16 were issued by the IASB in May 2020, and again in March 2021, to facilitate the application of the Standard in the case of a rent concession occurring as a direct consequence of the COVID-19 pandemic.

The practical expedient provided by the amendments only concerns the accounting by a lessee of these rent concessions.

Scope of the amendments

As these are exception rules designed to temporarily facilitate the application of the Standard in a particularly difficult context for companies, the scope of the first amendment published was deliberately restricted to apply only to rent concessions relating to lease payments due on or before 30 June 2021. The second published amendment merely extends the scope of the same provisions to a rent concession in respect of lease payments due on or before 30 June 2022.

> The Basis for Conclusions (see IFRS 16.BC205D.b) specifies that a rent concession for a series of lease payments extending beyond 30 June 2022 is entirely outside the scope of the amendments.

The scope of the amendments is also restricted to concessions:

- occurring as a direct consequence of the COVID-19 pandemic;
- which do not increase the overall consideration; and

> The Basis for Conclusions (see IFRS 16.BC205D.b) specifies that, under this condition, a related increase in some of the lease payments, even one that extends beyond 30 June 2022, does not prevent the rent concession from being within the scope of the amendments.

- which are not accompanied by any other substantive change in the terms and conditions of the contract.

Principle

These amendments offer a practical expedient that enables lessees not to assess whether the rent concession is a lease modification, and instead permit the rent concession to be accounted for as if it were not a lease modification (see above for how to account for a rent concession in a general case, in the absence of a lease modification).

The general requirements of IFRS 16 require a lessee to apply this option consistently to leases with similar characteristics and in similar circumstances.

> This analysis is explicitly confirmed in the Basis for Conclusions: see IFRS 16.BC205C.

Transition

The transitional provisions of the amendments require:

- retrospective application. Therefore, all contracts within the scope of the amendments are treated in the same way on the closing balance sheet of the year of initial application;
- comparatives not to be restated. Therefore, the cumulative impact of applying the amendments retrospectively is recognised as an adjustment to the opening balance of retained earnings in the year of initial application.

> As these amendments to IFRS 16 cannot have an effective date earlier than the date of their publication, their mandatory application starts with annual reporting periods beginning on or after 1 June 2020 for the first amendment and annual reporting periods beginning on or after 1 April 2021 for the second amendment. In practice, companies wishing to use the practical expedient generally applied the amendments early, as was permitted.

Given the principle of consistency of accounting policies, an entity must apply the second amendment consistently with the choices it made when the first amendment came into force.

Therefore:

- an entity which chose to apply the practical expedient to rent concessions falling within the scope of the first amendment must apply the practical expedient to rent concessions falling within the scope of the second amendment for contracts of a similar nature and in similar circumstances;

- an entity which chose not to apply the practical expedient to rent concessions falling within the scope of the first amendment is not permitted to apply the practical expedient to rent concessions falling within the scope of the second amendment for contracts of a similar nature and in similar circumstances;

- an entity which did not benefit from any rent concession falling within the scope of the first amendment is permitted to apply the practical expedient to rent concessions falling within the scope of the second amendment.

51. Does the recognition of leases on the lessee's balance sheet result in the recognition of deferred taxes?

[IAS 12.15; IAS 12.22-22A; IAS 12.24]

A lessee applying the general accounting model to a lease (see question **31**) recognises a right-of-use asset and a lease liability on its balance sheet at the commencement date of the lease.

At the same time, from a tax point of view, applicable rules often lead to the conclusion that there is no equivalent tax base, as defined in IAS 12 – *Income Taxes*, either on the asset or on the liability side.

This is the case, for example, when the lease payments are deductible from taxable income on a cash basis. In this case, there is no tax base, for either:

- the right-of-use asset (the entity has acquired no right to a future tax deduction, so the tax base for the asset is nil); or

- the lease liability (as the lease liability is fully deductible in the future, the tax base of the liability is nil).

Consequently, in such a situation, the recognition of a lease gives rise to temporary differences between:

- the right-of-use asset and its nil tax base (taxable temporary difference);
- the lease liability and its nil tax base (deductible temporary difference).

These temporary differences, excluding the effect of any initial direct cost and lease payments at or before commencement date, are of equal and opposite amounts.

Before the publication of amendments to IAS 12 in May 2021

This situation, which could arise under IAS 17 (the previous lease Standard) in the case of finance leases, was historically analysed according to one of two views (both of which were considered acceptable, in the absence of clarification in the Standards):

- View 1: the "initial recognition exemption" in IAS 12.22 (i.e. the exemption from recognising deferred tax on temporary differences arising on the initial recognition of an asset or liability that affects neither accounting profit nor taxable profit and is not the result of a business combination) applies, resulting in no deferred tax being recognised initially or subsequently;
- View 2: the "initial recognition exemption" does not apply because the net carrying amount of the lease (right-of-use asset less liability) on initial recognition is equal to the nil tax base of the lease on initial recognition (i.e. no temporary difference on initial recognition). Therefore, deferred taxes are recognised for any subsequent temporary difference between the net carrying amount of the lease and its tax base.

This view, compared to the previous one, had the advantage of recognising the impacts of the contract on pre-tax result over the same period as the related tax expense (resulting in a constant effective tax rate over time, provided that tax law remained the same).

Consequence of the application of the amendments to IAS 12 published in May 2021

The amendments to IAS 12 published in May 2021 (which are mandatory for annual reporting periods beginning on or after 1 January 2023) extended the “initial recognition exemption” to also include situations that give rise to equal taxable and deductible temporary differences, at the time of the transaction.

This results in a requirement to recognise deferred tax on all temporary differences arising from the recognition of a lease, whether these arise on initial recognition of the lease (e.g. where there is no equivalent tax base on either the asset or liability side at the commencement date of the lease) or from changes in the accounting and tax bases over time.

Presentation of a lease in the financial statements of a lessee

52. How should the impacts of a lease be presented in the financial statements of a lessee?

[IAS 1.82.b; IAS 7.31-34; IFRS 16.47-52]

On the balance sheet

According to the general accounting model (see question **31**), a lessee recognises a right-of-use asset (see question **43**) and a lease liability (see question **32**) on its balance sheet.

IFRS 16 provides guidance on their presentation on the balance sheet.

Right-of-use assets

Right-of-use assets are presented either:

- separately from other assets; or
- within the same line item as that within which the corresponding underlying assets would be presented if they were owned. In this case, a lessee discloses which line items include those right-of-use assets.

These presentation and disclosure requirements do not apply to right-of-use assets that meet the definition of investment property according to IAS 40, which are presented as investment property in the lessee's financial statements.

Lease liabilities

Lease liabilities may be presented separately from other liabilities or aggregated with other liabilities.

> The Basis for Conclusions (see IFRS 16.BC208) indicates that lease liabilities, although sharing many characteristics with financial liabilities, are sufficiently different from them that a separate presentation is useful to users of financial statements.

If lease liabilities are not presented separately from other liabilities, a lessee discloses which line items include those lease liabilities.

In the statement of profit or loss

The general accounting model for lessees (see question **31**) leads to the recognition of a depreciation charge for the right-of-use asset and an interest expense on the lease liability.

IFRS 16 requires these two expenses to be presented separately in the statement of profit or loss. Interest expense on lease liabilities is presented within finance costs, in accordance with IAS 1.

IFRS 16 does not specify how to present lease expenses resulting from payments that are not included in the measurement of lease liabilities. Disclosures in the notes (breakdown of expenses recognised in respect of leases – see question **53**) should normally provide adequate visibility.

> In our view, entities with significant payments not included in the measurement of lease liabilities (e.g. variable payments not linked to an index or rate) could rely on IAS 1 requirements to present additional line items in the statement of profit or loss.

In the statement of cash flows

In the statement of cash flows, a lessee classifies cash payments:

- for the principal portion of the lease liability within financing activities;
- for the interest portion of the lease liability within operating or financing activities (depending on its accounting policy choice regarding cash flows from interest paid, in accordance with IAS 7);
- not included in the measurement of the lease liability within operating activities.

Within the notes

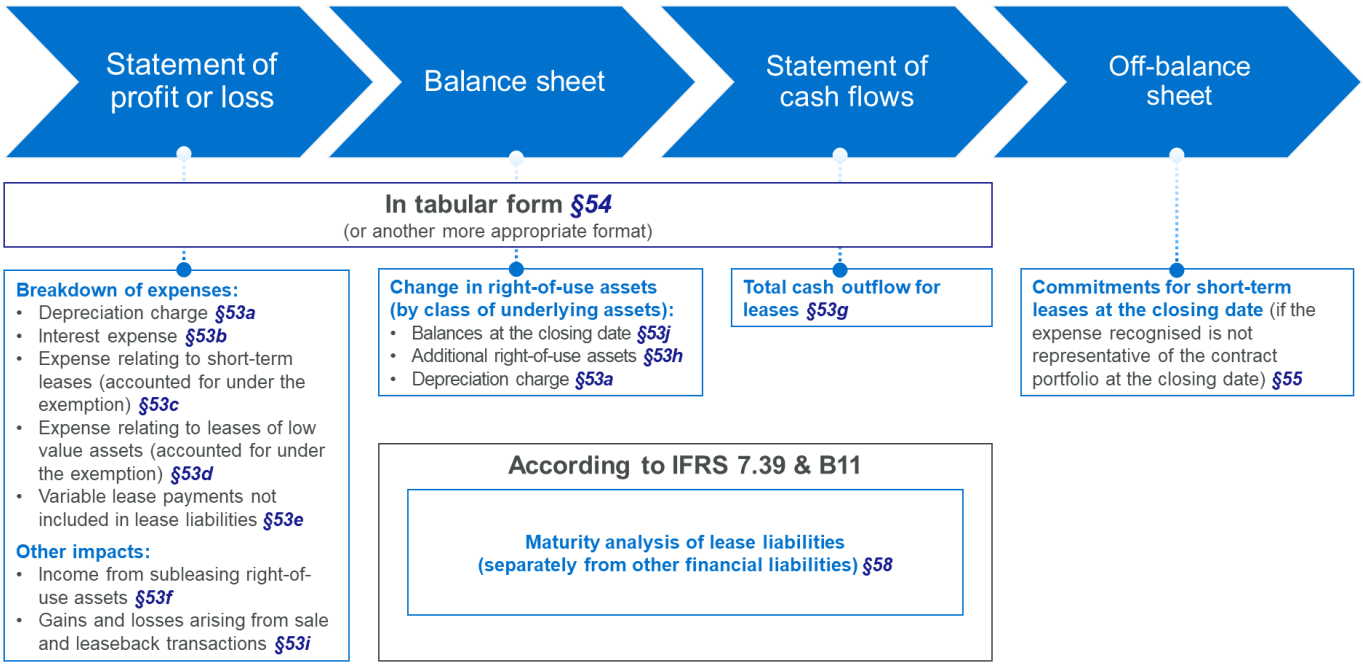
IFRS 16 specifies that an entity presents information about leases in which it is the lessee in a single note or separate section in its financial statements. However, if information has already been presented elsewhere in the financial statements, it need not be repeated, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

Disclosures in the financial statements of a lessee

53. What is the minimum quantitative information to be disclosed in the notes by a lessee?

[IFRS 16.53-58]

The requirements of IFRS 16 in this area can be represented as follows:



Regarding the maturity analysis of lease liabilities, it follows from the reference to the requirements of IFRS 7 that:

- disclosure is required of the undiscounted cash flows;
- judgement must be exercised to determine an appropriate number of time bands;
- the quantitative information provided should be supplemented with qualitative explanations on how an entity manages the liquidity risk inherent in the lease liability.

In addition, where right-of-use assets are subsequently measured at fair value (see question **44**), IFRS 16 provides the following clarifications:

- where right-of-use assets meet the definition of investment property, the lessee applies the disclosure requirements in IAS 40 (which exempts it from providing the disclosures required by paragraphs IFRS 16.53(a), (f), (h) and (j) for these assets – see diagram above);
- where right-of-use assets are measured using the revaluation model described in IAS 16, disclosures required by that Standard also apply to the revalued right-of-use assets.

In practice, the IAS 16 revaluation model is very rarely used for right-of-use assets resulting from the application of IFRS 16.

In addition to the specific requirements discussed above, IFRS 16 also requires a lessee to disclose further qualitative and quantitative information to enable users of the financial statements to assess the effect that leases have on its financial position, financial performance and cash flows (IFRS 16's disclosure objective). The IFRS 16 application guidance provides examples of the types of information that may be relevant (see question **54**).

54. What additional information (quantitative and/or qualitative) might a lessee be required to disclose in the notes to comply with IFRS 16's disclosure objective?

[IFRS 16.59-60; IFRS 16.B48-B52]

The level of detail provided should be commensurate with the materiality and complexity of an entity's leases.

> According to the IASB, judgement is required to determine the most useful and relevant information, depending on the circumstances (see IFRS 16.BC225).
>
> In our view, an entity with simple and very common leasing activities may only need to provide the minimum quantitative disclosures required by IFRS 16 (see question **53**) and indicate the absence of any significant option, judgement or commitment beyond the information already provided in the financial statements.

To assist an entity in assessing the need for additional disclosures, the IFRS 16 application guidance indicates that additional disclosures may be useful to users of the financial statements in understanding:

- the flexibility provided by leases (e.g. termination or extension options);
- restrictions imposed by leases (e.g. financial ratios to be respected);
- sensitivity of reported information to key variables (e.g. future variable payments);
- exposure to other risks arising from leases;
- deviations from industry practice (e.g. unusual or unique terms and conditions affecting the entity's lease portfolio).

These additional disclosures would be specific to the entity and its lease portfolio.

The examples provided in the application guidance mainly focus on the following three areas:

Description of the lessee's leasing activities	
Type of contracts by activity	For example, specify whether the lease portfolio includes (distinguishing, if necessary, between the different activities of the entity): • real estate leases (for what use? in which geographical areas? ...); • leases for other classes of underlying asset (which ones? for what use? in which geographical areas? ...); • sale and leaseback transactions (see question **66**) (reasons for and prevalence of these transactions; key terms and conditions; any specificity regarding the measurement of lease liabilities; cash flow effects in the reporting period).
Typical features of leases	For example, specify whether leases typically include: • termination and/or extension options (reasons for and prevalence of these options; relative magnitude of optional lease payments to lease payments; prevalence of the exercise of options that were not included in the measurement of lease liabilities; other operational and financial effects); • fixed and/or variable payments (regarding the latter: reasons for and prevalence of these payments; relative magnitude to fixed payments; key variables upon which variable payments depend and sensitivity of payments to changes in those key variables; other operational and financial effects); • residual value guarantees (reasons and prevalence of these guarantees; magnitude of a lessee's exposure to residual value risk; nature of the underlying assets for which these guarantees are provided; other operational and financial effects); • other notable features; • restrictions and covenants imposed on the lessee by leases.

Options and significant judgements	
Presentation choices	Specify the line items in which right-of-use assets and lease liabilities have been presented, where they do not appear on separate lines in the balance sheet.
Use of practical expedients	Where applicable, specify the use of the following options: • the use of a portfolio approach (for a set of contracts with similar characteristics) (see question **15**); • the choice not to separate lease and non-lease components (for one or more classes of underlying assets) (see question **11**); • the use of the exemption for short-term leases (for one or more classes of underlying assets) (see question **5**); • the use of the exemption for leases of low-value assets (for certain contracts) (see question **6**).
Discount rate for lease liabilities	For example, specify the key judgements made in determining the lessee's incremental borrowing rate for leases (see question **41**).
Lease term	For example, specify the key judgements made in determining the lease term (see question **24**).
Rent concession granted by a lessor	For example, specify (see question **50**): • the entity's choice regarding the application of the COVID-19 related rent concessions amendments to IFRS 16; • the analyses conducted to determine the appropriate accounting treatment; • the resulting accounting impacts.

Off balance sheet	
Cash outflows not reflected in lease liabilities on the balance sheet	Assess the extent to which additional quantitative and/or qualitative information should be provided on: • the use of the exemption for short-term leases (see above: choice of options); • the use of the exemption for leases of low-value assets (see above: choice of options); • termination and/or extension options (see above: typical contract features); • variable payments (see above: typical contract features); • leases for which the commencement date has not occurred yet.
Restrictions and covenants imposed on the lessee by leases	Assess the extent to which additional quantitative and/or qualitative information should be provided (see above: typical contract characteristics).

Accounting and presentation in the financial statements of a lessor

55. What is the general accounting model for lessors?

[IFRS 16.61]

The general accounting model for lessors is substantially the same as that in IAS 17 (the previous Standard on leases).

> The IASB wanted to substantially carry forward not only the lessor model under IAS 17, but also the way in which the relevant requirements were drafted in IAS 17 (see IFRS 16.BC231).

This model is based on a distinction between "operating leases" and "finance leases" (see question **56**), each with its own accounting model:

- the operating lease accounting model: see question **59**; and
- the finance lease accounting model: see question **60**.

56. What distinguishes a finance lease from an operating lease?

[IFRS 16.62; IFRS 16.B53-B54]

A lessor classifies a lease as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee (according to the IFRS 16 application guidance: risks include the possibility of losses from idle capacity or technological obsolescence; rewards may be represented by the expectation of profitable operation over the underlying asset's economic life and of gain from appreciation in value or realisation of a residual value). Otherwise, the lease is classified as an operating lease.

> This principle, as well as all the indicators and comments that follow relating to the distinction between operating and finance leases, were directly taken from IAS 17.

This distinction is based on an analysis of the substance of the transaction and not on the legal form of contract.

The analysis is based on the indicators provided by the Standard (see question **57**) and may require significant judgement, in particular because IFRS 16 does not specify any quantitative thresholds beyond which a contract would be considered to have transferred substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee.

Lease classification is determined at the inception date of the lease (see question **8**). Lease classification is only revised in the event of a lease modification (see question **30**).

57. What indicators are provided by IFRS 16 to help distinguish between operating and finance leases?

[IFRS 16.63-66]

Indicators of a finance lease

To assist an entity in making this analysis, IFRS 16 provides a (non-exhaustive) list of indicators that, individually or in combination, would normally lead to a lease being classified as a finance lease:

- the lease transfers ownership of the underlying asset to the lessee at the end of the lease term;
- the lessee has an option to purchase the underlying asset at a price that is expected to be sufficiently lower than its fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised;
- the lease term is for the major part of the economic life of the underlying asset even if title is not transferred;

  IFRS 16 does not set a quantitative threshold beyond which the lease term is for the major part of the economic life of the underlying asset. The US Standard on leases (*Leases*, ASC Topic 842) considers a threshold of 75% to be reasonable.

- at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset. The application guidance indicates that any adjustments to the lease payments between the lease inception date and the commencement date (such as an adjustment to the lease payments reflecting an increase in the lessor's cost of the underlying asset or a change in the lessor's cost of financing the lease) is deemed to have taken place at the inception date. Therefore, they are included in the present value of the lease payments considered for the assessment of this criterion;

  IFRS 16 does not set a quantitative threshold beyond which the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset. The US Standard on leases (*Leases*, ASC Topic 842) considers a threshold of 90% to be reasonable.

- the underlying asset is of such a specialised nature that only the lessee can use it without making major modifications.

This list is supplemented by three additional indicators which, individually or in combination, could also lead to a lease being classified as a finance lease:

- if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;
- gains or losses from the fluctuation in the residual fair value accrue to the lessee (e.g. in the form of a rent rebate equalling most of the sale proceeds at the end of the lease);
- the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Indicators of an operating lease

The Standard indicates that a review of the above criteria may not always be conclusive and that a lease qualifies as an operating lease if other features make it clear that the lease does not transfer substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee.

The Standard cites the following examples:

- if ownership of the underlying asset transfers at the end of the lease for a variable payment equal to its then fair value;
- if there are variable lease payments, as a result of which the lessor does not transfer substantially all such risks and rewards.

58. In the case of real estate leases, how to distinguish between operating and finance leases?

[IFRS 16.B55-B57]

IFRS 16 provides specific requirements for leases of land and buildings:

- the land and buildings elements must be analysed separately when determining their classification as finance or operating lease (see questions **56** and **57**), taking into account that land generally has an indefinite economic life (i.e. the lease of the land will usually be classified as an operating lease);
- for the purpose of determining whether the lease payments are for substantially all of the fair value of the underlying land or buildings, hence determining the classification of the land and buildings elements as either an operating or a finance lease, lease payments (including any initial lump-sum upfront payment) are allocated in proportion to the relative fair values of the leasehold interests in the land element and buildings element of the lease at the inception date;

  The leasehold interest in either one of these elements may indeed differ from the fair value of the asset itself, since the lessee's rights are limited in time and this period may be shorter than the economic life of the underlying asset (particularly in the case of land, which generally has an indefinite economic life). In addition, if the land is not expected to decrease in value over the lease term, the lessor would not normally need any compensation for wear and tear of the land, making an allocation of lease payments in proportion to the fair values of the leasehold interests in each element more representative of how a lessor would normally price a contract than an allocation in proportion to the fair values of the underlying land and buildings (see IFRS 16.BCZ246-247).

- however, if it is not possible to allocate the lease payments reliably between these two elements, the land and buildings elements together are classified as a single finance lease – unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease;
- where an allocation has been possible and the lease payments allocated to the land element is immaterial to the lease, a lessor may treat the land and buildings as a single unit of account and regard the economic life of the buildings as the economic life of the entire underlying asset for the purposes of lease classification.

59. How should an operating lease be recognised and presented in the financial statements of a lessor?

[IFRS 9.2.1.b.i; IFRS 16.81-86; IFRS 16.88; IFRS 16.Appendix A]

Lease payments are recognised as income over the lease term on either:

- a straight-line basis; or
- another systematic method, if it is more representative of the pattern in which benefit from the use of the underlying asset is diminishing.

The definition of lease payments for lessee accounting purposes (see question **34**) applies equally to the accounting for operating leases by lessors. Consequently, the lease payments recognised as income over the lease term by a lessor exclude variable payments that do not depend on an index or a rate.

IFRS 16 does not specify how to account for variable payments that do not depend on an index or a rate in the financial statements of a lessor. In practice, they are recognised in profit or loss as they are earned by the lessor.

For costs incurred by a lessor, IFRS 16 distinguishes between:

- costs incurred in earning the lease income (e.g. management fees, day-to-day maintenance costs, etc.), including depreciation of the underlying asset, which are recognised as expenses when incurred;
- initial direct costs incurred in obtaining the lease (i.e. costs that would not have been incurred by the lessor if the lease had not been obtained, other than those incurred by a manufacturer or dealer lessor in connection with a finance lease), which are added to the carrying amount of the underlying asset and depreciated over the lease term on the same basis as the lease income.

The notion of "initial direct cost" in IFRS 16 corresponds to the notion of incremental cost of obtaining a contract in IFRS 15 (see **Mazars Insight on IFRS 15**, question 62 and IFRS 16.BC237).

The above requirements (relating to the recognition of operating lease income and costs) also apply to manufacturer or dealer lessors.

The specific requirements of IFRS 16 for manufacturer or dealer lessors apply only to leases classified as finance leases (see question **60**).

Lease receivables

They are subject to IFRS 9 requirements regarding:

- impairment (in September 2022, the IFRS IC indicated that the lessor's intention to grant rent concessions to the lessee should be considered when measuring expected credit losses, even if such rent concessions are not linked to the credit situation of the lessee); and
- derecognition (see question **62**)

Recognition and presentation of underlying assets subject to operating leases

IFRS 16 does not change the requirements of other standards for the recognition and presentation of underlying assets subject to operating leases:

- they are presented on the lessor's balance sheet according to their nature;
- they are depreciated consistently with the methods applied by the lessor for similar assets, in accordance with IAS 16 and IAS 38;
- they are subject to the provisions of IAS 36 – *Impairment of Assets* for identifying and measuring any impairment loss.

60. How should a finance lease be initially recognised and presented in the financial statements of a lessor?

[IFRS 16.67-74]

General provisions

At the commencement date of the lease (see question **24**), a lessor presents the underlying asset of a finance lease as a receivable at an amount equal to the net investment in the lease.

The net investment in the lease is the sum of the following items, discounted at the interest rate implicit in the lease (see question **39**):

> IFRS 16 (and previously IAS 17) uses the term "gross investment in the lease" to refer to the sum of the undiscounted amounts below. The difference between the gross investment in the lease and the net investment in the lease is called *"*unearned finance income*"*.

- payments for the right to use the underlying asset during the lease term that have not yet been received by the lessor, comprising:
  - fixed payments, including "in-substance fixed" payments (see question 36), less any lease incentives (see question **35**);
  - variable payments that depend on an index or a rate, measured using the index or rate prevailing at the measurement date;

> IFRS 16 does not specify how to account for variable payments that do not depend on an index or a rate in the financial statements of a lessor. In practice, they are recognised in profit or loss as they are earned by the lessor.

  - expected payments under residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee;
  - the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (this assessment being performed in a similar way to the approach used to assess whether the lessee is reasonably certain to exercise, or not to exercise, an option affecting the duration of the contract: see question **25**);
  - payments of penalties for terminating the lease, if the lease term (see question **24**) reflects the lessee exercising a termination option (i.e. if the lessee is reasonably certain to exercise that option);

> The payments for the right to use the underlying asset during the lease term that are used in measuring the net investment in the lease are those used to measure the lease liability in the lessee's financial statements (see question **34**), plus, where applicable, expected payments under residual value guarantees by 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.

- any unguaranteed residual value accruing to the lessor.

Given the definition of the interest rate implicit in the lease (see question **39**), the initial direct costs incurred by a lessor to obtain the lease (i.e. costs that would not have been incurred by the lessor if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer lessor in connection with a finance lease) are *de facto* included in the initial measurement of the net investment in the lease.

> Because the interest rate implicit in the lease is calculated taking into account the initial direct costs incurred by the lessor, measuring the net investment by discounting the payments of the contract and the unguaranteed residual value of the asset at this rate amounts to capitalising the initial direct costs into the finance lease receivable on initial recognition.

Therefore, at the commencement date of a finance lease, a lessor:

- derecognises the underlying asset;
- cancels the expenses recognised for the initial direct costs incurred in obtaining the lease, unless the entity is a manufacturer or dealer lessor (see below);
- recognises a finance lease receivable at an amount equal to the net investment in the lease.

Specific provisions for manufacturer or dealer lessors

In the case of a finance lease entered into by a manufacturer or dealer lessor, the transaction is accounted for as a sale regardless of whether it transfers the underlying asset as described in IFRS 15.

Consequently, at the commencement date of the lease, a manufacturer or dealer lessor recognises:

- revenue equal to the fair value of the underlying asset or, if lower, the present value of the lease payments discounted at a market rate of interest;
- a cost of sale equal to the cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value.

Using a market rate of interest to calculate revenue prevents a lessor from recognising an excessive profit at the commencement date when the rates it advertises are artificially low.

The costs incurred by the manufacturer or dealer lessor in obtaining the lease are recognised as an expense at the commencement date of the lease. Therefore, unlike other lessors, the initial direct costs are not included in the finance lease receivable.

61. How should a finance lease be subsequently recognised and presented in the financial statements of a lessor?

[IFRS 16.75-78; IFRS 5.5]

Over the lease term (see question **24**), the lessor recognises finance income calculated by applying a constant rate of return to the net investment in the lease so as to achieve a systematic and rational allocation of finance income over the lease term.

The net investment in the lease is subject to the impairment and derecognition requirements of IFRS 9.

A lessor must regularly review the estimated unguaranteed residual values used in calculating the gross investment in the lease and immediately recognise an adjustment to the cumulative finance income already recognised if the value decreases.

> Decreasing the unguaranteed residual value leads to a decrease in the rate of return on the contract used to calculate the financial income.

Unlike an IFRS 9 financial asset, a finance lease is measured subsequently at the lower of carrying amount and fair value of costs to sell if it meets the conditions in IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations* to be classified as "held for sale".

> Financial assets are scoped out of IFRS 5's measurement requirements. Consequently, an IFRS 9 financial asset continues to be measured in accordance with IFRS 9 after its classification as " held for sale".

62. How are modifications to an operating lease accounted for?

[IFRS 16.87]

From its effective date (see question **30**), a lessor accounts for the modification as a new lease. Any prepaid or accrued lease payments relating to the original lease is treated as part of the lease payments for the new lease.

Illustration:

A private individual concludes a short-term lease with a car rental agency. The lease term is six days (without any extension option) and the price is €300, which is paid at inception of the contract. The commencement date falls on the same day as the inception date.

At the end of the fourth day, the parties agree to extend the total lease term by a further two days. In exchange, the private individual pays the agency an additional fee of €80.

Accounting for the original lease

In the financial statements of the lessor:

- the rental price (€300) paid by the individual at inception of the contract is booked as a deferred income liability;
- from the commencement date, lease income of €50 per day (corresponding to the lease payments recognised on a straight-line basis over the lease term, i.e. €300 / 6 days) is recognised against a reduction in the deferred income liability.

At the end of the fourth day and immediately before the effective date of the lease modification, the deferred income liability is therefore: €300 - (4 x €50) = €100.

Accounting for the lease modification

The extension of the lease term at the end of the fourth day was not part of the original terms and conditions of the lease. Therefore, it constitutes a lease modification under IFRS 16.

As the original lease was classified as an operating lease, the lease modification should be accounted for as a new lease.

As a result, in its financial statements the lessor:

- accounts for the additional cash received of €80 plus the deferred income liability of €100 on the original lease (i.e. €180) as the total consideration received for a new lease of 4 days (the 2 days remaining on the original contract plus the 2-day extension);
- recognises lease income of €45 per day on a straight-line basis over the lease term (i.e. €180 / 4 days), reducing the deferred income liability from €180 to €0 accordingly over those 4 days.

In September 2022, the IFRS IC specified how to account for a lease modification which only consists in a rent concession. On the date the rent concession is granted:

- operating lease receivables that have been waived by the lessor are derecognised against profit or loss, in accordance with IFRS 9;
- lessor's waiving of lease payments that have not yet been recognised as operating lease receivables is accounted for as a lease modification in accordance with IFRS 16 (i.e. with an impact in profit or loss recognised over the residual term of the lease).

63. How are modifications to a finance lease accounted for?

[IFRS 16.79-80]

Requirements in IFRS 16 differ depending on whether the modification leads to adding the right to use one or more underlying assets – in other words, a separate lease component – for additional consideration commensurate with its stand-alone price (see question **13**):

- if it does: the lease modification is treated as a separate lease on the effective date of the lease modification (see question **30**);
- otherwise, accounting for the modification in turn depends on whether the lease would have been classified as an operating lease had the amendment been in effect at the inception date:
  - if yes, the lessor:
    - also accounts for the lease modification as a new lease from the effective date; and
    - measures the carrying amount of the underlying asset as the net investment in the lease immediately prior to the effective date of the lease modification;

Illustration:

A lessor leases a photocopier for a non-cancellable period of five years. The lease term represents the estimated economic life of the photocopier. Furthermore, the present value of the lease payments is estimated to be close to the fair value of the photocopier.

In the second year, the lessor and lessee amend the contract so that it ends at the end of the current year, without changing the annual rent (the lessor, hoping to enter into further contracts, agrees not to charge the lessee for an amount equivalent to the present value of the lease payments it would have received in the absence of early termination).

Accounting for the original lease

As the term of the original lease represents the estimated economic life of the photocopier and the present value of the lease payments is estimated to be close to the fair value of the photocopier, the lease transfers substantially all the risks and rewards incidental to ownership of the photocopier. Therefore, the lease is classified as a finance lease at the inception date in the lessor's financial statements.

Consequently, at the commencement date of the lease, the lessor derecognises the underlying asset (the photocopier) and recognises a receivable for an amount equal to the net investment in the lease.

Accounting for the lease modification

The shortening of the duration of the lease in the second year was not part of the original terms and conditions of the lease. Therefore, it constitutes a lease modification under IFRS 16.

In addition:

- this lease modification does not lead to adding the right to use one or more underlying assets;
- if the lease modification had been in effect at the inception date, the lease would have been classified as an operating lease (indeed, the lease term would not have been for the major part of the economic life of the photocopier and the present value of the lease payments would not have amounted to substantially all of the fair value of the photocopier).

Therefore, this lease modification should be accounted for as a new lease (classified as an operating lease).

As a result, in the lessor's financial statements:

- at the effective date of the lease modification, the net investment in the lease is derecognised and an item of property, plant and equipment of equal carrying amount is recognised;
- from that date, lease payments (including any prepaid or accrued lease payments relating to the original lease) are recognised over the remaining term of the contract.

o if no, a lessor applies IFRS 9.

To the extent that the lease modification does not result in the derecognition of the net investment in the lease, the adjustment to the present value of the lease payments (with no change in the discount rate) is recognised in profit or loss.

For more details on IFRS 9 requirements: see **Mazars Insight, *IFRS for financial instruments***, paragraph 4.6.2.

64. How should a sublease be accounted for in the financial statements of the intermediate lessor?

[IAS 1.32-35; IAS 32.42-50; IFRS 16.68; IFRS 16.B58]

IFRS 16 defines a sublease as 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.

If a lessee subleases a low-value asset, or expects to sublease a low-value asset, then the headlease (i.e. the contract in which it is a lessee) does not qualify for the low-value exemption (see question **6**).

Subleases are within the scope of IFRS 16 (see question **2**). They are accounted for separately from the head lease in the financial statements of the intermediate lessor, applying the general requirements of the Standard applicable to lessors, subject to certain specific requirements (see below).

The IASB considers this approach to be appropriate as both the head lease and the sublease are usually negotiated separately and with different parties (see IFRS 16.BC232). Furthermore, the IASB did not want to create any exceptions to the general rules on offsetting. Therefore, the Basis for Conclusions specifies that an intermediate lessor should not offset assets and liabilities, or income and expense, arising from a head lease and a sublease of the same underlying asset, unless the general conditions for offsetting in IAS 1.32-35 and IAS 32.42-50 are met (see IFRS 16.BC235-236).

This has the following consequences:

Qualification of the sublease	Accounting for the head lease	Accounting for the sublease
Operating lease	The right-of-use asset and the lease liability are retained on the balance sheet	Sublease income is recognised on a straight-line basis over the lease term.
Finance lease	The right-of-use asset is derecognised (the lease liability remains on the balance sheet). A gain or loss is recognised (difference between the carrying amount of the derecognised right-of-use asset and the sublease receivable).	A sublease receivable is recognised at an amount equal to the net investment in the sublease.

In addition, specific provisions for accounting for subleases with an intermediate lessor apply concerning:

- the qualification of the sublease:
  - if the exemption for short-term leases (see question 5) is applied to the head lease, the sublease is classified as an operating lease;
  - otherwise, the sublease is classified as an operating or finance lease as appropriate (see questions **56** and **57**). Importantly, the assessment of whether risks and rewards incidental to ownership have transferred is done by reference to the right-of-use asset, not the underlying asset;

the discount rate to be used in measuring the net investment in a sublease that is classified as a finance lease. Specifically, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease).

Disclosures in the financial statements of a lessor

65. What information should be disclosed in the notes by a lessor?

[IFRS 16.89-97]

A lessor shall disclose the following information:

	Operating leases	Finance leases
Income and expenses (to be presented in a tabular format, unless another format is deemed more appropriate)	• Lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate	• Selling profit or loss • Finance income on the net investment in lease • Income relating to variable lease payments not included in the measurement of the net investment in the lease
Assets	• Information required by IAS 16 presenting separately, for each class of property, plant and equipment, information relating to assets not subject to an operating lease • Information required by IAS 36 • Where applicable: information required by IAS 38, IAS 40 and IAS 41	• Qualitative and quantitative explanation of the significant changes in the net investment in leases
Maturity analysis of lease payments	Undiscounted amount of lease payments to be received each year for at least the first five years and total amount expected for the following years	• Reconciliation of these amounts to the net investment in the lease, showing the discounting effect on the lease payments and the discounted amount of any unguaranteed residual value

These disclosures should be expanded as necessary to enable users of the financial statements to assess the effect that leases have on the lessor's financial position, financial performance and cash flows.

The Standard specifies that this additional information includes, *inter alia*:

- information on the nature of the lessor's leasing activities; and
- information on how the lessor manages the risks associated with any retained rights in the underlying assets, in particular, its risk management strategy, including any means of mitigating them (e.g. buy-back agreements, residual value guarantees or variable lease payments for use in excess of specified limits).

Sale and leaseback transactions

66. What is a sale and leaseback transaction?

[IFRS 16.98; IFRS 16.B45-B47]

In common parlance, a sale and leaseback transaction is a transaction in which an entity (seller-lessee) transfers an asset to a third party (buyer-lessor) and then immediately leases it back from that third party:



However, such a transaction only qualifies as a sale and leaseback under IFRS 16 if the seller-lessee controls the asset prior to its sale to the buyer-lessor.

> The IFRS 16 application guidance gives the example of a transaction between a manufacturer, a lessor and a lessee, whereby the lessee obtains legal title to the underlying asset from the manufacturer, sells it (i.e. transfers legal title) to the lessor and then leases it back from the lessor, but without ever taking control of it. In this case, the transaction does not qualify as a sale and leaseback, as defined in IFRS 16. Therefore, the lessee does not account for this as a purchase of the asset from the manufacturer followed by a sale and leaseback with the lessor, but as a lease from the lessor.

IFRS 16 includes specific requirements for accounting for sale and leaseback transactions in the financial statements of a seller-lessee and in the financial statements of a buyer-lessor (see question **67**).

67. How are sale and leaseback transactions generally accounted for?

[IFRS 16.53.i; IFRS 16.99-103]

Under IFRS 16, different requirements apply to sale and leaseback transactions (see question **66**) depending on whether the transfer of the underlying asset qualifies as a sale under IFRS 15, i.e. involves the transfer of control of the underlying asset from the lessee to the lessor.

Therefore, it must first be determined whether such a sale exists.

> A transaction can qualify as a sale from a legal perspective and not lead to the transfer of control of the asset from an accounting perspective. In any case, it is necessary to analyse the substance of the transaction to conclude whether it results in control of an asset being transferred (see **Mazars Insight on IFRS 15**, question 16).
>
> For example:
>
> - the existence of a leaseback does not preclude an entity from concluding that a sale (according to IFRS 15) has occurred;
> - on the other hand, if a seller is committed to repurchase an asset, or has the right to repurchase it (i.e. the seller has a "forward" or "call" on the asset), this would prevent an entity from concluding that the buyer has obtained control of the underlying asset (see **Mazars Insight on IFRS 15**, question 78).

Then, the appropriate requirements in IFRS 16 for each case should be applied.

Finally, in any case, a seller-lessee discloses gains and losses arising from sale and leaseback transactions (see question **53**).

The transfer of the underlying asset does not qualify as a sale under IFRS 15

A sale and leaseback transaction where the transfer of the underlying asset does not qualify as a sale under IFRS 15 is accounted for as a financing. Therefore:

- the seller-lessee retains the asset on its balance sheet and recognises a financial liability for the proceeds received;
- the lessor-buyer recognises a financial asset equal to the consideration paid.

The transfer of the underlying asset qualifies as a sale under IFRS 15

Measurement

IFRS 16 requires both the seller-lessee and the buyer-lessor to measure the sale proceeds at the fair value of the underlying asset at the date of sale.

This may require a reallocation of amounts stated in the contract for the sale and leaseback sides of the transaction. Adjustments to the contractual amounts are measured on the basis of the more readily determinable of:

- the difference between the fair value of the consideration for the sale (in the case of deferred payments: the present value of these payments at the time of sale) and the fair value of the asset; and
- the difference between the present value of the contractual payments for the lease and the present value of payments for the lease at market rates.

> IFRS 16 assumes that the contractual prices of the sale transaction and the lease are interdependent because they are negotiated as a package (see IFRS 16.BC267).
>
> As such, any difference between the consideration stated in the contract for the sale side of the transaction and the asset's market price is compensated by the pricing of the contractual payments for the lease. Conversely, any difference between the contractual payments for the lease and payments for the lease at market rates is compensated by the pricing of the sale.

Accounting consequences for the seller-lessee

In the financial statements of the seller-lessee, the sale, in substance, is not considered to be about the entire underlying asset, but about the right to use this asset at the end of the lease.

Consequently, IFRS 16 requires the seller-lessee to:

- recognise the right-of-use asset at an amount equal to a percentage of the previous carrying amount of the asset which has been sold and leased back. This percentage is the proportion of the asset that the seller-lessee retains through its right to use the underlying asset (this portion of the asset is considered never to have been sold); and
- recognise a disposal gain or loss relating to the remainder of the asset at the date of sale determined in accordance with IFRS 15. Consequently, a portion of the disposal gain or loss that would have typically been recognised in profit or loss for an outright sale (i.e. a portion of the difference between the sale proceeds less the asset's carrying amount at the date of sale) is deferred in the balance sheet.

Another way to describe the entries is that the seller-lessee:

- derecognises only a portion of the asset against the sale price, with the remaining portion of the asset being reclassified as a right-of-use asset;
- recognises a lease liability for the present value of the lease payments to be made over the lease term; and

When lease payments are variable and do not depend on an index or a rate, lease payments are determined in a way that the seller-lessee does not recognise any gain or loss on its retained right-of-use asset (see question **0**).

- recognises a disposal gain or loss for the difference between the debit amount (the sale price) and the credit amounts (the lease liability and the partial disposal of the asset).

In the absence of clarifications provided in the main text of the Standard, it is customary to rely on the illustrative example provided by IFRS 16 (Example 24) which suggests that the proportion of rights retained by the seller-lessee is the present value of the lease payments (if necessary, after reallocation of contractual prices between the sale transaction and the lease) divided by the fair value of the asset at the time of the transaction. In other words, the carrying amount of the asset is allocated between a retained interest and a transferred interest in proportion to their fair values (or approximations thereof).

Accounting consequences for the buyer-lessor

The buyer-lessor is deemed to have obtained control of the entire asset at the date of sale and to have entered into a lease with the seller-lessee.

Consequently, IFRS 16 requires the buyer-lessor to:

- account for the purchase of the underlying asset in accordance with applicable standards; and
- account for the lease in accordance with the requirements of IFRS 16 relating to lessors (see questions **55** to **64**).

The general model for recognising a lease in the financial statements of a lessee under IFRS 16 results in an asset being recognised on the lessee's balance sheet at commencement date (see question **31**). In contrast, IFRS 16 has not changed the general model for accounting for leases in the financial statements of a lessor, derived from IAS 17 (the previous lease Standard), whereby only finance leases result in an asset being derecognised from the lessor's balance sheet (see question **60**).

This explains the seemingly "asymmetrical" treatment of sale and leaseback transactions between the seller-lessee and the buyer-lessee (i.e. partial derecognition of the asset by the seller-lessee vs. full recognition of the asset by the buyer-lessor).

Illustration:



Carrying amount of the building in the financial statements of entity A immediately prior to the sale: €1,000k

Fair value of the building at the time of sale: €1,800k

Sale price of the building: €2,000k paid in cash

Lease term: eighteen years

Rent: €120k per year payable at the end of the year

Lessee's incremental borrowing rate (assumed to be equal to the interest rate implicit in the contract): 4.49%

Present value of annual payments: €1,460k

Step 1 – Existence of a sale according to IFRS 15:

It is assumed the transfer of the underlying asset qualifies as a sale under IFRS 15, i.e. involves the transfer of control of the building from the lessee to the lessor.

Step 2 – Measurement:

The contractual sale price of the building (€2,000k) is higher than its fair value at the time of sale (€1,800).

The excess (€2,000k - €1,800k = €200k) is considered as additional financing granted to entity A (seller-lessee) at the time of sale and subsequently repaid to Entity B (buyer-lessee) through the contractual lease payments.

As a result, the contractual payments are analysed as follows:

(k€)	Accounting view			
	Sale price	Rents	Additional financing	Total
Contractual sale price	1,800		200	2,000
Contractual rents (present value)		1,260	200	1,460

Step 3.a – Recognition in entity A's financial statements:

Proportion of the asset that relates to the right-of-use asset retained by the seller-lessee:
€1,260k (present value of rents) / €1,800k (fair value of the asset) = 70%.

Measurement of the right-of-use asset:
70% (proportion of the asset corresponding to the right-of-use asset retained by the seller-lessee) x €1,000k (carrying amount of the asset before the sale) = €700k

Disposal gain (calculated on the entire asset after having reallocated contractual amounts):
€1,800k (sale price) - €1,000k (carrying amount of the asset before the sale) = €800k

Part of this gain not recognised in the statement of profit or loss:
70% (proportion of the asset corresponding to the right-of-use asset retained by the seller-lessee) x €800k = €560k

Disposal gain to be recognised:
€800k - €560k = €240k

At the time of the transaction, entity A accounts for the transaction as follows:

(k€)	Debit	Credit
Cash	2,000	
Right-of-use asset	700	
Building		1,000
Lease liability		1,260
Financial liability		200
Gain on disposal		240

Step 3.b – Recognition in entity B's financial statements:

In this case, the lease is assumed to be an operating lease.

At the date of the sale, entity B accounts for the transaction as follows:

(k€)	Debit	Credit
Building	1,800	
Financial assets	200	
Cash		2,000

Subsequently, entity B recognises:

- the lease under the operating lease requirements in IFRS 16;
- the financial asset under IFRS 9.

To do this, the contractual rents must first be allocated between:

- a constant portion relating to the financial asset, such that the present value over eighteen years is equal to the initial amount of the financial asset (€200k), i.e. €16.4k (to be split between interest income – the amount of which results, in this case, from the application of the interest rate implicit in the lease to the balance of the financial asset at the beginning of the period – and a repayment of the financial asset);
- a portion relating to rent for the building, determined as the difference between the periodic lease payment and the amount allocated to settlement of the financial asset, i.e. €120k - €16.4k = €103.6k.

This leads to the following accounting:

Year	Contractual rent (Dr) (k€)	Operating lease income (Cr) (k€)	Interest income (Cr) (k€)	Repayment (Cr) (k€)
1	120	103.6	9.0	7.4
2	120	103.6	8.6	7.8
3	120	103.6	8.3	8.1
...	...	...	...	...
18	120	103.6	0.7	15.7

68. How should a sale and leaseback transaction (involving an initial sale of the underlying asset according to IFRS 15) be accounted for in the financial statements of the seller-lessee when the lease payments include variable payments that do not depend on an index or a rate?

[IFRS 16.100]

Nature of the problem

Where a sale and leaseback transaction involves variable payments that do not depend on an index or a rate, it is not clear from the Standard whether the proportion of the rights retained by the seller-lessee should be calculated by reference to:

- only payments for the lease that are included in the measurement of the lease liability (i.e. exclude variable payments); or

  In this case:

  - if the lease payments comprise only variable payments that do not depend on an index or rate, the entire carrying amount of the asset sold would be derecognised (the proportion of rights retained being zero) and the disposal gain or loss would be the same as for a sale of the entire asset. This would be inconsistent with the way IFRS 16 requires the gain or loss on the sale side of the transaction to be measured (see question 67);
  - no lease liability would be recognised, consistent with the requirements of IFRS 16 relating to payments included in the measurement of the lease liability (see question 34).

- all relevant payments to approximate the fair value of these rights (i.e. including all variable payments).

  In this case:

  - a proportion of the carrying amount of the asset would be derecognised against the disposal gain or loss, consistent with the way IFRS 16 requires the gain or loss on the sale side of the transaction to be measured;
  - a liability would be recognised at the time of the transaction, including variable payments that do not depend on an index or a rate, inconsistent with the way IFRS 16 generally requires the lease liability to be measured.

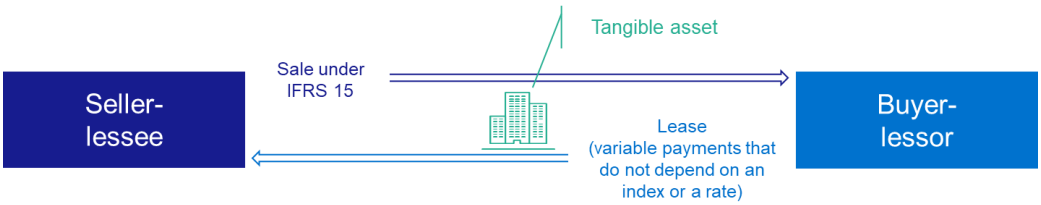
IFRS IC decision in June 2020

In a decision published in June 2020, the IFRC IC clarified that, in such a situation:

- the seller-lessee derecognises a share of the initially controlled asset against the disposal gain or loss;
- to determine this share, the seller-lessee compares the right-of-use asset it retains at the date of the transaction to the rights corresponding to control over the entire asset, for example, by comparing the present value of expected payments for the lease (including those that are variable) with the fair value of the asset at the date of the transaction;
- even when all lease payments are variable and do not depend on an index or a rate, the seller-lessee recognises a liability that is initially measured in a manner that is consistent with how the right-of-use asset is measured.

More generally, a similar issue arises for all sale and leaseback transactions involving an initial sale of the underlying asset that meets the criteria in IFRS 15 and where a significant proportion of the lease payments comprise variable payments that do not depend on an index or a rate. In our view, the IFRIC IC decision issued in June 2020 also applies to those situations.

Illustration (from the Interpretation Committee's response):



Carrying amount of the tangible asset in the financial statements of the seller-lessee immediately prior to the sale: €1,000k

Fair value of the tangible asset at the time of sale: €1,800k

Sale price of the tangible asset: €1,800k paid in cash

- Lease term: five years

Rents: calculated as a percentage of sales from use of the asset (in line with market conditions)

Present value of expected payments for the lease: €450k

The seller-lessee considers it appropriate to calculate the proportion of the asset relating to the retained right-of-use asset using the present value of the expected lease payments.

On this basis, the proportion of assets relating to the retained right-of-use asset is as follows:
€450k (present value of expected payments for the lease) / €1,800k (fair value of the asset) = 25%

Therefore, the right-of-use asset (representing the rights retained by the seller-lessee) amounts to:
€1,000k (carrying amount of the tangible asset) x 25% = €250k

In addition, the seller-lessee recognises a disposal gain:
[€1,800k (sale price) - €1,000k (carrying amount of the tangible asset)] x (1-25%) = €600k

Therefore, at the time of the transaction, the seller-lessee accounts for the transaction as follows:

(k€)	Debit	Credit
Cash	1,800	
Right-of-use asset	250	
Tangible asset		1,000
Lease liability		450
Gain on disposal		600

Amendments to IFRS 16 relating to the subsequent measurement of the lease liability arising from the leaseback published in 2022

The decision issued by the Interpretations Committee in June 2020 does not address the subsequent measurement of the liability. This issue was investigated by the IASB and led to the publication of amendments to IFRS 16, in September 2022.

In these amendments, the IASB clarified that the lease liability arising from a sale and leaseback transaction is subsequently measured in accordance with the general provisions of the Standard, but that a seller-lessee determines the lease payments (or revised lease payments) in a way that it does not recognise any gain or loss on its retained right-of-use asset. In practice, this allows a seller-lessee, in these circumstances, to include variable payments that do not depend on an index or a rate in the lease liability (*a priori*, consistently with how it determined the proportion of rights retained in the asset and the way in which it initially measured the lease liability).

However, these amendments do not prescribe how a seller-lessee determines the proportion of rights retained in the asset. Therefore, in practice, a seller-lessee determines an approach for measuring its retained right of use (the approach proposed in the IFRS IC's agenda decision of June 2020, based on the present value of the expected lease payments, being only one possibility). Once this proportion has been determined, a seller-lessee develops an accounting policy for determining lease payments in a way that it would not recognise any gain or loss on its retained right-of-use asset. Depending on the circumstances, possible approaches could comprise (as suggested in the Example 25 of the Illustrative examples, which was included in the 2022 amendments):

- an "Expected lease payments at the commencement date" approach: the lease payments correspond to the expected payments on the commencement date;
- an "Equal lease payments over the lease term" approach: the lease payments correspond to equal periodic payments over the lease term (the amount of these equal periodic payments can be deduced from the lease liability, as their present value, discounted at the seller-lessee's incremental borrowing rate, must be equal to the lease liability).

These amendments mandatorily apply to annual reporting periods beginning on or after 1 January 2024 (retrospective application required, in accordance with IAS 8). Earlier application is permitted.

69. In the financial statements of a seller-lessee, what presentation issues arise on a sale and leaseback transaction (involving an initial sale of the underlying asset according to IFRS 15)?

[IFRS 16.71]

In our view, it is first necessary to determine whether the disposal is part of the ordinary activities of the entity.

> The requirements on sale and leaseback transactions in IFRS 16 refer to "an asset", without specifying its nature (in particular, the Standard does not specify that these provisions apply only to property, plant and equipment and intangible assets, which are covered by IAS 16 and IAS 38 respectively). As a consequence, we believe that these requirements would still apply if inventory is subject to a sale and leaseback transaction.

If the disposal is not part of the entity's ordinary activities

In this case (e.g. the sale of an item of property, plant and equipment followed by its leaseback), the seller-lessee presents:

- a disposal gain or loss in profit or loss;
- a cash inflow within investment activities and a cash inflow within financing activities in the statement of cash flows.

> In the financial statements of the seller-lessee, a sale and leaseback transaction involves the recognition of a gain or loss on the underlying asset and the recognition of a liability for the leaseback payments (see question **67**).
>
> Therefore, the seller-lessee presents part of the cash flow it received as an investment inflow and another part as a financing inflow, in a manner that reflects how it determined the proportion of the underlying asset that was disposed of and the proportion it retained on its balance sheet.

Illustration:

The following illustration is based on the same context as in question **67**.

Of the €2,000k received in cash by the seller-lessee, €200k was analysed as relating to a "pure" financing transaction and €1,800k was analysed as relating to the sale and leaseback transaction. 30% of €1,800k was then analysed as relating to the partial disposal of the underlying asset and 70% of the same amount was analysed as relating to the retained right-of-use asset.

In its statement of cash flows, the seller-lessee presents:

- 30% x €1,800k = €540k as cash inflow within investment activities;
- €2,000k - €540k = €1,460k as cash inflow within financing activities.

If the disposal is part of the entity's ordinary activities

In this case (e.g. a property developer sells a building complex which it constructed, but retains the right to use it), in our view, the seller-lessee can present:

- revenue gross of expenses in the statement of profit or loss, as opposed to a net profit on disposal;

By analogy with the presentation requirements that apply to finance leases of a manufacturer or dealer lessor (see question 60).

Nevertheless, the seller-lessee must still ensure that it does not recognise a disposal gain or loss relating to the retained right-of-use asset. To do this, the seller-lessee must reduce the amount of the disposal gain or loss compared to the amount it would have typically recognised for an outright sale. In our opinion, there is an accounting policy choice between:

- reducing revenue and expenses on a proportional basis;
- increasing expenses.

Illustration:

The following illustration is based on the same context as in question 67, assuming the disposal is part of the seller-lessee's ordinary activities.

The disposal gain calculated on the entire asset (as for an outright sale) is: €1,800k (sale price for accounting purposes) - €1,000k (carrying amount of the underlying asset) = €800k.

Applying the requirements on sale and leaseback transactions in IFRS 16, 70% of this disposal gain (i.e. €560k) was analysed as relating to the retained right-of-use asset.

In its statement of profit or loss, the seller-lessee can present either:

- a net profit on disposal of €240k (30% x €800k); or
- €540k (30% x €1,800k) as revenue and €300k as expenses (30% x €1,000k) ; or
- €1,800k as revenue and €1,560k (€1,000k + 70% x €800k) as expenses.

- a cash inflow within operating activities (instead of investing activities, in the case where the disposal is not part of the entity's ordinary activities) and a cash inflow within financing activities in the statement of cash flows.

Transition to IFRS 16

70. When was IFRS 16 published and when is it mandatory?

[IFRS 16.C1-C2]

IFRS 16 was issued by the IASB in January 2016, after a process of almost ten years. The main steps in the Standard-setting process were the publication of a discussion paper in 2009 and the publication of two exposure drafts, in 2010 and 2013).

The European Union adopted IFRS 16 in November 2017, without changing the application dates set out in the Standard, namely:

- mandatory application for annual reporting periods beginning on or after 1 January 2019; and
- possible early application provided that IFRS 15 is also applied (IFRS 15 being mandatory for annual reporting periods beginning on or after 1 January 2018, i.e. one year earlier than IFRS 16).

IFRS 16 defines the date of initial application of the Standard as the beginning of the annual reporting period in which the entity first applies the Standard.

> For European Union entities with annual reporting period coinciding with the calendar year, the date of initial application of IFRS 16 was 1 January 2019.

71. What practical expedients are available to lessees and lessors on transition to IFRS 16?

[IFRS 16.C3]

IFRS 16 allow lessees and lessors not to reassess whether a contract is, or contains, a lease at the date of initial application of the Standard.

If an entity chooses to apply this practical expedient, it shall, at the date of initial application:

- apply IFRS 16 to contracts that were previously identified as leases applying IAS 17 Leases and IFRIC 4 – Determining whether an Arrangement contains a Lease (in which case it shall apply the transitional provisions in IFRS 16 to those leases); and
- not apply IFRS 16 to contracts that it had not previously identified as containing a lease applying IAS 17 and IFRIC 4.

72. What are the transition requirements in IFRS 16 for a lessee?

[IFRS 16.C5-C6]

A lessee must apply IFRS 16 either:

- retrospectively to each prior reporting period presented applying IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors (full retrospective method), in which case the comparative periods are restated and the cumulative effect of the initial application of IFRS 16 is recognised as an adjustment to the opening balance of equity of the earliest comparative period presented; or

- retrospectively with the cumulative effect of initially applying the Standard recognised at the beginning of initial application, without restating comparative information. This is referred to as “the modified retrospective method” (see questions **73** and **74**).

> In our view, it is acceptable for a lessee to present adjusted information on prior periods outside the financial statements. For entities that choose to do this, guidance on the presentation of alternative performance measures should be considered. We believe it is important to accompany comparative information presented outside the financial statements with a description of the assumptions used in their preparation.

A lessee must apply its transition method choice consistently to all leases in which it is a lessee.

73. In a lessee's financial statements, how is the modified retrospective method applied to leases previously classified as operating leases under IAS 17?

[IFRS 16.C7-C10]

For leases previously classified as operating leases under IAS 17, at the date of initial application, a lessee applying the modified retrospective method:

- recognises a lease liability measured at the present value of the remaining lease payments, determined using its incremental borrowing rate at the date of initial application;

  > In our view, in the absence of further clarification in IFRS 16, entities may determine this rate by reference to either the remaining or initial term of the lease contract, being an accounting policy choice to be applied consistently to all leases.

- recognises a right-of-use asset for those same leases and, for each lease, chooses to measure that asset at either:
  - its carrying amount as if IFRS 16 had been applied from the commencement date of the lease, but using the lessee's incremental borrowing rate at the date of initial application as the discount rate for the lease liability, or
  - an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments that were recognised on the balance sheet for that lease immediately before the date of initial application;
- apply IAS 36 – Impairment of assets to right-of-use assets recognised at the date of initial application, unless it applies the practical expedient provided for in IFRS 16 in connection with the test for the onerous nature of leases immediately before the date of initial application (see below).

In addition, IFRS 16 states that:

- a lessee is not required, on transition date, to restate leases of low-value assets (see question **6**);

> In practice, lease payments are still recognised as an expense over the lease term, before and after the date of initial application.

- a lessee is not required, on transition date, to make any adjustment for leases previously accounted for as investment property using the fair value model under IAS 40 Investment Property. This is because such leases, though classified as operating leases, were accounted for as finance leases and hence the lease liability should already be on balance sheet. A lessee applies IAS 40 and IFRS 16 to those leases from the date of initial application;
- for leases that will be accounted for as investment property under the IAS 40 fair value model from the date of initial application, a lessee shall measure the right-of-use asset at fair value at the date of initial application and apply IAS 40 and IFRS 16 to those contracts from that date.

Practical expedients on a lease-by-lease basis

Finally, on a lease-by-lease basis, the lessee may elect to apply one or more of the following practical expedients:

- apply a single discount rate to a portfolio of leases with reasonably similar characteristics (e.g. if the residual term, the class of underlying assets and the economic environment are similar);
- instead of performing an impairment test on the right-of-use asset recognised at the date of initial application, rely on its assessment of whether a lease was onerous applying IAS 37 – Provisions, Contingent Liabilities and Contingent Assets immediately before the date of initial application. If this practical expedient is used, the lessee adjusts the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised immediately before the date of initial application;
- elect not to apply the general lease requirements for leases that end within twelve months of the date of initial application, in which case the lessee:
  - accounts for these leases as if they were short-term leases (see question **5**); and
  - include the cost associated with these leases in the expense for short-term leases in the year of first application;
- exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application;
- use hindsight (e.g. to determine the lease term of a lease that contains extension or termination options).

74. In a lessee's financial statements, how is the modified retrospective method applied to leases previously classified as finance leases under IAS 17?

[IFRS 16.C11]

For leases previously classified as finance leases under IAS 17, a lessee applying the modified retrospective method:

- uses the carrying amount of those items measured in accordance with IAS 17 immediately before the date of initial application as the carrying amount of the right-of-use asset and the lease liability at that date; and
- accounts for the right-of-use asset and the lease liability in accordance with the requirements of IFRS 16 from the date of initial application.

75. What disclosures should a lessee make in the notes on transition?

[IAS 8.28; IFRS 16.C4; IFRS 16.C12-C13]

A lessee must disclose whether it has elected to apply the practical expedient that allows it not to reassess whether a contract is or contains a lease at the date of initial application (see question **71**).

If the modified retrospective method is used (see questions **73** and **74**), a lessee discloses:

- all the practical expedients it has elected;
- information required by IAS 8.28 about initial application, except for the disclosures required by paragraph 28(f) (i.e. the amount of the adjustment made to each affected line in the financial statements, for all periods presented);
- the weighted average incremental borrowing rate applied to lease liabilities recognised in the balance sheet at the date of initial application;

- an explanation, if any, of the difference between:
  - its operating lease commitment disclosed under IAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the lessee's incremental borrowing rate at the date of initial application (for details of how this rate is determined, see question **73**), and
  - lease liabilities recognised at the date of initial application.

76. What are the transition requirements in IFRS 16 for a lessor?

[IFRS 16.C14-C15]

Except in the specific cases listed below, a lessor is not required to restate leases in which it is the lessor on transition. Instead it accounts for such leases in accordance with IFRS 16 from the date of initial application.

An intermediary lessor (i.e. an entity that is the lessee in a head lease and lessor in a sublease):

- reassesses subleases that were previously classified as operating leases under IAS 17 and that are still in effect at the date of initial application to determine whether each such sublease should be classified as an operating lease or finance lease. It must make this assessment at the date of initial application based on the remaining contractual terms and conditions of the head lease and the sublease at that date; and
- accounts for subleases that are reclassified as finance leases under IFRS 16 as new finance leases entered into at the date of initial application.

77. What are the first-time application requirements under IFRS 1?

[IFRS 1.2-3; IFRS 1.7; IFRS 1.Appendix D9-D9E]

IFRS 1 – *First-time Adoption of International Financial Reporting Standards* is applied in an entity's IFRS financial statements that are the first annual financial statements for which the entity adopts IFRSs through an explicit and unreserved statement of compliance with IFRSs included in those financial statements.

Under IFRS 1, an entity is required to prepare and present an opening IFRS balance sheet at the "date of transition to IFRSs", which is the beginning of the earliest comparative period presented in its first set of IFRS accounts. This is the starting point for its IFRS accounting.

An entity adopting IFRSs for the first time must apply the same accounting policies in its opening IFRS balance sheet and for all periods presented in its first IFRS financial statements. Those accounting policies must comply with each IFRS effective at the end of the latest reporting period covered by its first IFRS financial statements.

IFRS 1 provides exemptions from retrospective application of IFRS 16 that are similar to the practical expedients provided in IFRS 16 for a lessee when applying the modified retrospective method (see questions **73** and **74**):

> Contrary to the modified retrospective method, these reliefs are applied at the start of the earliest comparative period presented (i.e. the date of transition), not the start of the current period.

- firstly, both lessees and lessors have an option to assess whether a contract existing at the date of transition to IFRSs contains a lease (see questions **16** to **23**) on the basis of the facts and circumstances that existed at that date ;

- secondly, lessees have an option to:
  - measure lease liabilities at the present value of the remaining lease payments determined using the lessee's incremental borrowing rate at the date of transition to IFRSs;
  - measure right-of-use assets, on a lease-by-lease basis, at either:
    - its carrying amount as if IFRS 16 had been applied at the commencement date of the lease, i.e. by reference to the lease liability that would have been recognised on that date, but using the incremental borrowing rate at the date of transition not the incremental borrowing rate on commencement of the lease; or
    - the amount of the lease liability, adjusted by the amount of any prepaid or accrued lease payments recognised in the balance sheet immediately before the date of transition to IFRSs;
  - apply IAS 36 to right-of-use assets at the date of transition to IFRSs;

  However, if a lessee's right-of-use asset meets the definition of an investment property in IAS 40 and the lessee has elected to measure investment property using the fair value model under that Standard, then it must measure the right-of-use asset at its fair value at the date of transition to IFRSs.
- thirdly, a first-time adopter that is a lessee may elect one or more of the following practical expedients on a lease-by-lease basis at the date of transition to IFRSs:
  - apply a single discount rate to a portfolio of leases with reasonably similar characteristics (e.g. if the residual term, the class of underlying assets and the economic environment are similar);
  - elect not to apply the general lease requirements to leases that end within twelve months of the date of transition to IFRSs, in which case the entity shall account for (and disclose) these leases as if they were short-term leases (see question **5**);
  - elect not to apply the general requirements for leases (as set out above) to leases of low-value assets (see question **6**), in which case the entity shall account for (and disclose) those leases by applying the requirements of IFRS 16 that are specific to those leases;
  - exclude the initial direct costs of measuring the measurement right at the date of transition to IFRSs;
  - use hindsight (e.g. to determine the lease term of a lease that contains extension or termination options).

Background

78. What were the IASB's objectives in revising the lease standard?

According to the IASB, the main criticisms regarding the previous standard, IAS 17, were:

- the existence of two models for leases in the financial statements of a lessee:
  - many users believed operating leases (for which the net payments were recognised on a straight-line basis over the lease term under IAS 17) should be reflected on the balance sheet of a lessee, like finance leases, and complained that they did not have sufficient information to make such a restatement themselves;
  - made it difficult to compare entities' the financial performance and position;
- the disclosure requirements in the financial statements of a lessor, which were not considered to provide adequate information on the credit risk arising from a lease and the risk relating to the lessor's retained interest in the underlying asset.

The main objectives of the IASB in revising the lease standard were, therefore, to achieve consistency of accounting for leases in the financial statements of a lessee and to improve the disclosures in the lessor's financial statements.

79. Are IFRS 16 and the new US lease standard converged?

The project to revise their standards on leases was initiated jointly by the IASB and the FASB, with common objectives. However, IFRS 16 and the revised US standard on leases (ASC Topic 842) are not fully converged.

The main difference concerns the model for accounting for leases in the financial statements of a lessee. Unlike the IASB, the FASB has chosen to maintain the distinction between operating and finance leases. For finance leases, the accounting model under the US Standard is similar to that in IFRS 16. For operating leases, while the US Standard requires the recognition of a right-of-use asset and a lease liability, it also requires the recognition of a single lease expense in the statement of profit or loss (typically an expense recognised on a straight-line basis over the lease term) and the presentation of a single cash outflow within operating activities in the statement of cash flows.

Other differences between IFRS 16 and the revised US standard in the lessee accounting model include:

- the accounting for sale and leaseback transactions,
- the exemption for leases of low-value assets (which is not included in the US Standard),
- the subsequent measurement of variable payments,
- presentation and disclosure requirements in the notes; and
- transitional arrangements.

Regarding the model for accounting by lessors, as the IASB and FASB have largely carried forward the principles of their previous standards, the divergences that existed in this area remain.

Key terms and definitions

80. What are the key terms and definitions relating to date and duration that are used in IFRS 16

[IFRS 16.Appendix A]

IFRS 16 uses several key terms relating to date and duration, some of which are defined and some of which are not, which we have compiled and commented on in the table below:

Term	IFRS 16 definition	Comments
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.	The existence of a lease (or lease component) is considered on these two dates only (see question **8**).
Effective date of the lease modification	The date when both parties agree to a lease modification.	
Commencement date	The date on which a lessor makes an underlying asset available for use by a lessee.	This is the date for recognising a lease in the financial statements of a lessee (see question **31**) and in the financial statements of a lessor (see questions **59** and **60**).
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.	This is the duration used for accounting for a lease (see question **24**).
Non-cancellable period	N/A	IFRS 16 specifies that it is part of the lease term and includes the lessor's termination options. The Basis for Conclusions further indicates that this period necessarily meets the definition of a contract (see IFRS 16.BC127), i.e. there are enforceable rights and obligations during this period.
The period for which the contract is enforceable	N/A	According to the IFRS 16 application guidance, a lease ceases to be enforceable when each party has the right to terminate the lease without permission from the other party and without incurring more than an insignificant penalty. The Interpretation Committee clarified in its decision of November 2019 that a lease is no longer enforceable only when this condition is met. Or, put differently, that it is a necessary and sufficient condition for a lease to cease to be enforceable (see question **26**).
Contractual lease term	N/A	The phrase "contractual lease term" is only used in the definition of a lease modification. In our view, it means all terms and conditions relating to the duration of the lease as specified in the contract. As a result, when those terms and conditions are changed (in a way that is not superficial), the lease has been “modified” which results in a revision of the duration used for accounting for the lease (see question **48**).
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).	The period of use may be shorter than the lease term if non-consecutive periods of use are required to fulfil the contract.

Term	IFRS 16 definition	Comments
Useful life of an asset	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.	This is the same definition as in IAS 16 – *Property, Plant and Equipment* and IAS 38 – *Intangible Assets*.
Date of initial application of the Standard	The date of initial application is the beginning of the annual reporting period in which an entity first applies this Standard.	

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