HKFRS 16
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Hong Kong Financial Reporting Standard 16

Leases

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Hong Kong Financial Reporting Standard 16 *Leases* (HKFRS 16) is set out in paragraphs 1–106 and Appendices A–D. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time that they appear in the Standard. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. The Standard should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Overview

IN1 Hong Kong Financial Reporting Standard 16 *Leases* (HKFRS 16) sets out the principles for the recognition, measurement, presentation and disclosure of leases. The objective is to ensure that lessees and lessors provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the entity.

IN2 HKFRS 16 is effective for annual periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply HKFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of HKFRS 16.

IN3 HKFRS 16 supersedes:

(a) HKAS 17 *Leases*;

(b) HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*;

(c) HK(SIC)-Int 15 *Operating Leases—Incentives*; and

(d) HK(SIC)-Int 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

Reasons for issuing HKFRS 16

The Hong Kong Institute of Certified Public Accountants supports the reasons for the International Accounting Standards Board (IASB) issuing IFRS 16 *Leases* and therefore issued HKFRS 16 to maintain convergence of HKFRS with International Financial Reporting Standards.

IN4 Leasing is an important activity for many entities. It is a means of gaining access to assets, of obtaining finance and of reducing an entity's exposure to the risks of asset ownership. The prevalence of leasing means that it is important that users of financial statements have a complete and understandable picture of an entity's leasing activities.

IN5 The previous accounting model for leases required lessees and lessors to classify their leases as either finance leases or operating leases and account for those two types of leases differently. That model was criticised for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognise assets and liabilities arising from operating leases.

IN6 Accordingly, the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), initiated a joint project to develop a new approach to lease accounting that requires a lessee to recognise assets and liabilities for the rights and obligations created by leases. This approach will result in a more faithful representation of a lessee's assets and liabilities and, together with enhanced disclosures, will provide greater transparency of a lessee's financial leverage and capital employed.

IN7 Both Boards decided that a lessee should be required to recognise assets and liabilities for all leases (with limited exceptions), and both Boards have defined leases in the same way. The Boards reached similar decisions regarding the measurement of lease liabilities, and how to account for leases that were formerly classified as finance leases. In addition, both Boards decided not to substantially change lessor accounting.

IN8 However, the Boards reached different decisions for leases that were formerly classified as operating leases with respect to the recognition of lease expenses and the reporting of lease-related cash flows. The IASB decided to adopt a single lessee accounting model whereby a lessee accounts for all leases in the same way. The FASB decided to adopt a dual lessee accounting model, classifying leases in a similar manner to the previous requirements in US Generally Accepted Accounting Principles (US GAAP) for distinguishing between operating leases and capital leases, and to account for those two types of leases differently.

IN9 IFRS 16 completes the IASB's project to improve the financial reporting of leases.

Main features

Lessee accounting

IN10 HKFRS 16 introduces a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognise a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments.

IN11 A lessee measures right-of-use assets similarly to other non-financial assets (such as property, plant and equipment) and lease liabilities similarly to other financial liabilities. As a consequence, a lessee recognises depreciation of the right-of-use asset and interest on the lease liability, and also classifies cash repayments of the lease liability into a principal portion and an interest portion and presents them in the statement of cash flows applying HKAS 7 *Statement of Cash Flows*.

IN12 Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease.

IN13 HKFRS 16 contains disclosure requirements for lessees. Lessees will need to apply judgement in deciding upon the information to disclose to meet the objective of providing a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

Lessor accounting

IN14 HKFRS 16 substantially carries forward the lessor accounting requirements in HKAS 17. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently.

IN15 HKFRS 16 also requires enhanced disclosures to be provided by lessors that will improve information disclosed about a lessor's risk exposure, particularly to residual value risk.

Hong Kong Financial Reporting Standard 16
Leases

Objective

1 This Standard sets out the principles for the recognition, measurement, presentation and disclosure of *leases*. The objective is to ensure that *lessees* and *lessors* provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity.

2 An entity shall consider the terms and conditions of *contracts* and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard consistently to contracts with similar characteristics and in similar circumstances.

Scope

3 An entity shall apply this Standard to all leases, including leases of *right-of-use assets* in a *sublease*, except for:

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

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

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

(d) licences of intellectual property granted by a lessor within the scope of HKFRS 15 *Revenue from Contracts with Customers*; and

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

4 A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3(e).

Recognition exemptions (paragraphs B3–B8)

5 A lessee may elect not to apply the requirements in paragraphs 22–49 to:

(a) *short-term leases*; and

(b) leases for which the *underlying asset* is of low value (as described in paragraphs B3–B8).

6 If a lessee elects not to apply the requirements in paragraphs 22–49 to either short-term leases or leases for which the underlying asset is of low value, the lessee shall recognise the *lease payments* associated with those leases as an expense on either a straight-line basis over the *lease term* or another systematic basis. The lessee shall apply another systematic basis if that basis is more representative of the pattern of the lessee's benefit.

7 If a lessee accounts for short-term leases applying paragraph 6, the lessee shall consider the lease to be a new lease for the purposes of this Standard if:

(a) there is a *lease modification*; or

(b) there is any change in the lease term (for example, the lessee exercises an option not previously included in its determination of the lease term).

8 The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis.

Identifying a lease (paragraphs B9–B33)

9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

10 A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

11 An entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.

Separating components of a contract

12 For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 15. Paragraphs B32–B33 set out guidance on separating components of a contract.

Lessee

13 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

14 The relative stand-alone price of lease and non-lease components shall be determined on the basis of 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, the lessee shall estimate the stand-alone price, maximising the use of observable information.

15 As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component. A lessee shall not apply this practical expedient to embedded derivatives that meet the criteria in paragraph 4.3.3 of HKFRS 9 *Financial Instruments*.

16 Unless the practical expedient in paragraph 15 is applied, a lessee shall account for non-lease components applying other applicable Standards.

Lessor

17 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessor shall allocate the consideration in the contract applying paragraphs 73–90 of HKFRS 15.

Lease term (paragraphs B34–B41)

18 An entity shall determine the lease term as the non-cancellable period of a lease, 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.

19 In assessing whether a lessee is reasonably certain to exercise an option to extend a lease, or not to exercise an option to terminate a lease, an entity shall consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease, as described in paragraphs B37–B40.

20 A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:

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

(b) affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term (as described in paragraph B41).

21 An entity shall revise the lease term if there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:

(a) the lessee exercises an option not previously included in the entity's determination of the lease term;

(b) the lessee does not exercise an option previously included in the entity's determination of the lease term;

(c) an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term; or

(d) an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term.

Lessee

Recognition

22 At the *commencement date*, a lessee shall recognise a right-of-use asset and a lease liability.

Measurement

Initial measurement

Initial measurement of the right-of-use asset

23 At the commencement date, a lessee shall measure the right-of-use asset at cost.

24 The cost of the right-of-use asset shall comprise:

(a) the amount of the initial measurement of the lease liability, as described in paragraph 26;

(b) any lease payments made at or before the commencement date, less any *lease incentives* received;

(c) any *initial direct costs* incurred by the lessee; and

(d) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

25 A lessee shall recognise the costs described in paragraph 24(d) as part of the cost of the right-of-use asset when it incurs an obligation for those costs. A lessee applies HKAS 2 *Inventories* to costs that are incurred during a particular period as a consequence of having used the right-of-use asset to produce inventories during that period. The obligations for such costs accounted for applying this Standard or HKAS 2 are recognised and measured applying HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Initial measurement of the lease liability

26 At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the *interest rate implicit in the lease*, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the *lessee's incremental borrowing rate*.

27 At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

(a) *fixed payments* (including in-substance fixed payments as described in paragraph B42), less any lease incentives receivable;

(b) *variable lease payments* that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);

(c) amounts expected to be payable by the lessee under *residual value guarantees*;

(d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraphs B37–B40); and

(e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

28 Variable lease payments that depend on an index or a rate described in paragraph 27(b) include, for example, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates.

Subsequent measurement

Subsequent measurement of the right-of-use asset

29 After the commencement date, a lessee shall measure the right-of-use asset applying a cost model, unless it applies either of the measurement models described in paragraphs 34 and 35.

Cost model

30 To apply a cost model, a lessee shall measure the right-of-use asset at cost:

(a) less any accumulated depreciation and any accumulated impairment losses; and

(b) adjusted for any remeasurement of the lease liability specified in paragraph 36(c).

31 A lessee shall apply the depreciation requirements in HKAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset, subject to the requirements in paragraph 32.

32 If the lease transfers ownership of the underlying asset to the lessee by the end of the lease term or if the cost of the right-of-use asset reflects that the lessee will exercise a purchase option, the lessee shall depreciate the right-of-use asset from the commencement date to the end of the *useful life* of the underlying asset. Otherwise, the lessee shall depreciate the right-of-use asset from the commencement date to the earlier of the end of the *useful life* of the right-of-use asset or the end of the lease term.

33 A lessee shall apply HKAS 36 *Impairment of Assets* to determine whether the right-of-use asset is impaired and to account for any impairment loss identified.

Other measurement models

34 If a lessee applies the fair value model in HKAS 40 *Investment Property* to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in HKAS 40.

35 If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in HKAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

Subsequent measurement of the lease liability

36 After the commencement date, a lessee shall measure the lease liability by:

(a) increasing the carrying amount to reflect interest on the lease liability;

(b) reducing the carrying amount to reflect the lease payments made; and

(c) remeasuring the carrying amount to reflect any reassessment or lease modifications specified in paragraphs 39–46, or to reflect revised in-substance fixed lease payments (see paragraph B42).

37 Interest on the lease liability in each period during the lease term shall be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The periodic rate of interest is the discount rate described in paragraph 26, or if applicable the revised discount rate described in paragraph 41, paragraph 43 or paragraph 45(c).

38 After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:

(a) interest on the lease liability; and

(b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

Reassessment of the lease liability

39 After the commencement date, a lessee shall apply paragraphs 40–43 to remeasure the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.

40 A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

(a) there is a change in the lease term, as described in paragraphs 20–21. A lessee shall determine the revised lease payments on the basis of the revised lease term; or

(b) there is a change in the assessment of an option to purchase the underlying asset, assessed considering the events and circumstances described in paragraphs 20–21 in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

41 In applying paragraph 40, a lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the date of reassessment, if the interest rate implicit in the lease cannot be readily determined.

42 A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:

(a) there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee.

(b) there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

43 In applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

Lease modifications

44 A lessee shall account for a lease modification as a separate lease if both:

(a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

45 For a lease modification that is not accounted for as a separate lease, at the *effective date of the lease modification* a lessee shall:

(a) allocate the consideration in the modified contract applying paragraphs 13–16;

(b) determine the lease term of the modified lease applying paragraphs 18–19; and

(c) remeasure the lease liability by discounting the revised lease payments using a revised discount rate. The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

46 For a lease modification that is not accounted for as a separate lease, the lessee shall account for the remeasurement of the lease liability by:

(a) decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.

(b) making a corresponding adjustment to the right-of-use asset for all other lease modifications.

46A As a practical expedient, a lessee may elect not to assess whether a rent concession that meets the conditions in paragraph 46B is a lease modification. A lessee that makes this election shall account for any change in lease payments resulting from the rent concession the same way it would account for the change applying this Standard if the change were not a lease modification.

46B The practical expedient in paragraph 46A applies only to rent concessions occurring as a direct consequence of the covid-19 pandemic and only if all of the following conditions are met:

(a) the change in lease payments results in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change;

(b) any reduction in lease payments affects only payments originally due on or before 30 June 2022 (for example, a rent concession would meet this condition if it results in reduced lease payments on or before 30 June 2022 and increased lease payments that extend beyond 30 June 2022); and

(c) there is no substantive change to other terms and conditions of the lease.

Presentation

47 A lessee shall either present in the statement of financial position, or disclose in the notes:

(a) right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:

(i) include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and

(ii) disclose which line items in the statement of financial position include those right-of-use assets.

(b) lease liabilities separately from other liabilities. If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

48 The requirement in paragraph 47(a) does not apply to right-of-use assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property.

49 In the statement of profit or loss and other comprehensive income, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, which paragraph 82(b) of HKAS 1 *Presentation of Financial Statements* requires to be presented separately in the statement of profit or loss and other comprehensive income.

50 In the statement of cash flows, a lessee shall classify:

(a) cash payments for the principal portion of the lease liability within financing activities;

(b) cash payments for the interest portion of the lease liability applying the requirements in HKAS 7 *Statement of Cash Flows* for interest paid; and

(c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

Disclosure

51 The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee. Paragraphs 52–60 specify requirements on how to meet this objective.

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

53 A lessee shall disclose the following amounts for the reporting period:

(a) depreciation charge for right-of-use assets by class of underlying asset;

(b) interest expense on lease liabilities;

(c) the expense relating to short-term leases accounted for applying paragraph 6. This expense need not include the expense relating to leases with a lease term of one month or less;

(d) the expense relating to leases of low-value assets accounted for applying paragraph 6. This expense shall not include the expense relating to short-term leases of low-value assets included in paragraph 53(c);

(e) the expense relating to variable lease payments not included in the measurement of lease liabilities;

(f) income from subleasing right-of-use assets;

(g) total cash outflow for leases;

(h) additions to right-of-use assets;

(i) gains or losses arising from sale and leaseback transactions; and

(j) the carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

54 A lessee shall provide the disclosures specified in paragraph 53 in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.

55 A lessee shall disclose the amount of its lease commitments for short-term leases accounted for applying paragraph 6 if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed applying paragraph 53(c) relates.

56 If right-of-use assets meet the definition of investment property, a lessee shall apply the disclosure requirements in HKAS 40. In that case, a lessee is not required to provide the disclosures in paragraph 53(a), (f), (h) or (j) for those right-of-use assets.

57 If a lessee measures right-of-use assets at revalued amounts applying HKAS 16, the lessee shall disclose the information required by paragraph 77 of HKAS 16 for those right-of-use assets.

58 A lessee shall disclose a maturity analysis of lease liabilities applying paragraphs 39 and B11 of HKFRS 7 *Financial Instruments: Disclosures* separately from the maturity analyses of other financial liabilities.

59 In addition to the disclosures required in paragraphs 53–58, a lessee shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 51 (as described in paragraph B48). This additional information may include, but is not limited to, information that helps users of financial statements to assess:

(a) the nature of the lessee's leasing activities;

(b) future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:

(i) variable lease payments (as described in paragraph B49);

(ii) extension options and termination options (as described in paragraph B50);

(iii) residual value guarantees (as described in paragraph B51); and

(iv) leases not yet commenced to which the lessee is committed.

(c) restrictions or covenants imposed by leases; and

(d) sale and leaseback transactions (as described in paragraph B52).

60 A lessee that accounts for short-term leases or leases of low-value assets applying paragraph 6 shall disclose that fact.

60A If a lessee applies the practical expedient in paragraph 46A, the lessee shall disclose:

(a) that it has applied the practical expedient to all rent concessions that meet the conditions in paragraph 46B or, if not applied to all such rent concessions,

information about the nature of the contracts to which it has applied the practical expedient (see paragraph 2); and

(b) the amount recognised in profit or loss for the reporting period to reflect changes in lease payments that arise from rent concessions to which the lessee has applied the practical expedient in paragraph 46A.

Lessor

Classification of leases (paragraphs B53–B58)

61 A lessor shall classify each of its leases as either an *operating lease or a finance lease*.

62 A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.

63 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the underlying asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the underlying asset at a price that is expected to be sufficiently lower than the *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;

(c) the lease term is for the major part of the *economic life* of the underlying asset even if title is not transferred;

(d) 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; and

(e) the underlying asset is of such a specialised nature that only the lessee can use it without major modifications.

64 Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and

(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

65 The examples and indicators in paragraphs 63–64 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, the lease is classified as an operating lease. For example, this may be the case if ownership of the underlying asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are variable lease payments, as a result of which the lessor does not transfer substantially all such risks and rewards.

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

Finance leases

Recognition and measurement

67 At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the *net investment in the lease*.

Initial measurement

68 The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. In the case of a sublease, 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) to measure the net investment in the sublease.

69 Initial direct costs, other than those incurred by manufacturer or dealer lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

Initial measurement of the lease payments included in the net investment in the lease

70 At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date:

(a) fixed payments (including in-substance fixed payments as described in paragraph B42), less any lease incentives payable;

(b) variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date;

(c) any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee;

(d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option (assessed considering the factors described in paragraph B37); and

(e) payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Manufacturer or dealer lessors

71 At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:

(a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;

(b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the *unguaranteed residual value*; and

(c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which HKFRS 15 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in HKFRS 15.

72 Manufacturers or dealers often offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to profit or loss equivalent to the profit or loss resulting from an outright sale of the underlying asset, at normal selling prices, reflecting any applicable volume or trade discounts.

73 Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in a lessor recognising an excessive portion of the total income from the transaction at the commencement date. If artificially low rates of interest are quoted, a manufacturer or dealer lessor shall restrict selling profit to that which would apply if a market rate of interest were charged.

74 A manufacturer or dealer lessor shall recognise as an expense costs incurred in connection with obtaining a finance lease at the commencement date because they are mainly related to earning the manufacturer or dealer's selling profit. Costs incurred by manufacturer or dealer lessors in connection with obtaining a finance lease are excluded from the definition of initial direct costs and, thus, are excluded from the net investment in the lease.

Subsequent measurement

75 A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.

76 A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the *gross investment in the lease* to reduce both the principal and the *unearned finance income*.

77 A lessor shall apply the derecognition and impairment requirements in HKFRS 9 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued.

78 A lessor that classifies an asset under a finance lease as held for sale (or includes it in a disposal group that is classified as held for sale) applying HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* shall account for the asset in accordance with that Standard.

Lease modifications

79 A lessor shall account for a modification to a finance lease as a separate lease if both:

(a) the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

(b) the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

80 For a modification to a finance lease that is not accounted for as a separate lease, a lessor shall account for the modification as follows:

(a) if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor shall:

(i) account for the lease modification as a new lease from the effective date of the modification; and

(ii) measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

(b) otherwise, the lessor shall apply the requirements of HKFRS 9.

Operating leases

Recognition and measurement

81 A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

82 A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense.

83 A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

84 The depreciation policy for depreciable underlying assets subject to operating leases shall be consistent with the lessor's normal depreciation policy for similar assets. A lessor shall calculate depreciation in accordance with HKAS 16 and HKAS 38.

85 A lessor shall apply HKAS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

86 A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

Lease modifications

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

Presentation

88 A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

Disclosure

89 The objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor. Paragraphs 90–97 specify requirements on how to meet this objective.

90 A lessor shall disclose the following amounts for the reporting period:

(a) for finance leases:

(i) selling profit or loss;

(ii) finance income on the net investment in the lease; and

(iii) income relating to variable lease payments not included in the measurement of the net investment in the lease.

(b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.

91 A lessor shall provide the disclosures specified in paragraph 90 in a tabular format, unless another format is more appropriate.

92 A lessor shall disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in paragraph 89. This additional information includes, but is not limited to, information that helps users of financial statements to assess:

(a) the nature of the lessor's leasing activities; and

(b) how the lessor manages the risk associated with any rights it retains in underlying assets. In particular, a lessor shall disclose its risk management strategy for the rights it retains in underlying assets, including any means by which the lessor reduces that risk. Such means may include, for example, buy-back agreements, residual value guarantees or variable lease payments for use in excess of specified limits.

Finance leases

93 A lessor shall provide a qualitative and quantitative explanation of the significant changes in the carrying amount of the net investment in finance leases.

94 A lessor shall disclose a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall reconcile the undiscounted lease payments to the net investment in the lease. The reconciliation shall identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value.

Operating leases

95 For items of property, plant and equipment subject to an operating lease, a lessor shall apply the disclosure requirements of HKAS 16. In applying the disclosure requirements in HKAS 16, a lessor shall disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases. Accordingly, a lessor shall provide the disclosures required by HKAS 16 for assets subject to an operating lease (by class of underlying asset) separately from owned assets held and used by the lessor.

96 A lessor shall apply the disclosure requirements in HKAS 36, HKAS 38, HKAS 40 and HKAS 41 for assets subject to operating leases.

97 A lessor shall disclose a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years.

Sale and leaseback transactions

98 If an entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the lease applying paragraphs 99–103.

Assessing whether the transfer of the asset is a sale

99 An entity shall apply the requirements for determining when a performance obligation is satisfied in HKFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

Transfer of the asset is a sale

100 If the transfer of an asset by the seller-lessee satisfies the requirements of HKFRS 15 to be accounted for as a sale of the asset:

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

(b) the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard.

101 If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset, or if the payments for the lease are not at market rates, an entity shall make the following adjustments to measure the sale proceeds at fair value:

(a) any below-market terms shall be accounted for as a prepayment of lease payments; and

(b) any above-market terms shall be accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

102 The entity shall measure any potential adjustment required by paragraph 101 on the basis of the more readily determinable of:

(a) the difference between the fair value of the consideration for the sale and the fair value of the asset; and

(b) 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.

Transfer of the asset is not a sale

103 If the transfer of an asset by the seller-lessee does not satisfy the requirements of HKFRS 15 to be accounted for as a sale of the asset:

(a) the seller-lessee shall continue to recognise the transferred asset and shall recognise a financial liability equal to the transfer proceeds. It shall account for the financial liability applying HKFRS 9.

(b) the buyer-lessor shall not recognise the transferred asset and shall recognise a financial asset equal to the transfer proceeds. It shall account for the financial asset applying HKFRS 9.

Temporary exception arising from interest rate benchmark reform

104 A lessee shall apply paragraphs 105–106 to all lease modifications that change the basis for determining future lease payments as a result of interest rate benchmark reform (see paragraphs 5.4.6 and 5.4.8 of HKFRS 9). These paragraphs apply only to such lease modifications. For this purpose, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark as described in paragraph 6.8.2 of HKFRS 9.

105 As a practical expedient, a lessee shall apply paragraph 42 to account for a lease modification required by interest rate benchmark reform. This practical expedient applies only to such modifications. For this purpose, a lease modification is required by interest rate benchmark reform if, and only if, both of these conditions are met:

(a) the modification is necessary as a direct consequence of interest rate benchmark reform; and

(b) the new basis for determining the lease payments is economically equivalent to the previous basis (ie the basis immediately preceding the modification).

106 However, if lease modifications are made in addition to those lease modifications required by interest rate benchmark reform, a lessee shall apply the applicable requirements in this Standard to account for all lease modifications made at the same time, including those required by interest rate benchmark reform.

Appendix A
Defined terms

This appendix is an integral part of the Standard.

commencement date of the lease (commencement date)	The date on which a **lessor** makes an **underlying asset** available for use by a **lessee**.
economic life	Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.
effective date of the modification	The date when both parties agree to a **lease modification**.
fair value	For the purpose of applying the **lessor** accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
finance lease	A **lease** that transfers substantially all the risks and rewards incidental to ownership of an **underlying asset**.
fixed payments	Payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term**, excluding **variable lease payments**.
gross investment in the lease	The sum of: (a) the **lease payments** receivable by a **lessor** under a **finance lease**; and (b) any **unguaranteed residual value** accruing to the lessor.
inception date of the lease (inception date)	The earlier of the date of a **lease** agreement and the date of commitment by the parties to the principal terms and conditions of the lease.
initial direct costs	Incremental costs of obtaining a **lease** that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer **lessor** in connection with a **finance lease**.
interest rate implicit in the lease	The rate of interest that causes the present value of (a) the **lease payments** and (b) the **unguaranteed residual value** to equal the sum of (i) the **fair value** of the **underlying asset** and (ii) any **initial direct costs** of the lessor.
lease	A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.
lease incentives	Payments made by a **lessor** to a **lessee** associated with a **lease**, or the reimbursement or assumption by a lessor of costs of a lessee.

lease modification A change in the scope of a **lease**, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more **underlying assets**, or extending or shortening the contractual **lease term**).

lease payments Payments made by a **lessee** to a **lessor** relating to the right to use an **underlying asset** during the **lease term**, comprising the following:

(a) **fixed payments** (including in-substance fixed payments), less any **lease incentives**;

(b) **variable lease payments** that depend on an index or a rate;

(c) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and

(d) payments of penalties for terminating the **lease**, if the lease term reflects the lessee exercising an option to terminate the lease.

For the lessee, lease payments also include amounts expected to be payable by the lessee under **residual value guarantees**. Lease payments do not include payments allocated to non-lease components of a contract, unless the lessee elects to combine non-lease components with a lease component and to account for them as a single lease component.

For the lessor, lease payments also include any residual value guarantees provided to the lessor by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee. Lease payments do not include payments allocated to non-lease components.

lease term The non-cancellable period for which a **lessee** has the right to use an **underlying asset**, together with both:

(a) periods covered by an option to extend the **lease** if the lessee is reasonably certain to exercise that option; and

(b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

lessee An entity that obtains the right to use an **underlying asset** for a period of time in exchange for consideration.

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

lessor An entity that provides the right to use an **underlying asset** for a period of time in exchange for consideration.

net investment in the lease The **gross investment in the lease** discounted at the **interest rate implicit in the lease**.

operating lease A **lease** that does not transfer substantially all the risks and rewards incidental to ownership of an **underlying asset**.

optional lease payments Payments to be made by a **lessee** to a **lessor** for the right to use an **underlying asset** during periods covered by an option to extend or terminate a **lease** that are not included in the **lease term**.

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

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

right-of-use asset An asset that represents a **lessee's** right to use an **underlying asset** for the **lease term**.

short-term lease A **lease** that, at the **commencement date**, has a **lease term** of 12 months or less. A lease that contains a purchase option is not a short-term lease.

sublease A transaction for which an **underlying asset** is re-leased by a **lessee** ('intermediate lessor') to a third party, and the **lease** ('head lease') between the head lessor and lessee remains in effect.

underlying asset An asset that is the subject of a **lease**, for which the right to use that asset has been provided by a **lessor** to a **lessee**.

unearned finance income The difference between:

(a) the **gross investment in the lease**; and

(b) the **net investment in the lease**.

unguaranteed residual value That portion of the residual value of the **underlying asset**, the realisation of which by a **lessor** is not assured or is guaranteed solely by a party related to the lessor.

variable lease payments The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time.

Terms defined in other Standards and used in this Standard with the same meaning

contract An agreement between two or more parties that creates enforceable rights and obligations.

useful life The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity.

Appendix B
Application guidance

This appendix is an integral part of the Standard. It describes the application of paragraphs 1–103 and has the same authority as the other parts of the Standard.

Portfolio application

B1 This Standard specifies the accounting for an individual lease. However, as a practical expedient, an entity may apply this Standard to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio would not differ materially from applying this Standard to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.

Combination of contracts

B2 In applying this Standard, an entity shall combine two or more contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty), and account for the contracts as a single contract if one or more of the following criteria are met:

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

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

(c) the rights to use underlying assets conveyed in the contracts (or some rights to use underlying assets conveyed in each of the contracts) form a single lease component as described in paragraph B32.

Recognition exemption: leases for which the underlying asset is of low value (paragraphs 5–8)

B3 Except as specified in paragraph B7, this Standard permits a lessee to apply paragraph 6 to account for leases for which the underlying asset is of low value. A lessee shall assess the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased.

B4 The assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets qualify for the accounting treatment in paragraph 6 regardless of whether those leases are material to the lessee. The assessment is not affected by the size, nature or circumstances of the lessee. Accordingly, different lessees are expected to reach the same conclusions about whether a particular underlying asset is of low value.

B5 An underlying asset can be of low value only if:

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

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

B6 A lease of an underlying asset does not qualify as a lease of a low-value asset if the nature of the asset is such that, when new, the asset is typically not of low value. For example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

B7 If a lessee subleases an asset, or expects to sublease an asset, the head lease does not qualify as a lease of a low-value asset.

B8 Examples of low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones.

Identifying a lease (paragraphs 9–11)

B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:

(a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and

(b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).

B10 If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

B11 A contract to receive goods or services may be entered into by a joint arrangement, or on behalf of a joint arrangement, as defined in HKFRS 11 *Joint Arrangements*. In this case, the joint arrangement is considered to be the customer in the contract. Accordingly, in assessing whether such a contract contains a lease, an entity shall assess whether the joint arrangement has the right to control the use of an identified asset throughout the period of use.

B12 An entity shall assess whether a contract contains a lease for each potential separate lease component. Refer to paragraph B32 for guidance on separate lease components.

Identified asset

B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

Substantive substitution rights

B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

(a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and

(b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

B15 If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

B16 An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur. Examples of future events that, at inception of the contract, would not be considered likely to occur and, thus, should be excluded from the evaluation include:

(a) an agreement by a future customer to pay an above market rate for use of the asset;

(b) the introduction of new technology that is not substantially developed at inception of the contract;

(c) a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; and

(d) 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.

B17 If the asset is located at the customer's premises or elsewhere, the costs associated with substitution are generally higher than when located at the supplier's premises and, therefore, are more likely to exceed the benefits associated with substituting the asset.

B18 The supplier's right or obligation to substitute the asset for repairs and maintenance, if the asset is not operating properly or if a technical upgrade becomes available does not preclude the customer from having the right to use an identified asset.

B19 If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer shall presume that any substitution right is not substantive.

Portions of assets

B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

Right to obtain economic benefits from use

B21 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

B22 When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer's right to use the asset (see paragraph B30). For example:

(a) if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory, and not beyond.

(b) if a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond.

B23 If a contract requires a customer to pay the supplier or another party a portion of the cash flows derived from use of an asset as consideration, those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset. For example, if the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, that requirement does not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the retail space. This is because the cash flows arising from those sales are considered to be economic benefits that the customer obtains from use of the retail space, a portion of which it then pays to the supplier as consideration for the right to use that space.

Right to direct the use

B24 A customer has the right to direct the use of an identified asset throughout the period of use only if either:

(a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or

(b) the relevant decisions about how and for what purpose the asset is used are predetermined and:

(i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or

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

How and for what purpose the asset is used

B25 A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision-making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.

B26 Examples of decision-making rights that, depending on the circumstances, grant the right to change how and for what purpose the asset is used, within the defined scope of the customer's right of use, include:

(a) rights to change the type of output that is produced by the asset (for example, to decide whether to use a shipping container to transport goods or for storage, or to decide upon the mix of products sold from retail space);

(b) rights to change when the output is produced (for example, to decide when an item of machinery or a power plant will be used);

(c) rights to change where the output is produced (for example, to decide upon the destination of a truck or a ship, or to decide where an item of equipment is used); and

(d) rights to change whether the output is produced, and the quantity of that output (for example, to decide whether to produce energy from a power plant and how much energy to produce from that power plant).

B27 Examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used include rights that are limited to operating or maintaining the asset. Such rights can be held by the customer or the supplier. Although rights such as those to operate or maintain an asset are often essential to the efficient use of an asset, they are not rights to direct how and for what purpose the asset is used and are often dependent on the decisions about how and for what purpose the asset is used. However, rights to operate an asset may grant the customer the right to direct the use of the asset if the relevant decisions about how and for what purpose the asset is used are predetermined (see paragraph B24(b)(i)).

Decisions determined during and before the period of use

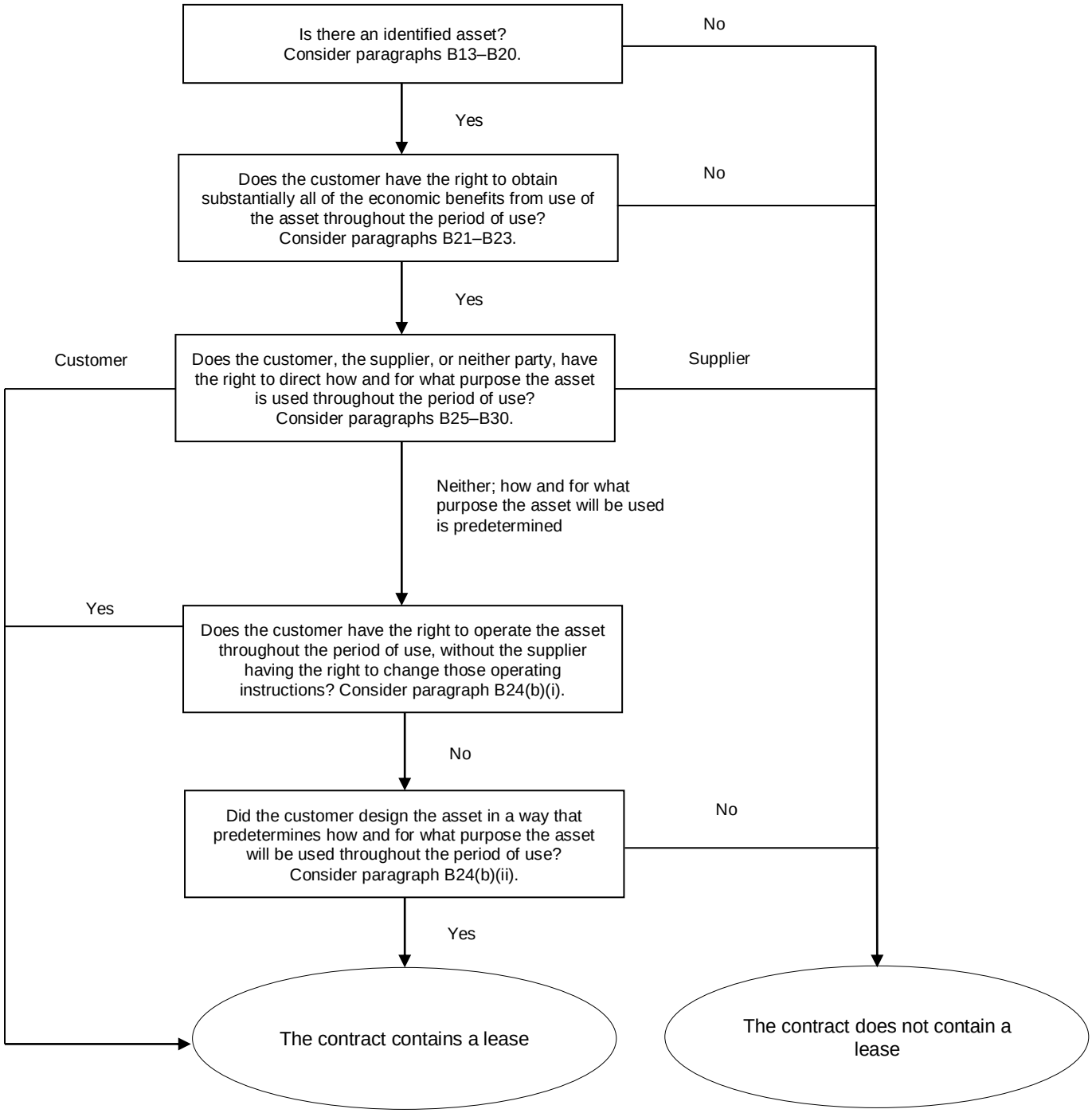
B28 The relevant decisions about how and for what purpose the asset is used can be predetermined in a number of ways. For example, the relevant decisions can be predetermined by the design of the asset or by contractual restrictions on the use of the asset.

B29 In assessing whether a customer has the right to direct the use of an asset, an entity shall consider only rights to make decisions about the use of the asset during the period of use, unless the customer designed the asset (or specific aspects of the asset) as described in paragraph B24(b)(ii). Consequently, unless the conditions in paragraph B24(b)(ii) exist, an entity shall not consider decisions that are predetermined before the period of use. For example, if a customer is able only to specify the output of an asset before the period of use, the customer does not have the right to direct the use of that asset. The ability to specify the output in a contract before the period of use, without any other decision-making rights relating to the use of the asset, gives a customer the same rights as any customer that purchases goods or services.

Protective rights

B30 A contract may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with laws or regulations. These are examples of protective rights. For example, a contract may (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset, (ii) require a customer to follow particular operating practices, or (iii) require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer's right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.

B31 The following flowchart may assist entities in making the assessment of whether a contract is, or contains, a lease.



Separating components of a contract (paragraphs 12–17)

B32 The right to use an underlying asset is a separate lease component if both:

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

(b) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the fact that a 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.

B33 A contract may include an amount payable by the lessee for activities and costs that do not transfer a good or service to the lessee. For example, a lessor may include in the total amount payable a charge for administrative tasks, or other costs it incurs associated with the lease, that do not transfer a good or service to the lessee. Such amounts payable do not give rise to a separate component of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract.

Lease term (paragraphs 18–21)

B34 In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. 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.

B35 If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

B36 The lease term begins at the commencement date and includes any rent-free periods provided to the lessee by the lessor.

B37 At the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease. The entity considers 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. Examples of factors to consider include, but are not limited to:

(a) contractual terms and conditions for the optional periods compared with market rates, such as:

(i) the amount of payments for the lease in any optional period;

(ii) the amount of any variable payments for the lease or other contingent payments, such as payments resulting from termination penalties and residual value guarantees; and

(iii) the terms and conditions of any options that are exercisable after initial optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates).

(b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;

(c) costs relating to the termination of the lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;

(d) the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialised asset, the location of the underlying asset and the availability of suitable alternatives; and

(e) conditionality associated with exercising the option (ie when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

B38 An option to extend or terminate a lease may be combined with one or more other contractual features (for example, a residual value guarantee) such that the lessee guarantees the lessor a minimum or fixed cash return that is substantially the same regardless of whether the option is exercised. In such cases, and notwithstanding the guidance on in-substance fixed payments in paragraph B42, an entity shall assume that the lessee is reasonably certain to exercise the option to extend the lease, or not to exercise the option to terminate the lease.

B39 The shorter the non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionately higher the shorter the non-cancellable period.

B40 A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option. For example, if a lessee has typically used particular types of assets for a particular period of time or if the lessee has a practice of frequently exercising options on leases of particular types of underlying assets, the lessee shall consider the economic reasons for that past practice in assessing whether it is reasonably certain to exercise an option on leases of those assets.

B41 Paragraph 20 specifies that, after the commencement date, a lessee reassesses the lease term upon the occurrence of a significant event or a significant change in circumstances that is within the control of the lessee and affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the lease term, or not to exercise an option previously included in its determination of the lease term. Examples of significant events or changes in circumstances include:

(a) significant leasehold improvements not anticipated at the commencement date that are expected to have significant economic benefit for the lessee when the option to extend or terminate the lease, or to purchase the underlying asset, becomes exercisable;

(b) a significant modification to, or customisation of, the underlying asset that was not anticipated at the commencement date;

(c) the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and

(d) 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-substance fixed lease payments (paragraphs 27(a), 36(c) and 70(a))

B42 Lease payments include any in-substance fixed lease payments. In-substance fixed lease payments are payments that may, in form, contain variability but that, in substance, are unavoidable. In-substance fixed lease payments exist, for example, if:

(a) payments are structured as variable lease payments, but there is no genuine variability in those payments. Those payments contain variable clauses that do not have real economic substance. Examples of those types of payments include:

(i) payments that must be made only if an asset is proven to be capable of operating during the lease, or only if an event occurs that has no genuine possibility of not occurring; or

(ii) payments that are initially structured as variable lease payments linked to the use of the underlying asset but for which the variability will be resolved at some point after the commencement date so that the payments become fixed for the remainder of the lease term. Those payments become in-substance fixed payments when the variability is resolved.

(b) there is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic. In this case, an entity shall consider the realistic set of payments to be lease payments.

(c) there is more than one realistic set of payments that a lessee could make, but it must make at least one of those sets of payments. In this case, an entity shall consider the set of payments that aggregates to the lowest amount (on a discounted basis) to be lease payments.

Lessee involvement with the underlying asset before the commencement date

Costs of the lessee relating to the construction or design of the underlying asset

B43 An entity may negotiate a lease before the underlying asset is available for use by the lessee. For some leases, the underlying asset may need to be constructed or redesigned for use by the lessee. Depending on the terms and conditions of the contract, a lessee may be required to make payments relating to the construction or design of the asset.

B44 If a lessee incurs costs relating to the construction or design of an underlying asset, the lessee shall account for those costs applying other applicable Standards, such as HKAS 16. Costs relating to the construction or design of an underlying asset do not include payments made by the lessee for the right to use the underlying asset. Payments for the right to use an underlying asset are payments for a lease, regardless of the timing of those payments.

Legal title to the underlying asset

B45 A lessee may obtain legal title to an underlying asset before that legal title is transferred to the lessor and the asset is leased to the lessee. Obtaining legal title does not in itself determine how to account for the transaction.

B46 If the lessee controls (or obtains control of) the underlying asset before that asset is transferred to the lessor, the transaction is a sale and leaseback transaction that is accounted for applying paragraphs 98–103.

B47 However, if the lessee does not obtain control of the underlying asset before the asset is transferred to the lessor, the transaction is not a sale and leaseback transaction. For example, this may be the case if a manufacturer, a lessor and a lessee negotiate a transaction for the purchase of an asset from the manufacturer by the lessor, which is in turn leased to the lessee. The lessee may obtain legal title to the underlying asset before legal title transfers to the lessor. In this case, if the lessee obtains legal title to the underlying asset but does not obtain control of the asset before it is transferred to the lessor, the transaction is not accounted for as a sale and leaseback transaction, but as a lease.

Lessee disclosures (paragraph 59)

B48 In determining whether additional information about leasing activities is necessary to meet the disclosure objective in paragraph 51, a lessee shall consider:

(a) whether that information is relevant to users of financial statements. A lessee shall provide additional information specified in paragraph 59 only if that information is expected to be relevant to users of financial statements. In this context, this is likely to be the case if it helps those users to understand:

(i) the flexibility provided by leases. Leases may provide flexibility if, for example, a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions.

(ii) restrictions imposed by leases. Leases may impose restrictions, for example, by requiring the lessee to maintain particular financial ratios.

(iii) sensitivity of reported information to key variables. Reported information may be sensitive to, for example, future variable lease payments.

(iv) exposure to other risks arising from leases.

(v) deviations from industry practice. Such deviations may include, for example, unusual or unique lease terms and conditions that affect a lessee's lease portfolio.

(b) whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.

B49 Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:

(a) the lessee's reasons for using variable lease payments and the prevalence of those payments;

(b) the relative magnitude of variable lease payments to fixed payments;

(c) key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and

(d) other operational and financial effects of variable lease payments.

B50 Additional information relating to extension options or termination options that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:

(a) the lessee's reasons for using extension options or termination options and the prevalence of those options;

(b) the relative magnitude of *optional lease payments* to lease payments;

(c) the prevalence of the exercise of options that were not included in the measurement of lease liabilities; and

(d) other operational and financial effects of those options.

B51 Additional information relating to residual value guarantees that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:

(a) the lessee's reasons for providing residual value guarantees and the prevalence of those guarantees;

(b) the magnitude of a lessee's exposure to residual value risk;

(c) the nature of underlying assets for which those guarantees are provided; and

(d) other operational and financial effects of those guarantees.

B52 Additional information relating to sale and leaseback transactions that, depending on the circumstances, may be needed to satisfy the disclosure objective in paragraph 51 could include information that helps users of financial statements to assess, for example:

(a) the lessee's reasons for sale and leaseback transactions and the prevalence of those transactions;

(b) key terms and conditions of individual sale and leaseback transactions;

(c) payments not included in the measurement of lease liabilities; and

(d) the cash flow effect of sale and leaseback transactions in the reporting period.

Lessor lease classification (paragraphs 61–66)

B53 The classification of leases for lessors in this Standard is based on the extent to which the lease transfers the risks and rewards incidental to ownership of an underlying asset. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions. 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.

B54 A lease contract may include terms and conditions to adjust the lease payments for particular changes that occur between the inception date and the commencement date (such as a change in the lessor's cost of the underlying asset or a change in the lessor's cost of financing the lease). In that case, for the purposes of classifying the lease, the effect of any such changes shall be deemed to have taken place at the inception date.

B55 When a lease includes both land and buildings elements, a lessor shall assess the classification of each element as a finance lease or an operating lease separately applying paragraphs 62–66 and B53–B54. In determining whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life.

B56 Whenever necessary in order to classify and account for a lease of land and buildings, a lessor shall allocate lease payments (including any lump-sum upfront payments) between the land and the buildings elements 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. If the lease payments cannot be allocated reliably between these two elements, the entire lease is classified as a finance lease, unless it is clear that both elements are operating leases, in which case the entire lease is classified as an operating lease.

B57 For a lease of land and buildings in which the amount for the land element is immaterial to the lease, a lessor may treat the land and buildings as a single unit for the purpose of lease classification and classify it as a finance lease or an operating lease applying paragraphs 62–66 and B53–B54. In such a case, a lessor shall regard the economic life of the buildings as the economic life of the entire underlying asset.

Sublease classification

B58 In classifying a sublease, an intermediate lessor shall classify the sublease as a finance lease or an operating lease as follows:

(a) if the head lease is a short-term lease that the entity, as a lessee, has accounted for applying paragraph 6, the sublease shall be classified as an operating lease.

(b) otherwise, the sublease shall be classified by reference to the right-of-use asset arising from the head lease, rather than by reference to the underlying asset (for example, the item of property, plant or equipment that is the subject of the lease).

Appendix C
Effective date and transition

This appendix is an integral part of the Standard and has the same authority as the other parts of the Standard.

Effective date

C1 An entity shall apply this Standard for annual reporting periods beginning on or after 1 January 2019. Earlier application is permitted for entities that apply HKFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of this Standard. If an entity applies this Standard earlier, it shall disclose that fact.

C1A *Covid-19-Related Rent Concessions*, issued in June 2020, added paragraphs 46A, 46B, 60A, C20A and C20B. A lessee shall apply that amendment for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements not authorised for issue at 4 June 2020.

C1B *Interest Rate Benchmark Reform—Phase 2*, which amended HKFRS 9, HKAS 39, HKFRS 7, HKFRS 4 and HKFRS 16, issued in October 2020, added paragraphs 104–106 and C20C–C20D. An entity shall apply these amendments for annual reporting periods beginning on or after 1 January 2021. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

C1C *Covid-19-Related Rent Concessions beyond 30 June 2021*, issued in April 2021, amended paragraph 46B and added paragraphs C20BA–C20BC. A lessee shall apply that amendment for annual reporting periods beginning on or after 1 April 2021. Earlier application is permitted, including in financial statements not authorised for issue at 9 April 2021.

Transition

C2 For the purposes of the requirements in paragraphs C1–C19, the date of initial application is the beginning of the annual reporting period in which an entity first applies this Standard.

Definition of a lease

C3 As a practical expedient, an entity is not required to reassess whether a contract is, or contains, a lease at the date of initial application. Instead, the entity is permitted:

(a) to apply this Standard to contracts that were previously identified as leases applying HKAS 17 *Leases* and HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*. The entity shall apply the transition requirements in paragraphs C5–C18 to those leases.

(b) not to apply this Standard to contracts that were not previously identified as containing a lease applying HKAS 17 and HK(IFRIC)-Int 4.

C4 If an entity chooses the practical expedient in paragraph C3, it shall disclose that fact and apply the practical expedient to all of its contracts. As a result, the entity shall apply the requirements in paragraphs 9–11 only to contracts entered into (or changed) on or after the date of initial application.

Lessees

C5 A lessee shall apply this Standard to its leases either:

(a) retrospectively to each prior reporting period presented applying HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or

(b) retrospectively with the cumulative effect of initially applying the Standard recognised at the date of initial application in accordance with paragraphs C7–C13.

C6 A lessee shall apply the election described in paragraph C5 consistently to all of its leases in which it is a lessee.

C7 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall not restate comparative information. Instead, the lessee shall recognise the cumulative effect of initially applying this Standard as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the date of initial application.

Leases previously classified as operating leases

C8 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall:

(a) recognise a lease liability at the date of initial application for leases previously classified as an operating lease applying HKAS 17. The lessee shall measure that lease liability at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate at the date of initial application.

(b) recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying HKAS 17. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either:

(i) its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.

(c) apply HKAS 36 *Impairment of Assets* to right-of-use assets at the date of initial application, unless the lessee applies the practical expedient in paragraph C10(b).

C9 Notwithstanding the requirements in paragraph C8, for leases previously classified as operating leases applying HKAS 17, a lessee:

(a) is not required to make any adjustments on transition for leases for which the underlying asset is of low value (as described in paragraphs B3–B8) that will be accounted for applying paragraph 6. The lessee shall account for those leases applying this Standard from the date of initial application.

(b) is not required to make any adjustments on transition for leases previously accounted for as investment property using the fair value model in HKAS 40 *Investment Property*. The lessee shall account for the right-of-use asset and the lease liability arising from those leases applying HKAS 40 and this Standard from the date of initial application.

(c) shall measure the right-of-use asset at fair value at the date of initial application for leases previously accounted for as operating leases applying HKAS 17 and that will

be accounted for as investment property using the fair value model in HKAS 40 from the date of initial application. The lessee shall account for the right-of-use asset and the lease liability arising from those leases applying HKAS 40 and this Standard from the date of initial application.

C10 A lessee may use one or more of the following practical expedients when applying this Standard retrospectively in accordance with paragraph C5(b) to leases previously classified as operating leases applying HKAS 17. A lessee is permitted to apply these practical expedients on a lease-by-lease basis:

(a) a lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

(b) a lessee may rely on its assessment of whether leases are onerous applying HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* immediately before the date of initial application as an alternative to performing an impairment review. If a lessee chooses this practical expedient, the lessee shall adjust the right-of-use asset at the date of initial application by the amount of any provision for onerous leases recognised in the statement of financial position immediately before the date of initial application.

(c) a lessee may elect not to apply the requirements in paragraph C8 to leases for which the lease term ends within 12 months of the date of initial application. In this case, a lessee shall:

(i) account for those leases in the same way as short-term leases as described in paragraph 6; and

(ii) include the cost associated with those leases within the disclosure of short-term lease expense in the annual reporting period that includes the date of initial application.

(d) a lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.

(e) a lessee may use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

Leases previously classified as finance leases

C11 If a lessee elects to apply this Standard in accordance with paragraph C5(b), for leases that were classified as finance leases applying HKAS 17, the carrying amount of the right-of-use asset and the lease liability at the date of initial application shall be the carrying amount of the lease asset and lease liability immediately before that date measured applying HKAS 17. For those leases, a lessee shall account for the right-of-use asset and the lease liability applying this Standard from the date of initial application.

Disclosure

C12 If a lessee elects to apply this Standard in accordance with paragraph C5(b), the lessee shall disclose information about initial application required by paragraph 28 of HKAS 8, except for the information specified in paragraph 28(f) of HKAS 8. Instead of the information specified in paragraph 28(f) of HKAS 8, the lessee shall disclose:

(a) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognised in the statement of financial position at the date of initial application; and

(b) an explanation of any difference between:

(i) operating lease commitments disclosed applying HKAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application as described in paragraph C8(a); and

(ii) lease liabilities recognised in the statement of financial position at the date of initial application.

C13 If a lessee uses one or more of the specified practical expedients in paragraph C10, it shall disclose that fact.

Lessors

C14 Except as described in paragraph C15, a lessor is not required to make any adjustments on transition for leases in which it is a lessor and shall account for those leases applying this Standard from the date of initial application.

C15 An intermediate lessor shall:

(a) reassess subleases that were classified as operating leases applying HKAS 17 and are ongoing at the date of initial application, to determine whether each sublease should be classified as an operating lease or a finance lease applying this Standard. The intermediate lessor shall perform this assessment at the date of initial application on the basis of the remaining contractual terms and conditions of the head lease and sublease at that date.

(b) for subleases that were classified as operating leases applying HKAS 17 but finance leases applying this Standard, account for the sublease as a new finance lease entered into at the date of initial application.

Sale and leaseback transactions before the date of initial application

C16 An entity shall not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in HKFRS 15 to be accounted for as a sale.

C17 If a sale and leaseback transaction was accounted for as a sale and a finance lease applying HKAS 17, the seller-lessee shall:

(a) account for the leaseback in the same way as it accounts for any other finance lease that exists at the date of initial application; and

(b) continue to amortise any gain on sale over the lease term.

C18 If a sale and leaseback transaction was accounted for as a sale and operating lease applying HKAS 17, the seller-lessee shall:

(a) account for the leaseback in the same way as it accounts for any other operating lease that exists at the date of initial application; and

(b) adjust the leaseback right-of-use asset for any deferred gains or losses that relate to off-market terms recognised in the statement of financial position immediately before the date of initial application.

Amounts previously recognised in respect of business combinations

C19 If a lessee previously recognised an asset or a liability applying HKFRS 3 *Business Combinations* relating to favourable or unfavourable terms of an operating lease acquired as part of a business combination, the lessee shall derecognise that asset or liability and adjust the carrying amount of the right-of-use asset by a corresponding amount at the date of initial application.

References to HKFRS 9

C20 If an entity applies this Standard but does not yet apply HKFRS 9 *Financial Instruments*, any reference in this Standard to HKFRS 9 shall be read as a reference to HKAS 39 *Financial Instruments: Recognition and Measurement*.

Covid-19-related rent concessions for lessees

C20A A lessee shall apply *Covid-19-Related Rent Concessions* (see paragraph C1A) retrospectively, recognising the cumulative effect of initially applying that amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of the annual reporting period in which the lessee first applies the amendment.

C20B In the reporting period in which a lessee first applies *Covid-19-Related Rent Concessions*, a lessee is not required to disclose the information required by paragraph 28(f) of HKAS 8.

C20BA A lessee shall apply *Covid-19-Related Rent Concessions beyond 30 June 2021* (see paragraph C1C) retrospectively, recognising the cumulative effect of initially applying that amendment as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of the annual reporting period in which the lessee first applies the amendment.

C20BB In the reporting period in which a lessee first applies *Covid-19-Related Rent Concessions beyond 30 June 2021*, a lessee is not required to disclose the information required by paragraph 28(f) of HKAS 8.

C20BC Applying paragraph 2 of this Standard, a lessee shall apply the practical expedient in paragraph 46A consistently to eligible contracts with similar characteristics and in similar circumstances, irrespective of whether the contract became eligible for the practical expedient as a result of the lessee applying *Covid-19-Related Rent Concessions* (see paragraph C1A) or *Covid-19-Related Rent Concessions beyond 30 June 2021* (see paragraph C1C).

Interest Rate Benchmark Reform—Phase 2

C20C An entity shall apply these amendments retrospectively in accordance with HKAS 8, except as specified in paragraph C20D.

C20D An entity is not required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

Withdrawal of other Standards

C21 This Standard supersedes the following Standards and Interpretations:

(a) HKAS 17 *Leases*;

(b) HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*;

(c) HK(SIC)-Int 15 *Operating Leases—Incentives*; and

(d) HK(SIC)-Int 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*.

Appendix D
Amendments to other Standards

This appendix sets out the amendments to other Standards that are a consequence of the issuance of HKFRS 16. An entity shall apply the amendments for annual periods beginning on or after 1 January 2019. If an entity applies this Standard for an earlier period, it shall also apply these amendments for that earlier period.

An entity is not permitted to apply HKFRS 16 before applying HKFRS 15 Revenue from Contracts with Customers *(see paragraph C1).*

Consequently, for Standards that were effective on 1 January 2016, the amendments in this appendix are presented based on the text of those Standards that was effective on 1 January 2016, as amended by HKFRS 15. The text of those Standards in this appendix does not include any other amendments that were not effective at 1 January 2016.

For Standards that were not effective on 1 January 2016, the amendments in this appendix are presented based on the text of the initial publication of that Standard, as amended by HKFRS 15. The text of those Standards in this appendix does not include any other amendments that were not effective at 1 January 2016.

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The amendments contained in this appendix when this HKFRS was issued in 2016 have been incorporated into the relevant Standards.

HKFRS 16 BC

Revised ~~December 2021~~September 2022

Basis for Conclusions on
Hong Kong Financial Reporting Standard 16

Leases

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Basis for Conclusions on IFRS 16 *Leases*

HKFRS 16 is based on IFRS 16 *Leases*. In approving HKFRS 16, the Financial Reporting Standards Committee of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 16. Accordingly, there are no significant differences between HKFRS 16 and IFRS 16. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 16 referred to below generally correspond with those in HKFRS 16.

CONTENTS

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Basis for Conclusions on IFRS 16 *Leases*

This Basis for Conclusions accompanies, but is not part of, IFRS 16.

Introduction

BC1 This Basis for Conclusions summarises the IASB's considerations in developing IFRS 16 *Leases*. It includes the reasons for accepting particular views and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2 IFRS 16 is also accompanied by an Effects Analysis. The Effects Analysis describes the likely costs and benefits of IFRS 16, which the IASB has prepared based on insight gained through the exposure of proposals and feedback on these proposals, and through the IASB's analysis and consultation with stakeholders.

Overview

Why the need to change previous accounting?

BC3 The previous accounting model for leases required lessees and lessors to classify their leases as either finance leases or operating leases and to account for those two types of leases differently. It did not require lessees to recognise assets and liabilities arising from operating leases, but it did require lessees to recognise assets and liabilities arising from finance leases. The IASB, together with the US national standard-setter, the Financial Accounting Standards Board (FASB) (together 'the Boards'), initiated a joint project to improve the financial reporting of leasing activities under IFRS and US Generally Accepted Accounting Principles (US GAAP) in the light of criticisms that the previous accounting model for leases failed to meet the needs of users of financial statements. In particular:

(a) information reported about operating leases lacked transparency and did not meet the needs of users of financial statements. Many users adjusted a lessee's financial statements to capitalise operating leases because, in their view, the financing and assets provided by leases should be reflected on the statement of financial position ('balance sheet'). Some tried to estimate the present value of future lease payments. However, because of the limited information that was available, many used techniques such as multiplying the annual lease expense by eight to estimate, for example, total leverage and the capital employed in operations. Other users were unable to make adjustments—they relied on data sources such as data aggregators when screening potential investments or making investment decisions. These different approaches created information asymmetry in the market.

(b) the existence of two different accounting models for leases, in which assets and liabilities associated with leases were not recognised for operating leases but were recognised for finance leases, meant that transactions that were economically similar could be accounted for very differently. The differences reduced comparability for users of financial statements and provided opportunities to structure transactions to achieve a particular accounting outcome.

(c) the previous requirements for lessors did not provide adequate information about a lessor's exposure to credit risk (arising from a lease) and exposure to asset risk (arising from the lessor's retained interest in the underlying asset), particularly for leases of equipment and vehicles that were classified as operating leases.

BC4 The Boards decided to address the first two criticisms by developing a new approach to lessee accounting that requires a lessee to recognise assets and liabilities for the rights and obligations created by leases. IFRS 16 requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months and for which the underlying asset is not of low

value. The IASB concluded that such an approach will result in a more faithful representation of a lessee's assets and liabilities and, together with enhanced disclosures, greater transparency of a lessee's financial leverage and capital employed. To address the third criticism, IFRS 16 requires enhanced disclosure by lessors of information about their risk exposure.

Background

BC5 In March 2009 the Boards published a joint Discussion Paper *Leases: Preliminary Views*. The Discussion Paper set out the Boards' preliminary views on lessee accounting, proposing a 'right-of-use' accounting model. Feedback on the Discussion Paper generally supported the 'right-of-use' model for lessees, by which a lessee would recognise a right-of-use asset and a lease liability at the commencement date of the lease. The Discussion Paper did not discuss lessor accounting in any detail.

BC6 In August 2010 the Boards published a joint Exposure Draft *Leases* (the '2010 Exposure Draft'). The Boards developed the 2010 Exposure Draft after considering the comment letters received on the Discussion Paper, as well as input obtained from their Lease Accounting Working Group and from others who were interested in the financial reporting of leases. The 2010 Exposure Draft:

(a) further developed the 'right-of-use' accounting model for lessees that had been proposed in the Discussion Paper, and that respondents had generally supported.

(b) added proposals for changes to lessor accounting. The Boards decided to include lessor accounting in the proposals in response to comments from respondents to the Discussion Paper. Some respondents had recommended that the Boards develop accounting models for lessees and lessors on the basis of a consistent rationale. The Boards also saw merit in developing lessor accounting proposals at the same time as they were developing proposals for recognising revenue (which the IASB subsequently finalised in IFRS 15 *Revenue from Contracts with Customers*).

BC7 For lessors, the 2010 Exposure Draft proposed a dual accounting model:

(a) for some leases, a lessor would apply a 'performance obligation' approach. Applying this approach, a lessor would recognise a lease receivable and a liability at the commencement date, and would also continue to recognise the underlying asset.

(b) for other leases, a lessor would apply a 'derecognition' approach. Applying this approach, a lessor would derecognise the underlying asset, and recognise a lease receivable and any retained interest in the underlying asset (a 'residual asset') at the commencement date.

BC8 The 2010 Exposure Draft also included detailed proposals on the measurement of the lessee's lease liability and the lessor's lease receivable. Of particular note was its proposal that in estimating the lease payments, a lessee should:

(a) assume the longest possible term that was more likely than not to occur, taking into account any options to extend or terminate the lease; and

(b) include an estimate of variable lease payments, if those payments could be measured reliably.

BC9 The Boards received 786 comment letters in response to the 2010 Exposure Draft. The Boards also conducted extensive outreach on the proposals in the 2010 Exposure Draft. Round table discussions were held in Hong Kong, the United Kingdom and the United States. Workshops were organised in Australia, Brazil, Canada, Japan, South Korea, the UK and the US. Members of the Boards also participated in conferences, working group meetings, discussion forums, and one-to-one discussions that were held across all major geographical

regions. In 2011 and 2012, while redeliberating the proposals in the 2010 Exposure Draft, the Boards conducted additional targeted outreach with more than 100 organisations. The purpose of the targeted outreach was to obtain additional feedback to assist the Boards in developing particular aspects of the revised proposals. The targeted outreach meetings involved international working group members, representatives from accounting firms, local standard-setters, users and preparers of financial statements, particularly those from industries most affected by the lease accounting proposals.

BC10 Responses to the 2010 Exposure Draft indicated that:

(a) there was general support for lessees recognising assets and liabilities arising from a lease. That support was consistent with comments received on the Discussion Paper.

(b) there were mixed views on the effects of the proposed right-of-use model on a lessee's profit or loss. The effect was that a lessee would recognise two separate expenses in its statement of profit or loss and other comprehensive income ('income statement')—depreciation of the right-of-use asset and interest on the lease liability. Some respondents supported the identification of two separate expenses, on the grounds that leases are a source of finance for a lessee and should be accounted for accordingly. However, others did not support these effects because they thought that they would not properly reflect the economics of all lease transactions. In particular, some respondents referred to shorter-term property leases as examples of leases that, in their view, were not financing transactions from either the lessee's or lessor's perspective.

(c) many respondents disagreed with the proposals for lessor accounting:

(i) some respondents were concerned that the dual accounting model proposed for lessors was not consistent with the single accounting model proposed for lessees.

(ii) many respondents opposed the performance obligation approach. In the view of those respondents, the approach would artificially inflate a lessor's assets and liabilities.

(iii) some respondents recommended applying the derecognition approach to all leases. However, many disagreed with the proposal to prevent a lessor from accounting for the effects of the time value of money on the residual asset.

(iv) some respondents thought that the lessor accounting requirements in IAS 17 *Leases* and FASB Topic 840 *Leases* work well in practice and supported retaining those requirements.

(d) almost all respondents were concerned about the cost and complexity of the proposals, in particular the proposals regarding the measurement of the lessee's lease liability and the lessor's lease receivable. Some questioned whether lease payments to be made during optional extension periods would meet the definition of an asset (for the lessor) or a liability (for the lessee). Others suggested that it would be extremely difficult in many cases to estimate variable lease payments if the amounts depended on future sales or use of the underlying asset and that such estimates would be subject to a high level of measurement uncertainty. Many expressed a view that, because of the amount of judgement involved, the cost of including variable lease payments and payments to be made during optional periods in the measurement of lease assets and lease liabilities would outweigh the benefit for users of financial statements.

(e) many respondents also were concerned about the breadth of the scope of the proposals, indicating that the proposed definition of a lease had the potential to capture some contracts that they considered to be for services.

BC11 The Boards considered the feedback received on the 2010 Exposure Draft and observed that it would not be possible to reflect the views of all stakeholders because stakeholders did not have a united view of the economics of leases. However, in response to views that the economics of leases can be different the Boards decided to develop a revised model that identified two classes of leases and specified different requirements for each type. The classification depended on the extent to which the lessee was expected to consume the economic benefits embedded in the underlying asset.

BC12 Consequently, in May 2013 the Boards published a second joint Exposure Draft *Leases* (the '2013 Exposure Draft'). The 2013 Exposure Draft proposed:

(a) for lessees, simpler measurement requirements and a dual approach for the recognition and measurement of expenses related to a lease:

(i) for leases for which the lessee was expected to consume more than an insignificant amount of the economic benefits embedded in the underlying asset, a lessee would apply an approach similar to that proposed in the 2010 Exposure Draft, ie recognise depreciation of the right-of-use asset and interest on the lease liability separately in the income statement.

(ii) for leases for which the lessee was expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset, a lessee would recognise a single lease expense in the income statement. This approach was based on the view that a single lease expense would provide better information about leases for which the lessee in essence is paying mainly for the use of the underlying asset and is expected to consume only an insignificant amount of the economic benefits embedded in the underlying asset itself.

(b) for lessors, a dual approach for the recognition and measurement of lease assets:

(i) for leases for which the lessee was expected to consume more than an insignificant portion of the economic benefits embedded in the underlying asset, a lessor would recognise its residual interest in the underlying asset separately from its receivable from the lessee.

(ii) for other leases, a lessor would recognise the underlying asset, ie apply requirements similar to those in IAS 17 for operating leases.

BC13 The Boards received 641 comment letters in response to the 2013 Exposure Draft. In addition, the Boards conducted extensive outreach on the proposals in the 2013 Exposure Draft, including:

(a) consultations with over 270 users of financial statements based in Australia, Belgium, Canada, France, Hong Kong, Japan, the Netherlands, New Zealand, Sweden, Switzerland, the UK and the US;

(b) fieldwork meetings with individual preparers of financial statements from various industries including consumer goods, retail, aviation, oil and gas, telecommunications and automotive industries. These meetings were held in Brazil, France, Germany, Japan, Spain, the UK and the US and included detailed discussions about the costs of implementation for those entities.

(c) round table discussion held in London, Los Angeles, Norwalk, São Paulo and Singapore. These discussions were attended by approximately 100 stakeholder representatives.

(d) meetings with the IASB's advisory bodies—the Capital Markets Advisory Committee, the Global Preparers Forum, the IFRS Advisory Council and the Accounting Standards Advisory Forum.

(e) outreach meetings with various other individual preparers and groups of preparers, standard-setters and regulators. These meetings included presentations during accounting conferences and at industry forums, and meetings with individual organisations or groups.

(f) project webcasts that attracted over 2,000 participants.

BC14 The feedback received on the proposals in the 2013 Exposure Draft indicated that:

(a) consistently with the views they had expressed on the 2010 Exposure Draft, many stakeholders supported the recognition of a right-of-use asset and a lease liability by a lessee for all leases of more than 12 months in duration. These stakeholders included the majority of users of financial statements consulted, who were of the view that the proposed recognition of assets and liabilities by a lessee would provide them with a better starting point for their analyses.

(b) nonetheless, many stakeholders had significant concerns about the proposed lessee accounting model. Some were of the view that the previous lessee accounting model in IAS 17 did not need to be changed, or that deficiencies in that model could be rectified by improving the disclosure requirements, instead of changing the recognition and measurement requirements. Others disagreed with one or more specific aspects of the proposed lessee accounting model, such as the proposed dual approach or the proposal to periodically reassess the measurement of lease assets and lease liabilities.

(c) many stakeholders thought that the measurement proposals in the 2013 Exposure Draft represented a significant improvement over the proposals in the 2010 Exposure Draft, especially relating to simplifications in respect of variable lease payments and payments under renewal and purchase options. Nonetheless, the majority of stakeholders still had concerns about the cost and complexity of the proposals in the 2013 Exposure Draft. Specific areas of the proposals that stakeholders highlighted as being particularly costly or complex included the dual lessee and lessor accounting models (both the lease classification proposals and the accounting requirements), the reassessment proposals, the disclosure proposals and the scope of the transactions subject to the proposals.

(d) the majority of stakeholders disagreed with the proposed lessor accounting model. Most of these stakeholders were of the view that the previous lessor accounting model in IAS 17 was not fundamentally flawed and should not be changed.

BC15 The Boards considered the feedback they had received in response to the different models proposed in the 2010 and 2013 Exposure Drafts. The Boards confirmed their previous decision that a lessee should be required to recognise right-of-use assets and lease liabilities for all leases (with limited exceptions). However, the Boards reached different decisions with respect to the expense recognition model. For the reasons described in paragraphs BC41–BC56, the IASB decided to adopt a single lessee accounting model in which a lessee would account for all leases as providing finance. In the light of all of the feedback received, the IASB is of the view that this model provides the most useful information to the broadest range of users of financial statements. The IASB thinks that the model also addresses many of the concerns raised by stakeholders about cost and complexity, and the concerns raised about the conceptual basis of the dual model proposed in the 2013 Exposure Draft (see paragraph BC45). In contrast, the FASB decided to adopt a dual lessee expense recognition model, classifying leases in a similar manner to the previous US GAAP requirements for distinguishing between operating leases and capital leases. In making these decisions, the Boards observed that, for lessees with a portfolio of leases starting and ending at different times, any difference in reported profit or loss between IFRS and US GAAP is not expected to be significant for many lessees.

BC16 There are a number of other differences between IFRS 16 and the decisions made by the FASB, mainly because of the different decisions reached on the lessee accounting model. This Basis for Conclusions summarises only the reasons for decisions made by the IASB and reflected in IFRS 16. Paragraphs BC303–BC310 summarise the differences between IFRS 16 and the decisions made by the FASB.

BC17 In response to feedback received, the IASB and the FASB also decided to substantially carry forward the lessor accounting requirements in IAS 17 and Topic 840 respectively.

BC18 IFRS 16 addresses many of the concerns raised by stakeholders about the cost and complexity of the proposals in the 2010 and 2013 Exposure Drafts. In addition to the single lessee accounting model, which removes the need for lessees to classify leases, and the decision to substantially carry forward the lessor accounting requirements in IAS 17, the IASB decided to:

(a) permit a lessee not to recognise assets and liabilities for short-term leases and leases of low-value assets;

(b) confirm that an entity may apply the Standard at a portfolio level for leases with similar characteristics;

(c) further simplify the measurement requirements for lease liabilities, in particular the requirements for variable lease payments, payments during optional periods and the reassessment of lease liabilities;

(d) simplify the requirements for separating lease and non-lease components of a contract;

(e) change the lessee disclosure requirements to enable lessees to more effectively focus disclosures on the most significant features of their lease portfolios; and

(f) simplify the lessee transition requirements.

The approach to lease accounting

BC19 All contracts create rights and obligations for the parties to the contract. Lessee accounting in IFRS 16 considers the rights and obligations created by a lease from the perspective of the lessee. As discussed further in paragraphs BC105–BC126, a lease is defined as a ‘contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration’. The lessee accounting model in IFRS 16 reflects the economics of a lease because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee.

BC20 A lessee has the right to use an underlying asset during the lease term and an obligation to make payments to the lessor for providing the right to use that asset. The lessee also has an obligation to return the underlying asset in a specified condition to the lessor at the end of the lease term. The lessor has a right to receive payments from the lessee for providing the right to use the underlying asset. The lessor also retains rights associated with ownership of the underlying asset.

BC21 Having identified the rights and obligations that arise from a lease, the IASB considered which of those rights and obligations create assets and liabilities for the lessee and lessor.

Rights and obligations arising from a lease that create assets and liabilities for the lessee

Right to use an underlying asset

BC22 The IASB's *Conceptual Framework for Financial Reporting* (*Conceptual Framework*)[1] defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. The IASB concluded that a lessee's right to use an underlying asset meets the definition of an asset for the following reasons:

(a) the lessee controls the right to use the underlying asset throughout the lease term. Once the asset is made available for use by the lessee, the lessor is unable to retrieve or otherwise use the underlying asset for its own purposes during the lease term, despite being the legal owner of the underlying asset.

(b) the lessee has the ability to determine how to use the underlying asset and, thus, how it generates future economic benefits from that right of use. This ability demonstrates the lessee's control of the right of use. For example, suppose a lessee leases a truck for four years, for up to a maximum of 160,000 miles over the lease term. Embedded in the right to use the truck is a particular volume of economic benefits or service potential that is used up over the period that the truck is driven by the lessee. After the truck is made available for use by the lessee, the lessee can decide how it wishes to use up or consume the economic benefits embedded in its right of use within the parameters defined in the contract. The lessee could decide to drive the truck constantly during the first three years of the lease, consuming all of the economic benefits in those first three years. Alternatively, it could use the truck only during particular months in each year or decide to use it evenly over the four-year lease term.

(c) the right to control and use the asset exists even when a lessee's right to use an asset includes some restrictions on its use. Although restrictions may affect the value and scope of a lessee's right to use an asset (and thus the payments made for the right of use), they do not affect the existence of the right-of-use asset. It is not unusual for restrictions to be placed on the use of owned assets as well as leased assets. For example, assets acquired from a competitor may be subject to restrictions on where they can be used, how they can be used or to whom they can be sold; assets that are used as security for particular borrowings may have restrictions placed on their use by the lender; or a government may place restrictions on the use or transfer of assets in a particular region for environmental or security reasons. Those restrictions do not necessarily result in the owner of such assets failing to control those assets—the restrictions may simply affect the economic benefits that will flow to the entity from the asset and that will be reflected in the price that the entity is willing to pay for the asset. Similarly, such restrictions do not prevent a lessee from controlling a right-of-use asset.

(d) the lessee's control of the right of use arises from past events—not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee for the duration of the non-cancellable period of the lease. Some have noted that the lessee's right to use an asset is conditional on the lessee making payments during the lease term, ie that the lessee may forfeit its right to use the asset if it does not make payments. However, unless the lessee breaches the contract, the lessee has an unconditional right to use the underlying asset. Its position is similar to that of an entity that had made an instalment purchase and has not yet made the instalment payments.

BC23 The IASB also considered the proposed definition of an asset in the May 2015 Exposure Draft *The Conceptual Framework for Financial Reporting* (the '*Conceptual Framework* Exposure Draft'). That exposure draft proposes to define an asset as 'a present economic resource controlled by the entity as a result of past events' and defines an economic resource as 'a right that has the potential to produce economic benefits'. In the IASB's view, a lessee's right

[1] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

to use an underlying asset would meet this proposed definition of an asset, for the reasons described in paragraph BC22.

BC24 Consequently, the IASB concluded that the lessee's right to use an underlying asset meets both the existing and proposed definitions of an asset.

Obligation to make lease payments

BC25 The *Conceptual Framework* defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. The IASB concluded that the lessee's obligation to make lease payments meets the definition of a liability for the following reasons:

(a) the lessee has a present obligation to make lease payments once the underlying asset has been made available to the lessee. That obligation arises from past events—not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee. Unless the lessee renegotiates the lease, the lessee has no right to cancel the lease and avoid the contractual lease payments (or termination penalties) before the end of the lease term.

(b) the obligation results in a future outflow of economic benefits from the lessee—typically contractual cash payments in accordance with the terms and conditions of the lease.

BC26 The IASB also considered the *Conceptual Framework* Exposure Draft, which proposes to define a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events'. In the IASB's view, a lessee's obligation to make lease payments would also meet this definition of a liability for the reasons described in paragraph BC25.

BC27 Consequently, the IASB concluded that a lessee's obligation to make lease payments meets both the existing and proposed definitions of a liability.

Obligation to return the underlying asset to the lessor

BC28 The lessee controls the use of the underlying asset during the lease term, and has an obligation to return the underlying asset to the lessor at the end of the lease term. That obligation is a present obligation that arises from past events (the underlying asset being made available for use by the lessee under the terms of the lease contract).

BC29 Some are of the view that there is an outflow of economic benefits at the end of the lease term because the lessee must surrender the underlying asset, which will frequently still have some potential to generate economic benefits. However, in the IASB's view, there is no outflow of economic benefits (other than incidental costs) from the lessee when it returns the leased item, because the lessee does not control the economic benefits associated with the asset that it returns to the lessor. Even if the lessee has physical possession of the underlying asset, it has no right to obtain the remaining economic benefits associated with the underlying asset once the lease term expires (ignoring any options to extend the lease or purchase the underlying asset). Once it reaches the end of the lease term, the position of the lessee is like that of an asset custodian. The lessee is holding an asset on behalf of a third party, the lessor, but has no right to the economic benefits embodied in that asset at the end of the lease term.

BC30 Consequently, the IASB concluded that the lessee's obligation to return the underlying asset does not meet the definition of a liability in the *Conceptual Framework*. The IASB is of the view that the changes proposed to the definition of a liability in the *Conceptual Framework* Exposure Draft would not affect this conclusion.

BC31 Having considered whether the lessee's right to use an underlying asset, obligation to make lease payments and obligation to return the underlying asset meet the definition of an asset or a liability, the IASB considered the lessee accounting model. This is discussed in paragraphs BC41–BC56.

Why leases are different from service contracts for the lessee

BC32 The IASB concluded that leases create rights and obligations that are different from those that arise from service contracts. This is because, as described in paragraph BC22, the lessee obtains and controls the right-of-use asset at the time that the underlying asset is made available for use by the lessee.

BC33 When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee now controls that right of use. Consequently, the lessee has an unconditional obligation to pay for that right of use.

BC34 In contrast, in a typical service contract, the customer does not obtain an asset that it controls at commencement of the contract. Instead, the customer obtains the service only at the time that the service is performed. Consequently, the customer typically has an unconditional obligation to pay only for the services provided to date. In addition, although fulfilment of a service contract will often require the use of assets, fulfilment typically does not require making those assets available for use by the customer throughout the contractual term.

Rights and obligations arising from a lease that create assets and liabilities for the lessor

Lease receivable

BC35 When the lessor makes the underlying asset available for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee controls the right of use. Accordingly, the lessor has an unconditional right to receive lease payments (the lease receivable). The lessor controls that right—for example, it can decide to sell or securitise that right. The right arises from past events (not only the commitment to the lease contract but also the underlying asset being made available for use by the lessee) and is expected to result in future economic benefits (typically cash from the lessee) flowing to the lessor.

BC36 Consequently, the IASB concluded that the lessor's lease receivable meets the definition of an asset in the *Conceptual Framework*. The IASB is of the view that the changes proposed to the definition of an asset in the *Conceptual Framework* Exposure Draft would not affect this conclusion.

Rights retained in the underlying asset

BC37 Although the lessor transfers the right to use the underlying asset to the lessee at the commencement date, the lessor has the right to the underlying asset at the end of the lease term (and retains some rights to the underlying asset during the lease term; for example, the lessor retains title to the asset). Consequently, the lessor retains some of the potential economic benefits embedded in the underlying asset.

BC38 The lessor controls the rights that it retains in the underlying asset. A lessor can often, for example, sell the underlying asset (with the lease attached) or agree at any time during the initial lease term to sell or re-lease the underlying asset at the end of the lease term. The lessor's rights to the underlying asset arise from a past event—the purchase of the underlying asset or commitment to a head lease, if the lessor subleases the asset. Future economic benefits from the lessor's retained rights in the underlying asset are expected to flow to the lessor, assuming that the lease is for anything other than the full economic life of the underlying asset. The lessor would expect to obtain economic benefits either from the sale, re-lease or use of the underlying asset at the end of the lease term.

BC39 Consequently, the IASB concluded that the lessor's rights retained in the underlying asset meet the definition of an asset in the *Conceptual Framework*. The IASB is of the view that the changes proposed to the definition of an asset in the *Conceptual Framework* Exposure Draft would not affect this conclusion.

BC40 Having considered whether the lessor's lease receivable and rights retained in the underlying asset meet the definition of an asset, the IASB considered the lessor accounting model. This is discussed in paragraphs BC57–BC66.

The lessee accounting model

BC41 Having concluded that the lessee's right to use the underlying asset meets the definition of an asset and the lessee's obligation to make lease payments meets the definition of a liability (as described in paragraphs BC22–BC40), the IASB then considered whether requiring a lessee to recognise that asset and liability for all leases would improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with such a change.

BC42 The IASB considered comments from respondents to the Discussion Paper and the 2010 and 2013 Exposure Drafts, and from participants at consultation meetings (including meetings with users of financial statements) as described in paragraphs BC9 and BC13. In the light of these comments, the IASB concluded that there would be significant benefits from requiring a lessee to recognise right-of-use assets and lease liabilities for all leases (except short-term leases and leases of low-value assets as described in paragraphs BC87–BC104), particularly for users of financial statements and others who have raised concerns about the extent of off balance sheet financing provided through operating leases.

BC43 The IASB considered the costs associated with requiring a lessee to recognise right-of-use assets and lease liabilities for all leases throughout its redeliberations. In the light of comments from respondents to the 2010 and 2013 Exposure Drafts, IFRS 16 contains a number of simplifications and practical expedients to address concerns about costs. The costs and benefits of the lessee accounting model are discussed extensively in the Effects Analysis.

BC44 The IASB also consulted extensively on the approach to the recognition of lease expenses. The feedback from that consultation emphasised that different stakeholders have different views about the economics of lease transactions. Some view all leases as providing finance. Some view almost no leases as providing finance. Others think that the economics are different for different leases.

BC45 The 2010 Exposure Draft proposed a single lessee expense recognition model that was based on the premise that all leases provide finance to the lessee. The IASB received a significant amount of feedback in response to the 2010 Exposure Draft with stakeholders expressing differing views. In the light of this feedback, the IASB decided to expose for comment an alternative lessee expense recognition model—a dual model—that was responsive to those stakeholders who thought that a dual model would provide more useful information than a single model. Applying the dual model proposed in the 2013 Exposure Draft, leases would have been classified based upon the extent to which the lessee was expected to consume the economic benefits embedded in the underlying asset. Although some stakeholders supported that model, the feedback received in response to the proposals reiterated the mixed views that had been received throughout the project regarding lessee accounting. In particular:

(a) some stakeholders, including most users of financial statements, were of the view that all leases provide finance to lessees and, thus, create assets and 'debt-like' liabilities. Consequently, they supported a single lessee expense recognition model according to which a lessee would recognise interest on those debt-like liabilities separately from depreciation of lease assets for all leases.

(b) some were of the view that a lessee receives equal benefits from use of the underlying asset in each period and pays equal amounts for that benefit. Consequently, they supported a single lessee expense recognition model in which a lessee would allocate the total cost of the lease to each period on a straight-line basis to reflect the pattern in which the lessee consumes benefits from use of the underlying asset. These stakeholders also noted that a decision to lease assets rather than purchase them is sometimes made in order to obtain operational flexibility (rather than to obtain finance). Consequently, they were of the view that a single straight-line lease expense would be a more faithful representation of the transaction in the income statement.

(c) some supported a single lessee expense recognition model because they had concerns about the cost and complexity of a dual expense recognition model. They noted the administrative benefits of removing the need for a lease classification test and having only one method of accounting for all leases. They also questioned whether more than one expense recognition pattern would provide useful information to users of financial statements.

(d) some supported a single lessee expense recognition model for conceptual reasons. They thought that, if all leases are recognised on a lessee's balance sheet, any attempt to differentiate between those leases in the income statement would be arbitrary and result in inconsistencies with the accounting for a non-financial asset and a financial liability in the balance sheet. Many also criticised the accounting that would result from a dual model that required the recognition of assets and liabilities together with a single, straight-line lease expense (as was proposed for some leases in the 2013 Exposure Draft). This is because, under that model, the right-of-use asset would have been measured as a balancing figure.

(e) some stakeholders noted that any dual model perpetuates the risk of structuring to gain a particular accounting outcome.

(f) some stakeholders thought that there are real economic differences between different leases, particularly between property leases and leases of assets other than property. These stakeholders recommended a dual lessee expense recognition model in which a lessee would recognise a single, straight-line lease expense for most property leases. They recommended such a model because they view property lease expenses as an important part of operating expenses, particularly for entities such as retailers, hoteliers and restaurateurs.

(g) some stakeholders recommended retaining a dual model that classified leases using the classification principle in IAS 17. They thought that recognition of a single, straight-line lease expense for all leases previously classified as operating leases would appropriately reflect the benefit that the lessee receives evenly over the lease term. This accounting would also align the lease expense more closely with lease payments, which some stakeholders viewed as preferable.

BC46 The IASB also consulted many users of financial statements (see paragraphs BC9 and BC13). Most users consulted (including almost all of those who analyse industrial, airline, transport and telecommunications sectors) were of the view that leases create assets and 'debt-like' liabilities. Consequently, they thought that recognising interest on lease liabilities separately from depreciation of right-of-use assets would be beneficial to their analyses, particularly in assessing the operating performance of an entity. The separate recognition of those expenses would be particularly beneficial for those users of financial statements who use reported information for their analyses without making further adjustments—it would create greater comparability in the income statement between entities that borrow to buy assets and those that lease similar assets. Separating interest and depreciation would also provide coherency between the lessee's balance sheet and income statement (ie the interest expense would correspond to the lease liabilities presented as financial liabilities, and depreciation would correspond to the right-of-use assets presented as non-financial assets).

This coherency is important for some analyses, such as calculating return on capital employed and some leverage ratios.

BC47 Credit analysts consulted were generally of the view that all leases create assets and 'debt-like' liabilities for lessees. Consequently, they saw benefit in recognising interest on lease liabilities separately from depreciation of right-of-use assets. Many of those credit analysts already adjust a lessee's income statement for operating leases to estimate an allocation of operating lease expense between depreciation and interest.

BC48 Most users of the financial statements of retailers, hoteliers and restaurateurs (ie those entities that typically have significant amounts of leased property) expressed support for a model that would recognise a single lease expense for property leases. Some of those users view leases of property as executory contracts. For them, a single lease expense recognised within operating expenses would have best satisfied their needs. However, other users of the financial statements of retailers, hoteliers and restaurateurs had estimated an allocation of operating lease expense between depreciation and interest in their analyses based on previous lessee accounting requirements. Consequently, those users thought that requiring a lessee to recognise interest on lease liabilities separately from depreciation of right-of-use assets would provide them with information that is useful for their analyses.

BC49 The IASB also considered the adjustments made by those lessees that, in applying the previous lessee accounting requirements, reported lease-adjusted 'non-GAAP' information alongside their financial statements. These lessees often reported ratios based on amounts in the balance sheet, income statement and statement of cash flows that were adjusted to reflect the amounts that would have been reported if operating leases were accounted for as financing transactions (as is required by IFRS 16). For example, a commonly reported amount was lease-adjusted return on capital employed which was often calculated as (a) operating profit adjusted for the estimated interest on operating leases; divided by (b) reported equity plus financial liabilities adjusted to include liabilities for operating leases.

BC50 The IASB also observed that the consequence of any model that requires both the recognition of right-of-use assets and lease liabilities in the balance sheet together with a single, straight-line lease expense in the income statement (as was proposed for some leases in the 2013 Exposure Draft) would be a lack of coherency between the primary financial statements. In particular, any such model:

(a) would result in a lessee recognising a financial liability in the balance sheet without presenting a commensurate interest expense in the income statement. Similarly, a lessee would recognise a non-financial asset without any commensurate depreciation in the income statement. These inconsistencies could distort ratio analyses performed on the basis of the amounts reported in the primary financial statements.

(b) would require either the right-of-use asset or the lease liability to be measured as a balancing figure. This is because measuring (i) the right-of-use asset on the basis of cost less accumulated depreciation and impairment; and (ii) the lease liability using an effective interest method would generally not result in a straight-line lease expense.

BC51 Consequently, the IASB concluded that:

(a) a lessee model that separately presents depreciation and interest for all leases recognised in the balance sheet provides information that is useful to the broadest range of users of financial statements. The IASB reached this conclusion for three main reasons:

(i) most users of financial statements consulted think that leases create assets and 'debt-like' liabilities for a lessee. Consequently, they benefit from lessees recognising interest on those liabilities in a similar way to interest on other financial liabilities, because that enables them to perform meaningful

ratio analyses. The same is true regarding the recognition of depreciation of right-of-use assets in a similar way to depreciation of other non-financial assets such as property, plant and equipment. The model is particularly beneficial for those users that rely on reported information without making adjustments.

(ii) the model is easy to understand—a lessee recognises assets and financial liabilities, and corresponding amounts of depreciation and interest.

(iii) the model addresses the concern of some users of financial statements that a dual model would perpetuate the risk of structuring to create a particular accounting outcome.

(b) accounting for all leases recognised in the balance sheet in the same way appropriately reflects the fact that all leases result in a lessee obtaining the right to use an asset, regardless of the nature or remaining life of the underlying asset.

(c) a single model reduces cost and complexity by removing the need to classify leases and the need for systems that can deal with two lessee accounting approaches.

BC52 In reaching its decisions relating to the lessee expense recognition model, the IASB observed that much of the negative feedback received in response to the single model proposed in the 2010 Exposure Draft related to the proposed measurement of lease assets and lease liabilities—in particular, the requirements for a lessee to estimate future variable lease payments and to determine the lease term based on the longest possible term that was more likely than not to occur. The measurement proposals for variable lease payments and optional lease periods were simplified in the 2013 Exposure Draft, and these simplifications have been retained in IFRS 16. As described in paragraph BC18, the IASB also introduced a number of further simplifications and exemptions after considering feedback on the 2013 Exposure Draft. The IASB expects the simpler measurement requirements and exemptions in IFRS 16 to alleviate many of the concerns that were received in response to the single model proposed in the 2010 Exposure Draft.

BC53 Consequently, the IASB decided to require a single lessee accounting model for all leases recognised in a lessee's balance sheet. This model requires a lessee to depreciate the right-of-use asset similarly to other non-financial assets and to account for the lease liability similarly to other financial liabilities.

Other approaches considered for the lessee accounting model

BC54 The IASB also considered an approach similar to the lessee accounting requirements that have been decided upon by the FASB. Applying that approach, a lessee would generally recognise a single, straight-line lease expense for leases that would have been classified as operating leases applying IAS 17.

BC55 Most lessees that predominantly lease property supported such an approach, as did some users of financial statements that analyse entities that predominantly lease property. In the view of those lessees and users, recognising lease expenses for property leases on a straight-line basis reflects the nature of the transaction. For example, some noted that, when a lessee enters into a typical five-year lease of retail space, the lessee is simply paying to use the retail space rather than consuming any of the value of the underlying asset. In their view, a lessee should recognise these rentals on a straight-line basis.

BC56 The IASB did not adopt the approach decided upon by the FASB because, in its view:

(a) information reported under the single lessee accounting model specified in IFRS 16 would provide the most useful information to the broadest range of users of financial statements as described in paragraphs BC46–BC52; and

(b) the costs for preparers under the approach decided upon by the FASB would be broadly similar to the costs of the single lessee accounting model specified in IFRS 16. For both approaches, the most significant cost associated with a new lessee accounting model would be the cost associated with recognising and measuring right-of-use assets and lease liabilities for all leases. Although the approach decided upon by the FASB would have retained the classification requirements of IAS 17 (which are familiar to lessees), it would still have required a lessee to recognise right-of-use assets and lease liabilities on a discounted basis for all leases (with some exceptions).

The lessor accounting model

BC57 Having concluded that the lessor's lease receivable and rights retained in the underlying asset both meet the definition of an asset (as described in paragraphs BC35–BC40), the IASB considered whether requiring a lessor to recognise those assets for all leases would improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with such a change.

BC58 The IASB considered the feedback received throughout the project regarding lessor accounting and concluded that the costs associated with making changes to lessor accounting would be difficult to justify at this time because most stakeholders (including users of financial statements) were of the view that lessor accounting in IAS 17 is not 'broken'. Consequently, the IASB decided to substantially carry forward the lessor accounting model in IAS 17.

BC59 In reaching this decision, the IASB noted that criticisms of the accounting model for leases under IAS 17 were primarily focused on lessee accounting. Consequently, when the IASB initially added the Leases project to its agenda, the project was intended to address only lessee accounting and not lessor accounting.

BC60 The IASB had earlier proposed to address lessor accounting in response to feedback received from some respondents to the Discussion Paper (as described in paragraph BC6). Those respondents had asked the IASB to address both lessee and lessor accounting at the same time because they thought that developing consistent and symmetrical accounting for lessees and lessors would be beneficial. In addition, some users of financial statements had argued that the lessor accounting model in IAS 17 did not provide sufficient information about a lessor's exposure to residual asset risk (ie the risks retained as a result of its remaining interest in the underlying asset). Accordingly, the IASB proposed changes to lessor accounting in the 2010 and 2013 Exposure Drafts that were more symmetrical with the lessee accounting model ultimately included in IFRS 16, because these proposals would have required a lessor to recognise a lease receivable for all (or many) leases.

BC61 The feedback received in response to the proposals in the 2010 and 2013 Exposure Drafts highlighted that the majority of stakeholders did not support changing the lessor accounting model in IAS 17. In particular, stakeholders observed that:

(a) the lessor accounting model in IAS 17 is well understood.

(b) most users of financial statements do not currently adjust lessors' financial statements for the effects of leases—indicating that the lessor accounting model in IAS 17 already provides users of financial statements with the information that they need. In addition, investors generally analyse the financial statements of individual entities (and not a lessee and lessor of the same underlying asset). Accordingly, it is not essential that the lessee and lessor accounting models are symmetrical.

(c) in contrast to lessee accounting, lessor accounting in IAS 17 is not fundamentally flawed and should not be changed solely because lessee accounting is changing.

BC62 Some stakeholders also acknowledged that their views on lessor accounting had changed over the life of the Leases project. These stakeholders noted that they had originally suggested that the IASB should address lessor accounting at the same time as lessee accounting. However, in response to the 2013 Exposure Draft, they suggested that no changes should be made to lessor accounting. These stakeholders had changed their views primarily for cost-benefit reasons.

BC63 In the light of this feedback, the IASB concluded that requiring a lessor to recognise a lease receivable for all leases would not improve financial reporting to the extent that the benefits from the improvements would outweigh the costs associated with such a change.

BC64 Nonetheless, the IASB decided to change selected elements of the lessor accounting model in IAS 17 in the light of the decisions made about the lessee accounting model. In particular, the IASB made changes to the accounting for subleases, the definition of a lease, initial direct costs and lessor disclosures.

BC65 Accordingly, IFRS 16 substantially carries forward the lessor accounting requirements in IAS 17, with the exception of the definition of a lease (see paragraphs BC105–BC126), initial direct costs (see paragraph BC237) and lessor disclosures (see paragraphs BC251–BC259). IFRS 16 also includes requirements and examples on subleases (see paragraphs BC232–BC236) in the light of the new lessee accounting requirements, and includes requirements on lease modifications (see paragraphs BC238–BC240). The IASB has also incorporated into this Basis for Conclusions material from the Basis for Conclusions on IAS 17 that discusses matters relating to the lessor accounting requirements that are carried forward in IFRS 16 (see paragraphs BCZ241–BCZ250). That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to IFRS 16 have been updated accordingly and necessary editorial changes have been made.

BC66 The IASB also decided to carry forward substantially all of the wording in IAS 17 with respect to lessor accounting. This is because any changes to the words in the Standard would have a risk of unintended consequences for lessors applying IFRS 16 and may imply that changes in application of the lessor accounting requirements were intended when that was not the case.

Scope (paragraphs 3–4)

BC67 The IASB decided that the scope of IFRS 16 should be based on the scope of the leases requirements in IAS 17. IAS 17 applies to all leases, with specified exceptions.

BC68 Accordingly, IFRS 16 contains scope exceptions for:

(a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources. IFRS 6 *Exploration for and Evaluation of Mineral Resources* specifies the accounting for rights to explore for and evaluate mineral resources.

(b) leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee. IAS 41 specifies the accounting for biological assets, other than bearer plants, which are within the scope of IAS 16. Consequently, leases of bearer plants such as orchards and vineyards held by a lessee are within the scope of IFRS 16.

(c) service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements* (see paragraph BC69).

(d) licences of intellectual property granted by a lessor within the scope of IFRS 15. There are specific requirements relating to those licences within IFRS 15.

(e) leases of intangible assets held by a lessee (see paragraphs BC70–BC71).

Service concession arrangements

BC69 The IASB decided to exclude from the scope of IFRS 16 service concession arrangements within the scope of IFRIC 12. Consistently with the conclusions in IFRIC 12, any arrangement within its scope (ie that meets the conditions in paragraph 5 of the Interpretation) does not meet the definition of a lease. This is because the operator in a service concession arrangement does not have the right to control the use of the underlying asset. For this reason, the IASB considered whether it was necessary to explicitly exclude from the scope of IFRS 16 service concession arrangements within the scope of IFRIC 12. However, such a scope exclusion had been included in IFRIC 4 *Determining whether an Arrangement contains a Lease*, and stakeholders informed the IASB that including a scope exclusion for service concession arrangements in IFRS 16 would provide clarity in this respect.

Intangible assets

BC70 IFRS 16 excludes from its scope rights held by a lessee under licensing agreements within the scope of IAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. This is because these licensing agreements are accounted for applying IAS 38.

BC71 IFRS 16 also states that a lessee may, but is not required to, apply IFRS 16 to leases of other intangible assets. The IASB did not want to prevent a lessee from applying IFRS 16 to leases of intangible assets for which there are no specific requirements in other Standards. The IASB acknowledged that there is no conceptual basis for excluding leases of intangible assets from the scope of IFRS 16 for lessees. However, the IASB concluded that a separate and comprehensive review of the accounting for intangible assets should be performed before requiring leases of intangible assets to be accounted for applying the requirements of IFRS 16. Many stakeholders agreed with this approach.

Onerous contracts

BC72 The IASB decided not to specify any particular requirements in IFRS 16 for onerous contracts. The IASB made this decision because:

(a) for leases that have already commenced, no requirements are necessary. After the commencement date, an entity will appropriately reflect an onerous lease contract by applying the requirements of IFRS 16. For example, a lessee will determine and recognise any impairment of right-of-use assets applying IAS 36 *Impairment of Assets*.

(b) for leases that have not already commenced, the requirements for onerous contracts in IAS 37 *Provisions, Contingent Liabilities and Contingent Asset*s are sufficient. The requirements in IAS 37 apply to any contract (and hence any lease contract) that meets the definition of an onerous contract in that Standard.

Subleases

BC73 The IASB decided that an entity should account for leases of right-of-use assets (ie subleases) in the same way as other leases. Accordingly, subleases are within the scope of IFRS 16 (see paragraphs BC232–BC236).

Inventory

BC74 IFRS 16 does not specifically exclude leases of inventory from its scope. The term ‘leased inventory’ is sometimes used to describe purchases of non-depreciating spare parts, operating materials, and supplies that are associated with leasing another underlying asset. The IASB noted that few of these transactions, if any, would meet the definition of a lease because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by

another party) for sale in the ordinary course of business, or for consumption in the process of production for sale in the ordinary course of business. Accordingly, the IASB decided that a scope exclusion was not necessary.

Non-core assets

BC75 Information about assets that are not essential to the operations of an entity is sometimes of less interest to users of financial statements, because those assets are often less significant to the entity. Accordingly, some think that the costs associated with recognising and measuring the assets and liabilities arising from leases of non-core assets could outweigh the benefits to users. For example, information about assets and liabilities arising from leases of delivery vans is important to assess the operations of a delivery company, but it may not be important for materiality reasons in assessing the operations of a bank that uses vans to deliver supplies to its retail banking locations. Consequently, the IASB considered whether to exclude leases of non-core assets from IFRS 16.

BC76 Although some Board members favoured such an approach, the IASB noted that:

(a) defining 'core' and 'non-core' would be extremely difficult. For example, would office buildings used by a bank be a core asset, and would the conclusion be different if the bank has retail banking operations? Would an entity consider some offices or cars to be core assets and others non-core? If core assets were defined as those essential to the operations of an entity, it could be argued that every lease would be a lease of a core asset. Otherwise, why would an entity enter into the lease?

(b) different entities might interpret the meaning of non-core assets differently, thereby reducing comparability for users of financial statements.

(c) other Standards do not distinguish between core and non-core purchased assets. Because of this, it would be difficult to justify distinguishing a right-of-use asset relating to a core asset from one that relates to a non-core asset.

BC77 Consequently, IFRS 16 does not make any distinction in accounting on the basis of whether the underlying asset is core to an entity's operations.

Long-term leases of land

BC78 A long-term lease of land is sometimes regarded as being economically similar to the purchase of the land. Consequently, some stakeholders suggested that long-term leases of land should be excluded from the scope of IFRS 16. However, the IASB decided not to specifically exclude such leases from the scope of IFRS 16 because:

(a) there is no conceptual basis for differentiating long-term leases of land from other leases. If the contract does not transfer control of the land to the lessee, but gives the lessee the right to control the use of the land throughout the lease term, the contract is a lease and should be accounted for as such.

(b) for a long-term lease of land (for example, a 99-year lease), the present value of the lease payments is likely to represent substantially all of the fair value of the land. In this case, the accounting applied by the lessee will be similar to accounting for the purchase of the land. If the lessee obtains control of the land, it will account for the contract as the purchase of the land by applying IAS 16 *Property, Plant and Equipment*, rather than by applying IFRS 16.

BC79 The IASB also noted that the IFRS Interpretations Committee had received questions about distinguishing between a lease and a sale or purchase when legal title to the underlying asset is not transferred. This is discussed in paragraphs BC138–BC140.

Leases of investment property at fair value

BC80 The IASB considered whether leases of investment property measured at fair value should be excluded from the scope of IFRS 16. It considered such an exclusion because many users of the financial statements of investment property lessors informed the IASB that the requirements of IAS 40 *Investment Property* provide useful information about the leasing activities of a lessor, especially when the fair value model is used. However, the IASB concluded that a lessor of investment property should apply IAS 40 when accounting for its investment property and apply IFRS 16 when accounting for the lease. That is similar to how IAS 17 and IAS 40 interacted. Accordingly, a user of financial statements would obtain fair value information about investment property subject to operating leases, which is required by IAS 40, and information about rental income earned by the lessor, which is required by IFRS 16.

Embedded derivatives

BC81 The IASB decided to require an entity to separate from a lease any derivatives embedded in the lease (as defined in IFRS 9 *Financial Instruments*), and account for the derivatives applying IFRS 9. Nonetheless, IFRS 16 includes specific requirements for features of a lease such as options and residual value guarantees that may meet the definition of a derivative. The IASB noted that the lease accounting model in IFRS 16 was not developed with derivatives in mind and, thus, IFRS 16 would not provide an appropriate basis on which to account for derivatives. Accordingly, if derivatives embedded in leases were not accounted for separately, unrelated derivative contracts could be bundled with leases to avoid measuring the derivatives at fair value.

Portfolio application (paragraph B1)

BC82 The 2010 and 2013 Exposure Drafts would not have precluded an entity from applying the leases requirements at a portfolio level. However, many entities noted that the 2011 Exposure Draft *Revenue from Contracts with Customers* proposed guidance on applying its requirements at a portfolio level (which has subsequently been confirmed in IFRS 15). These stakeholders asked whether the absence of guidance on this subject meant that an entity would not be permitted to apply IFRS 16 at a portfolio level.

BC83 In response to these concerns, the IASB decided to add application guidance on portfolios to IFRS 16. The guidance clarifies that an entity is permitted to apply the requirements in IFRS 16 to a portfolio of leases with similar characteristics, if the entity reasonably expects that the effects on the financial statements of applying IFRS 16 to the portfolio would not differ materially from applying IFRS 16 to the individual leases within that portfolio. This approach may be particularly useful for lessees with a large number of similar leases.

Materiality

BC84 Many lessees expressed concerns about the costs of applying the requirements in IFRS 16 to leases that are large in number but low in value, particularly when the aggregate value of those leases would have little effect on the financial statements as a whole. These lessees thought that applying the requirements of IFRS 16 to those leases would involve a significant amount of time and effort without a corresponding benefit in terms of the effect on reported information.

BC85 In the light of these concerns, the IASB considered including explicit guidance on materiality within IFRS 16—either an explicit reminder that immaterial leases are excluded from the scope of IFRS 16 or by providing clarity about how the concept of materiality in the *Conceptual Framework* and in IAS 1 *Presentation of Financial Statements* applies to leases. The IASB observed that the concept of materiality applies to leases, however, other Standards do not provide materiality guidance about particular transactions and events. The IASB also noted that applying materiality considerations to the requirements in IFRS 16 is no different from applying those considerations to the requirements of other Standards.

Accordingly, the IASB decided not to provide specific guidance on materiality within IFRS 16. The IASB concluded that it would be appropriate, and consistent with other Standards, to rely on the materiality guidance in the *Conceptual Framework* and in IAS 1. Nonetheless, IFRS 16 includes some recognition exemptions as described in paragraphs BC87–BC104.

BC86 In making this decision not to include materiality guidance in IFRS 16, the IASB noted that a lessee would not be required to apply the recognition and measurement requirements in IFRS 16 if the effect of doing so would not be material to its financial statements. Similarly, if a lessee's leasing activities are material to its financial statements, but the effect of measuring lease liabilities on a discounted basis is not material, the lessee would not be required to measure its lease liabilities on a discounted basis and could instead, for example, measure them on an undiscounted basis.

Recognition exemptions (paragraphs 5–8)

Short-term leases

BC87 The IASB concluded that the benefits of requiring a lessee to apply all of the requirements in IFRS 16 to short-term leases do not outweigh the associated costs. In considering how to reduce the costs for lessees, the IASB considered both the nature and the scope of a possible exemption.

Nature of the exemption

BC88 The IASB considered simplifying the measurement requirements for short-term leases. Specifically, it considered exempting lessees from the requirement to discount the payments used to measure the assets and liabilities arising from short-term leases. Many stakeholders, however, thought that this exemption would provide insufficient cost relief for lessees because it would still require an entity to track a possibly large volume of leases of a low value.

BC89 The IASB concluded that, even with simplified measurement requirements, the benefits of requiring a lessee to recognise right-of-use assets and lease liabilities for short-term leases would not outweigh the associated costs. Consequently, paragraph 5(a) of IFRS 16 permits a lessee to elect not to apply the recognition requirements to short-term leases. Instead, a lessee can recognise the lease payments associated with short-term leases as an expense over the lease term, typically on a straight-line basis. The IASB decided that this choice should be made by class of underlying asset.

BC90 In the light of the feedback that an exemption for short-term leases did not provide sufficient relief for leases of low-value assets, the IASB also developed a separate exemption for those leases (see paragraphs BC98–BC104).

Definition of 'short-term'

BC91 The IASB first considered defining a short-term lease as a lease that, at the commencement date, has a maximum possible term of 12 months or less. However, many stakeholders thought that a short-term lease exemption defined in this way would provide limited cost relief for lessees. These stakeholders noted that, in their experience, a lease rarely has a maximum possible term of 12 months or less. For example, stakeholders suggested that many leases that run month-to-month would not qualify for the exemption.

BC92 In the light of these comments, the IASB considered expanding the short-term lease exemption to leases of more than 12 months. Some stakeholders had suggested that 'short-term' should be up to five years. The IASB, however, did not adopt this approach because, for example, three-year leases are more likely to give rise to material assets and liabilities than 12 month leases, and the objective of the project was to ensure greater transparency about an entity's leasing activities.

BC93 Instead, the IASB decided to expand the short-term lease exemption by making the determination of duration of short-term leases consistent with the determination of lease term, thus considering the likelihood of extension options being exercised or termination options not being exercised (see paragraphs BC152–BC159). Accordingly, IFRS 16 defines a short-term lease as a lease that, at the commencement date, has a lease term of 12 months or less.

BC94 In reaching this decision, the IASB considered the risk that leases could be structured to meet the short-term lease exemption. The IASB concluded that this risk is mitigated by the economic consequences of a short-term lease for a lessor. There would often be an economic disincentive for lessors to grant shorter term leases, because shortening the lease term would increase the risk associated with a lessor's residual interest in the underlying asset. Consequently, the IASB is of the view that a lessor would often either demand increased lease payments from the lessee to compensate for this change in risk or refuse to shorten the non-cancellable period of the lease. In addition, the IASB noted the rigour that lessees are expected to apply when determining the lease term, as described in paragraphs B37–B40 of IFRS 16. This should reduce the risk of non-substantive break clauses being inserted within contracts solely for accounting purposes. The IASB also decided that a lessee should reassess the lease term of a short-term lease by treating it as a new lease if that lease term changes.

BC95 The IASB observed that little incremental information would be lost by defining short-term leases by reference to the IFRS 16 determination of lease term, instead of the maximum possible term. That is because a lessee would include only lease payments for the duration of the lease term as an asset and a liability, irrespective of the maximum possible term. For example, for a lease with an extension option after six months which the lessee is not reasonably certain to exercise, the lease term is six months. If that lease were not captured by the short-term lease exemption (because the maximum term is longer than the lease term), the lessee would include only lease payments for the six-month lease term in measuring the asset and liability. Consequently, by aligning the determination of short-term with the determination of lease term, the only incremental change in information would be that the lessee would no longer reflect the six months of lease payments on its balance sheet.

BC96 The IASB also considered whether identifying short-term leases using the IFRS 16 determination of lease term would be more complex to apply, because more judgement would be needed to identify that lease term than the maximum term. However, on the basis of feedback received, the IASB concluded that any additional complexity in determining the lease term would be more than compensated for by the additional cost relief provided overall as a result of:

(a) applying the exemption to a wider group of leases; and

(b) requiring lessees to perform only one assessment of lease term for the purposes of both identifying whether the lease is a short-term lease and measuring the assets and liabilities for leases that are not short-term.

BC97 The IASB also decided to require a lessee to disclose the expense related to short-term leases for which the lessee has elected to apply the short-term lease exemption (see paragraph 53(c) of IFRS 16 and paragraph BC217(c)). In the IASB's view, this disclosure provides useful information to users of financial statements about the lease payments that are excluded from lease liabilities as a consequence of the short-term lease exemption.

Leases of low-value assets

BC98 As noted in paragraph BC84, many lessees expressed concerns about the costs of applying the requirements of IFRS 16 to leases that are large in number but low in value. They suggested that such an exercise would require a significant amount of effort with potentially little effect on reported information.

BC99 In the light of these concerns, the IASB decided to provide a recognition exemption for leases of low-value assets. Consequently, IFRS 16 permits a lessee to elect, on a lease-by-lease basis, not to apply the recognition requirements of IFRS 16 to leases for which the underlying asset is of low value.

BC100 In developing the exemption, the IASB attempted to provide substantive relief to preparers while retaining the benefits of the requirements in IFRS 16 for users of financial statements. The IASB intended the exemption to apply to leases for which the underlying asset, when new, is of low value (such as leases of tablet and personal computers, small items of office furniture and telephones). At the time of reaching decisions about the exemption in 2015, 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. A lease will not qualify for the exemption if the nature of the underlying asset is such that, when new, its value is typically not low. The IASB also decided that the outcome of the assessment of whether an underlying asset is of low value should not be affected by the size, nature, or circumstances of the lessee—ie the exemption is based on the value, when new, of the asset being leased; it is not based on the size or nature of the entity that leases the asset.

BC101 The IASB conducted fieldwork to assess the effect that low-value asset leases would have if the right-of-use assets and lease liabilities were recognised in the financial statements of lessees. On the basis of this fieldwork, the IASB observed that, in most cases, assets and liabilities arising from leases within the scope of the exemption would not be material, even in aggregate. The IASB considered whether these findings demonstrated that the exemption would be of limited benefit to lessees because most leases that would be within its scope might instead be excluded from the recognition requirements of IFRS 16 by applying the concept of materiality in the *Conceptual Framework* and in IAS 1. However, in the light of feedback received from preparers of financial statements, the IASB concluded that the exemption would provide substantial cost relief to many lessees (and, in particular, smaller entities) by removing the burden of justifying that such leases would not be material in the aggregate.

BC102 The IASB acknowledged the risk that the aggregate value of leases captured by the exemption might be material in some cases. The IASB's fieldwork suggested that the aggregate value is most likely to be material for large assets made up of a number of individual leases of low-value assets (such as IT equipment made up of individually low-value component parts). Consequently, the IASB decided that if an underlying asset is highly dependent on, or highly interrelated with, other underlying assets, a lessee should not apply the recognition exemption to the lease of that individual asset. Similarly, the IASB decided that a lessee should not apply the recognition exemption to a lease of an underlying asset if the lessee cannot benefit from that underlying asset on its own or together with other readily available resources, irrespective of the value of that underlying asset.

BC103 The IASB decided that the recognition exemption for leases of low-value assets should be applied on a lease-by-lease basis. A requirement to apply the exemption by class of underlying asset, instead of lease-by-lease, would have introduced a burden on lessees to assess every individual asset within a class. Consequently, in the IASB's view, the recognition exemption for leases of low-value assets will be easier to apply, and of more benefit to lessees, if applied on a lease-by-lease basis.

BC104 The IASB also decided to require a lessee to disclose the amount of the expense recognised related to leases of low-value assets for which the lessee has elected to apply the recognition exemption (see paragraph 53(d) of IFRS 16 and paragraph BC217(c)). In the IASB's view, this disclosure provides useful information to users of financial statements about the amount of lease payments that are excluded from lease liabilities as a consequence of a lessee applying the exemption relating to leases of low-value assets.

Identifying a lease (paragraphs 9–17)

Definition of a lease (paragraphs 9–11)

BC105 IFRS 16 defines a lease on the basis of whether a customer controls the use of an identified asset for a period of time, which may be determined by a defined amount of use. If the customer controls the use of an identified asset for a period of time, then the contract contains a lease. This will be the case if the customer can make the important decisions about the use of the asset in a similar way to that in which it makes decisions about owned assets that it uses. In such cases, the customer (the lessee) has obtained the right to use an asset (the right-of-use asset) that it should recognise in its balance sheet (subject to the recognition exemptions in paragraph 5 of IFRS 16). In contrast, in a service contract, the supplier controls the use of any assets used to deliver the service.

BC106 The 2010 Exposure Draft essentially retained the definition of a lease in IAS 17 and the accompanying requirements in IFRIC 4. Many respondents expressed concerns about the population of contracts that would be captured by the proposed requirements (and in particular that some contracts that they viewed as service contracts would be captured). Respondents also identified practice issues with IFRIC 4, such as difficulties in assessing the pricing structure of a contract, and questioned why the control criteria used in IFRIC 4 to define a lease were different from the control proposals that were then being developed within the context of revenue recognition and the control principle in IFRS 10 *Consolidated Financial Statements*.

BC107 Accordingly, in the 2013 Exposure Draft, the IASB proposed changes to the guidance on the definition of a lease to address those concerns. The 2013 Exposure Draft proposed using a control principle as the means of distinguishing between a service and a lease, and to align the principle with that in other Standards. Respondents generally supported these changes. However, many respondents stressed the increased importance of the definition of a lease, noting that the assessment of whether a contract contains a lease would generally determine whether a customer would recognise lease assets and lease liabilities. Some of these respondents thought that the IASB had not provided adequate guidance to support consistent application of the proposed definition to more complicated scenarios.

BC108 Accordingly, IFRS 16 generally retains the approach to the definition of a lease that was proposed in the 2013 Exposure Draft, but makes a number of changes to clarify the IASB's intentions and reduce the risk of inconsistent application.

BC109 The IASB is of the view that, in most cases, the assessment of whether a contract contains a lease should be straightforward. A contract will either fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgement. However, application guidance has been added to make it easier for entities to make the lease assessment for more complicated scenarios.

BC110 IFRS 16 requires an entity to assess whether a contract contains a lease at inception of the contract, rather than at commencement. This is because a lessor is required to classify a lease as either a finance lease or an operating lease at the inception date; this is consistent with the previous lessor lease classification requirements in IAS 17, which the IASB decided not to change. In addition, a lessee is required to disclose information about leases not yet commenced to which the lessee is committed if that information is relevant to users of financial statements.

Identified asset

BC111 The first requirement for a contract to meet the definition of a lease in IFRS 16 is that a customer should control the use of an identified asset. The requirement for an identified asset is substantially the same as the requirement in IFRIC 4 for the contract to depend on the use of a specified asset. It is important to know what the asset is in order to assess whether the

customer has the right to control the use of that asset and, for example, to determine which asset finance lessors should derecognise. Nonetheless, when assessing at the inception date whether there is an identified asset, an entity does not need to be able to identify the particular asset (for example, a specific serial number) that will be used to fulfil the contract to conclude that there is an identified asset. Instead, the entity simply needs to know whether an identified asset is needed to fulfil the contract from commencement. If that is the case, then an asset is implicitly specified. IFRS 16 clarifies that an asset can be implicitly specified at the time that the asset is made available for use by the customer.

BC112 IFRS 16 includes requirements on asset substitution. If a supplier has a substantive right to substitute the asset throughout the period of use, then there is no identified asset and the contract does not contain a lease. This is because the supplier (and not the customer) controls the use of an asset if it can substitute the asset throughout the period of use.

BC113 The IASB has included application guidance to help determine the circumstances in which substitution rights are substantive. This guidance focuses on whether the supplier has the practical ability to substitute the asset and would benefit economically from doing so. The IASB's intention in including this guidance is to differentiate between:

(a) substitution rights that result in there being no identified asset because the supplier, rather than the customer, controls the use of an asset; and

(b) substitution rights that do not change the substance or character of the contract because it is not likely, or practically or economically feasible, for the supplier to exercise those rights.

If a substitution clause is not substantive because it does not change the substance of the contract, then that substitution clause should not affect an entity's assessment of whether a contract contains a lease. The IASB thinks 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.

BC114 Substitution rights may not be substantive for a number of reasons. Some substitution rights are not substantive because the contract restricts when a supplier can substitute the asset. For example, if a contract states that a supplier can substitute the asset only on a specified future date or after the occurrence of a specified event, that substitution right is not substantive because it does not give the supplier the practical ability to substitute the asset throughout the period of use. Other substitution rights are not substantive even if the supplier contractually has the right to substitute the asset at any time. For example, if a supplier substitutes an asset for purposes of repair and maintenance, or if a supplier would benefit from substitution only in circumstances that are not considered likely to arise, those substitution rights are not substantive, regardless of whether those circumstances are specified in the contract.

BC115 Stakeholders raised concerns that in some cases it would be difficult, if not impossible, for a customer to determine whether a supplier's substitution right is substantive. Difficulties may arise because the customer often does not have information about the costs of substitution that would be incurred by the supplier. On the basis of this feedback, the IASB decided to state in IFRS 16 that, if a customer cannot readily determine whether a supplier has a substantive substitution right, then the customer should presume that any substitution right is not substantive. It is intended that a customer should assess whether substitution rights are substantive if it is reasonably able to do so—if substitution rights are substantive, then the IASB thinks that this would be relatively clear from the facts and circumstances. However, the requirement is also intended to clarify that a customer is not expected to exert undue effort in order to provide evidence that a substitution right is not substantive.

BC116 IFRS 16 also clarifies that an asset must be physically distinct to be an identified asset. The IASB concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (for example, if it is a 20 per cent capacity portion of a pipeline). The customer is unlikely to have the right to control the

use of its portion because decisions about the use of the asset are typically made at the larger asset level. Widening the notion of an identified asset to possibly capture portions of a larger asset that are not physically distinct might have forced entities to consider whether they lease assets used to fulfil any contract for services, only to conclude that they do not. Consequently, the IASB concluded that widening the definition to include capacity portions of a larger asset would increase complexity for little benefit.

The right to control the use of an identified asset

BC117 IFRS 16 contains application guidance regarding what it means to have the right to control the use of an asset. The IASB decided that, to control the use of an asset, a customer is required to have not only the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use (a 'benefits' element) but also the ability to direct the use of that asset (a 'power' element), ie a customer must have decision-making rights over the use of the asset that give it the ability to influence the economic benefits derived from use of the asset throughout the period of use. Without any such decision-making rights, the customer would have no more control over the use of the asset than any customer purchasing supplies or services. If this were the case, the customer would not control the use of the asset. This guidance is consistent with the concept of control in IFRS 10 and IFRS 15, and with the IASB's proposals regarding control in the *Conceptual Framework* Exposure Draft. IFRS 10 and IFRS 15 define control to require both a 'benefits' element and a 'power' element.

Right to obtain substantially all of the economic benefits from use of the identified asset

BC118 IFRS 16 clarifies that only the economic benefits arising from use of an asset, rather than the economic benefits arising from ownership of that asset, should be considered when assessing whether a customer has the right to obtain the benefits from use of an asset. A lease does not convey ownership of an underlying asset; it conveys only the right to use that underlying asset. Accordingly, the IASB concluded that, when considering whether a contract contains a lease, a customer should not consider economic benefits relating to ownership of an asset (for example, tax benefits as a result of owning an asset). However, a customer should consider benefits relating to the use of the asset (for example, renewable energy credits received from the use of an asset or by-products resulting from the use of an asset).

Right to direct the use of the identified asset

BC119 IFRS 16 clarifies that a customer has the right to direct the use of an asset if it has the right to direct how and for what purpose the asset is used throughout the period of use (ie the right to make relevant decisions about how and for what purpose the asset is used throughout the period of use). If the supplier has that right, the supplier directs the use of the asset and, thus, no lease exists.

BC120 In the IASB's view, the decisions about how and for what purpose an asset is used are more important in determining control of the use of an asset than other decisions to be made about use, including decisions about operating and maintaining the asset. This is because decisions about how and for what purpose an asset is used determine how, and what, economic benefits are derived from use. How and for what purpose an asset is used is a single concept, ie 'how' an asset is used is not assessed separately from 'for what purpose' an asset is used. Decisions regarding operating an asset are generally about implementing the decisions about how and for what purpose an asset is used and are dependent upon (and subordinate to) those decisions. For example, a supplier's operational decisions would have no effect on the economic benefits derived from use of an asset if the customer decides that the asset should not be used. In addition, if the supplier makes decisions about operating or maintaining an underlying asset, it often does so to protect its interest in that asset. The IASB observed that considering decisions about how and for what purpose an asset is used can be viewed as similar to considering the decisions made by a board of directors when assessing control of the entity. Decisions made by a board of directors about the operating and financing activities

of an entity are generally the decisions that matter in that control assessment, rather than the actions of individuals in implementing those decisions.

BC121 The IASB noted that, in some cases, decisions about how and for what purpose an asset is used are predetermined and cannot be made by either the customer or the supplier during the period of use. This could happen if, for example, all decisions about how and for what purpose an asset is used are agreed between the customer and supplier in negotiating the contract and cannot be changed after the commencement date, or are, in effect, predetermined by the design of the asset. The IASB noted that it would expect decisions about how and for what purpose an asset is used to be predetermined in relatively few cases.

BC122 The approach to determining whether a customer has the right to direct the use of an identified asset changes if the decisions about how and for what purpose an asset is used are predetermined. IFRS 16 clarifies that, if decisions about how and for what purpose an asset is used are predetermined, a customer can still direct the use of an asset if it has the right to operate the asset, or if it designed the asset in a way that predetermines how and for what purpose the asset will be used. In either of these cases the customer controls rights of use that extend beyond the rights of a customer in a typical supply or service contract (ie the customer has rights that extend beyond solely ordering and receiving output from the asset). In these cases, the customer has the right to make (or has made in the case of design) decisions that affect the economic benefits to be derived from use of the asset throughout the period of use. Although the IASB thinks that each of these cases represents a scenario in which the customer directs the use of an asset, it expects that, for most leases, the assessment of whether a customer directs the use of an asset will be based on identifying the party that decides how and for what purpose an asset is used.

BC123 IFRS 16 also clarifies that only decisions made during the period of use (and not before the period of use) should be considered in the control assessment, unless the customer designed the asset in a way that predetermines how and for what purpose the asset will be used. In the IASB's view, if a customer specifies the output from an asset at or before the beginning of the period of use (for example, within the terms of the contract), and cannot change that specification during the period of use, it generally does not control the use of an asset. In that case, it would have no more decision-making rights than any customer in a typical supply or service contract.

BC124 In addition, IFRS 16 provides application guidance about protective rights—for example, terms and conditions included in the contract to protect the supplier's interest in the underlying asset or other assets, to protect its personnel or to ensure the supplier's compliance with applicable laws and regulations. In the IASB's view, such protective rights define the scope of the rights obtained by a customer without preventing a customer from having the right to direct the use of that asset. Accordingly, protective rights may affect the price paid for the lease (ie a lessee may pay less for the use of the asset if it is more restricted in its use of that asset). However, protective rights generally would not affect the existence of the customer's right to direct the use of the asset.

Other approaches considered for the definition of a lease

BC125 In developing IFRS 16, the IASB considered alternatives suggested by stakeholders regarding the definition of a lease. The main alternatives considered are described below:

(a) *Financing component*: the IASB considered requiring a lease to be a financing arrangement for the right to use an asset. In other words, there would have to be a clearly identifiable financing component for a contract to contain a lease. However, the IASB did not adopt this approach because:

(i) in the IASB's view, it is appropriate to focus on whether the customer has obtained control of a right-of-use asset to determine whether a contract contains a lease. The right-of-use asset gives rise to a corresponding lease liability if payments are made over time, but exists even if there is no lease liability (for example, when lease payments are fully prepaid). If an entity

obtains the right to use an asset for a period of time, the contract contains a lease, regardless of the timing of payments for that right of use. The focus on the asset obtained in a lease also distinguishes leases from other contracts, such as service or supply arrangements.

(ii) many of the suggested indicators of 'financing arrangements' focus on the form of the payments, and on those payments being similar to payments within a loan agreement. The IASB was concerned that if it focused on the form of an arrangement, rather than its substance:

(A) many existing leases, including many existing finance leases and property leases, would no longer meet the definition of a lease, even when it is clear that the customer has obtained a right of use at contract commencement.

(B) it would be relatively easy to structure a contract to fail to meet the definition of a lease by, for example, changing the payment structure, while not changing the customer's right to use an asset.

(b) *IFRS 15*: the IASB considered whether to link the requirements on the definition of a lease more closely to the requirements in IFRS 15, in particular the requirements on whether a good or service is 'distinct'. Applying such an approach, the concept of 'distinct' could have been used to distinguish between contracts that contain distinct lease and service components (that an entity should unbundle and account for separately) and those that do not contain distinct lease and service components (and therefore would be accounted for entirely as a contract for services). The IASB did not adopt this approach because:

(i) the 'distinct' requirements in IFRS 15 were developed to address a different objective from that of identifying a lease. They were developed to identify the nature of an entity's promises in a contract with a customer to ensure the most appropriate allocation and recognition of revenue. In contrast, the lease definition requirements aim to identify whether a customer has obtained the right to use an asset and, therefore, should recognise the assets and liabilities associated with that transaction. Because the 'distinct' requirements in IFRS 15 were developed for a different purpose, applying those requirements might have resulted in customers failing to recognise items that meet the conceptual definition of assets and liabilities (see paragraphs BC22–BC27). The IASB thinks that control is a more appropriate basis on which to make this determination.

(ii) the IASB was concerned that a requirement to determine whether lease and service components were distinct would add unnecessary complexity to the guidance. This is because such an approach was expected to result in little difference in outcomes and yet would have included an additional requirement that could have been complicated to interpret and apply within the context of leases.

(c) *Stand-alone utility*: the IASB considered whether to specify that a customer controls the use of an asset only if that asset has stand-alone utility to the customer, ie only if the customer has the ability to derive the economic benefits from use of an asset, either on its own or together with other resources that could be sourced in a reasonable period of time. The IASB decided not to add this criterion because:

(i) the additional criterion is not necessary to appropriately determine if a customer controls the use of an asset. Such an approach is not used elsewhere in IFRS when assessing control of an asset, such as the purchase of an item of property, plant and equipment.

(ii) entities might reach different conclusions for contracts that contain the same rights of use, depending on differences in customers' resources or suppliers' business models.

(iii) assessing whether the criterion had been met would have been subjective and required judgement beyond that required to apply the definition of a lease in IFRS 16. It may also have had unintended consequences. In addition, the IASB did not identify any existing scenarios for which the inclusion of such a criterion would have been expected to change the lease conclusion. Consequently, the IASB concluded that the costs of including such a criterion would outweigh any possible benefits.

(d) *Substantial services*: the IASB considered whether to require an entity to account for a contract with lease and service components entirely as a service if the service components are substantial and are the predominant portion of the overall contract. The IASB decided not to include this requirement. Again, in the IASB's view, if a contract conveys to the customer the right to use an asset, the contract contains a lease. The presence of services, no matter how substantial, does not change the rights of use that a lessee obtains. The IASB was concerned that similar rights of use could be accounted for differently because services of a more significant value had been bundled together with some right-of-use assets and not with others.

Assessing whether a contract contains a lease when the customer is a joint arrangement

BC126 When two or more parties form a joint arrangement of which they have joint control as defined in IFRS 11 *Joint Arrangements*, those parties can decide to lease assets to be used in the joint arrangement's operations. The joint arrangement might be a joint venture or a joint operation. The contract might be signed by the joint arrangement itself if the joint arrangement has its own legal identity, or it might be signed by one or more of the parties to the joint arrangement on behalf of the joint arrangement. In these cases, the IASB decided to clarify that an entity should consider the joint arrangement to be the customer when assessing whether the contract contains a lease applying paragraphs 9–11 of IFRS 16—ie the parties to the joint arrangement should not each be considered to be a customer. Accordingly, if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use through their joint control of the arrangement, the contract contains a lease. In that scenario, it would be inappropriate to conclude that a contract does not contain a lease on the grounds that each of the parties to the joint arrangement either obtains only a portion of the economic benefits from use of the underlying asset or does not unilaterally direct the use of the underlying asset.

Cancellable leases

BC127 For the purposes of defining the scope of IFRS 16, the IASB decided that a contract would be considered to exist only when it creates rights and obligations that are enforceable. Any non-cancellable period or notice period in a lease would meet the definition of a contract and, thus, would be included as part of the lease term. 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; for example the lessee must be able to enforce its right to extend the lease beyond the non-cancellable period. 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. Consequently, by definition, there is no contract beyond the non-cancellable period (plus any notice period) if there are no enforceable rights and obligations existing between the lessee and lessor beyond that term. 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.

BC128 Accordingly, if the lessee has the right to extend or terminate the lease, there are enforceable rights and obligations beyond the initial non-cancellable period and the parties to the lease would be required to consider those optional periods in their assessment of the lease term. In contrast, a lessor's right to terminate a lease is ignored when determining the lease term because, in that case, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease.

BC129 The IASB considered whether applying enforceability to leases in this way might encourage entities to add a clause to a lease that does not have economic substance, for example, stating that the lease could be cancelled at any point, knowing that, in practice, it would not be cancelled. However, the IASB is of the view that such clauses are unlikely to be added because there often is an economic disincentive for either the lessor or lessee to agree to their inclusion. For example, if a lessor has priced a contract assuming that the lessee will not cancel the contract, including such a clause would put the lessor at risk of being exposed to higher residual asset risk than had been anticipated when pricing the contract, which would be an economic disincentive for the lessor. Conversely, if the lessor has priced the contract assuming that the lessee will or may cancel the contract, the lessee would be likely to have to pay higher rentals to compensate the lessor for taking on more residual asset risk. Those higher rentals would be an economic disincentive for the lessee, if it does not intend to cancel the contract.

Combination of contracts (paragraph B2)

BC130 The IASB noted that, although it is usually appropriate to account for contracts individually, it is also necessary to assess the combined effect of contracts that are interdependent. An entity may enter into a number of contracts in contemplation of one another such that the transactions, in substance, form a single arrangement that achieves an overall commercial objective that cannot be understood without considering the contracts together. For example, assume that a lessee enters into a one-year lease of an asset with particular characteristics. The lessee also enters into a one-year lease for an asset with those same characteristics starting in one year's time and a similar forward contract starting in two years' time and in three years' time. The terms and conditions of all four contracts are negotiated in contemplation of each other such that the overall economic effect cannot be understood without reference to the series of transactions as a whole. In effect, the lessee has entered into a four-year lease. In such situations, accounting for the contracts independently of each other might not result in a faithful representation of the combined transaction.

BC131 The IASB noted that some view the concept of faithful representation in the *Conceptual Framework* as sufficient to identify the circumstances in which contracts should be combined. However, in the IASB's view, it is beneficial to add more clarity as to when to combine contracts within the context of leases, particularly with respect to sale and leaseback transactions, short-term leases and leases of low-value assets.

BC132 Consequently, the IASB decided to specify in IFRS 16 circumstances in which contracts should be combined and accounted for as a single contract. The requirements are similar to those in IFRS 15 and consistent with the concepts proposed in the *Conceptual Framework* Exposure Draft.

Separating components of a contract (paragraphs 12–17 and B32–B33)

BC133 Some contracts contain both lease and non-lease (service) components. For example, a contract for a car may combine a lease with maintenance services. In addition, many contracts contain two or more lease components. For example, a single contract may include leases of land, buildings and equipment.

Separating lease components

BC134 IFRS 16 contains requirements for determining whether a contract that contains a lease has only one lease component or a number of lease components. The IASB noted that the identification of separate lease components in a lease contract is similar to the identification of performance obligations in a revenue contract—in both circumstances, an entity is trying to identify whether a customer or a lessee is contracting for a number of separate deliverables or contracting for one deliverable that may incorporate a number of different assets. Accordingly, rather than developing new requirements addressing how to identify separate lease components, the IASB decided to include in IFRS 16 requirements similar to those in IFRS 15 on the identification of performance obligations. The IASB intends that those requirements in IFRS 16 are applied in a similar way to their application within the context of a revenue contract in IFRS 15.

Separating lease and non-lease components

BC135 The objective of the Leases project is to change the accounting for leases—not the accounting for services. The IASB, therefore, took the view that IFRS 16 should apply only to the lease components of any contract. The accounting for services (or the service components of a contract) should not be affected, regardless of whether the contract is only for services or includes the purchase, or lease, of an asset as well as services. Accordingly, IFRS 16 requires:

(a) a lessor to separate lease components and non-lease components of a contract. On the basis of feedback received from lessors, the IASB concluded that a lessor should be able to separate payments made for lease and non-lease components. This is because the lessor would need to have information about the value of each component, or a reasonable estimate of it, when pricing the contract.

(b) a lessee to separate lease components and non-lease components of a contract, unless it applies a practical expedient whereby it is not required to separate a lease component from any associated non-lease components and can instead elect to treat these as a single lease component. The IASB decided to permit this practical expedient for cost benefit reasons and in response to requests from preparers not to require separation in all scenarios. In the IASB's view, the practical expedient will reduce cost and complexity for some lessees, while not creating significant issues of comparability. This is because, in general, a lessee is not expected to adopt the practical expedient for contracts with significant service components because that would significantly increase the lessee's lease liabilities for those contracts. The IASB expects that lessees are likely to adopt this practical expedient only when the non-lease components of a contract are relatively small.

BC136 IFRS 16 requires a lessor to allocate the consideration in a contract to lease components and non-lease components applying the requirements in IFRS 15 on allocating the transaction price to performance obligations. This approach will ensure consistency for entities that are both a lessor and a seller of goods or services in the same contract. The IASB concluded that the approach applied by a lessor should not be different from the approach applied by a seller to allocate consideration in a revenue contract with more than one performance obligation.

BC137 If a lessee separates lease and non-lease components of a contract, IFRS 16 requires the lessee to allocate the consideration to those components on the basis of the relative stand-alone price of each lease component and the aggregate stand-alone price of the non-lease components. The IASB acknowledged that the stand-alone price of lease and non-lease components might not be readily available and, consequently, decided to permit the use of estimates, maximising the use of observable information. In the IASB's view, the use of estimated stand-alone prices by a lessee, if observable prices are not readily available, addresses some of the most significant concerns raised by both lessors and lessees with respect to the separation of lease and non-lease components: lessors had expressed concerns about providing pricing information to lessees and lessees had expressed concerns that obtaining observable stand-alone pricing information that is not readily available could be

onerous and costly. The IASB also observed that applying the previous requirements in IAS 17, a lessee had been required to allocate the consideration in a contract between lease and non-lease components using estimates of the relative fair value of those components. The IASB was not aware of any significant practical difficulties in applying those requirements.

Distinguishing between a lease and a sale or purchase

BC138 The IASB considered whether to include requirements in IFRS 16 to distinguish a lease from the sale or purchase of an asset. The IFRS Interpretations Committee had received questions about whether particular contracts that do not transfer legal title of land should be considered to be a lease or a purchase of the land.

BC139 The IASB decided not to provide requirements in IFRS 16 to distinguish a lease from a sale or purchase of an asset. There was little support from stakeholders for including such requirements. In addition, the IASB observed that:

(a) the accounting for leases that are similar to the sale or purchase of the underlying asset would be similar to that for sales and purchases applying the respective requirements of IFRS 15 and IAS 16; and

(b) accounting for a transaction depends on the substance of that transaction and not its legal form. Consequently, if a contract grants rights that represent the in-substance purchase of an item of property, plant and equipment, those rights meet the definition of property, plant and equipment in IAS 16 and would be accounted for applying that Standard, regardless of whether legal title transfers. If the contract grants rights that do not represent the in-substance purchase of an item of property, plant and equipment but that meet the definition of a lease, the contract would be accounted for applying IFRS 16.

BC140 IFRS 16 applies to contracts that convey the right to use an underlying asset for a period of time and does not apply to transactions that transfer control of the underlying asset to an entity—such transactions are sales or purchases within the scope of other Standards (for example, IFRS 15 or IAS 16).

Recognition and the date of initial measurement: lessee (paragraphs 22–23 and 26)

Inception versus commencement of a lease

BC141 IFRS 16 requires a lessee to initially recognise and measure right-of-use assets and lease liabilities at the commencement date (ie the date on which the lessor makes the underlying asset available for use by the lessee).

BC142 Recognising assets and liabilities arising from a lease at the commencement date is consistent with the lessee accounting model, in which a lessee recognises an asset representing its right to use an underlying asset for the period of the lease and a liability representing its obligation to make lease payments. A lessee does not obtain and control its right to use the underlying asset until the commencement date. Before that date, the lessor has not yet performed under the contract. Although a lessee may have a right and an obligation to exchange lease payments for a right-of-use asset from the date of inception, the lessee is unlikely to have an obligation to make lease payments before the asset is made available for its use. The IASB noted that an obligation to exchange payments for a right-of-use asset could be onerous if the terms of the exchange are unfavourable. In such circumstances, a lessee could have an onerous contract liability before the commencement date. That liability would be accounted for consistently with other onerous contracts applying IAS 37.

BC143 The IASB noted that its intentions with respect to initial measurement of right-of-use assets and lease liabilities were that the measurement would reflect the nature of the transaction and the terms and conditions of the lease. That would require a lessee to look to the terms and conditions agreed to in the contract at the inception date (which could be before the commencement date). However, if the inception date was considered to be the date of initial measurement, that could result in a lessee recognising a gain or loss relating to changes between the dates of inception and commencement when recognising lease assets and lease liabilities at the commencement date. Therefore, the IASB decided to align the date of recognition with the date of initial measurement of right-of-use assets and lease liabilities.

BC144 The IASB noted that this approach has the following benefits:

(a) it clarifies that a gain or loss should not arise on initial recognition of right-of-use assets and lease liabilities by a lessee.

(b) it removes the need to add requirements (and thus potentially increase complexity) on how to account for changes to the terms and conditions of a lease, or assumptions used in measuring right-of-use assets and lease liabilities, between the inception date and the commencement date. Any changes to a lease that occur after the inception date and before the commencement date are taken into account when initially measuring the right-of-use asset and lease liability at the commencement date.

(c) it is more consistent with the measurement date for other transactions, such as the acquisition of property, plant and equipment.

Measurement: lessee (paragraphs 23–46B)

Measurement bases of the right-of-use asset and the lease liability

BC145 The IASB decided to require a cost measurement basis for the right-of-use asset and lease liability, with cost measured by reference to the present value of the lease payments. The IASB concluded that this approach will provide useful information to users of financial statements. This is because it is consistent with the approach used to measure other similar assets and liabilities and thus is expected to result in more comparable information than other approaches. The IASB also concluded that using a cost measurement basis will be less costly for preparers than other approaches.

BC146 The IASB considered whether to refer to other Standards rather than specify in IFRS 16 the initial and subsequent measurement of the right-of-use asset and lease liability. The IASB did not adopt an approach that would refer to other Standards because:

(a) the approach would have been inconsistent with the IASB's decision not to apply a components approach to lease accounting (see paragraph BC153). For example, if a lessee were to account for all of the features of a lease applying other Standards, the requirements on financial instruments may have routinely required options in a lease to be accounted for separately.

(b) the approach could have been complex to apply, particularly when a lease contains relatively common features such as extension options, variable lease payments and residual value guarantees.

Initial measurement of the right-of-use asset (paragraphs 23–25)

BC147 The IASB decided that a lessee should measure the right-of-use asset at cost, defined as:

(a) the present value of the lease payments;

(b) any initial direct costs incurred by the lessee (see paragraphs BC149–BC151); and

(c) an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

BC148 The IASB considered whether a lessee should initially measure the right-of-use asset at fair value, which may provide more relevant information about the economic benefits to be derived from use of the underlying asset. However, initial measurement of a right-of-use asset at cost is consistent with the measurement of many other non-financial assets, such as assets within the scope of IAS 16 and IAS 38. Measuring right-of-use assets on a basis similar to that used to measure the underlying asset maintains the comparability of amounts reported for leased and owned assets, which contributes to the usefulness of the information provided to users of financial statements. Furthermore, measuring the right-of-use asset at cost is less complex and less costly for entities than measuring that asset at fair value, because there often is not an active market for right-of-use assets. The IASB thinks that, for many leases, a cost measurement basis will also provide a reasonable approximation of the fair value of the right-of-use asset at the commencement date.

Initial direct costs (paragraph 24(c))

BC149 IFRS 16 requires a lessee to include initial direct costs in the initial measurement of the right-of-use asset and depreciate those costs over the lease term. Including initial direct costs in the measurement of the right-of-use asset is consistent with the treatment of costs associated with acquiring other non-financial assets (for example, property, plant and equipment and intangible assets).

BC150 The IASB decided that lessees and lessors should apply the same definition of initial direct costs. This decision was made primarily to reduce complexity in applying IFRS 16. As described in paragraph BC237, the IASB also decided that the definition of initial direct costs for lessors should be consistent with the definition of ‘incremental costs’ in IFRS 15. Consequently, IFRS 16 defines initial direct costs as incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained.

BC151 The IASB considered whether initial direct costs incurred by lessees should be allocated between the right-of-use asset and the lease liability at the commencement date. However, the IASB concluded that such an approach could be costly for entities to apply, with little incremental benefit for users of financial statements.

Initial measurement of the lease liability

Lease term: options to extend or terminate a lease (paragraphs 18–19)

BC152 Leases often grant the lessee a right to extend a lease beyond the non-cancellable period, or to terminate a lease before the end of the lease period. Depending on the terms and conditions of the option, a three-year lease with an option to extend for two years could be economically similar to a three-year non-cancellable lease or a five-year non-cancellable lease. However, a lease with options would never be exactly the same as a lease without any options.

BC153 There are a number of different ways that an entity could reflect duration-related options that exist in leases:

(a) *a components approach*, in which options in a lease are recognised and measured as separate components of the lease. The IASB did not adopt a components approach because it would have created a complex lease accounting model, would have been difficult to apply because options may be difficult to measure, and would have ignored the interrelationship between the term of a lease and the exercise of options.

(b) *a disclosure approach*, in which an entity recognises a lease liability or a lease receivable for the non-cancellable period and discloses the existence of any options to extend the term. Although simple to apply, the IASB did not adopt this approach because the measurement of lease assets and lease liabilities would ignore the existence of options, including those that are virtually certain to be exercised. Consequently, this approach would potentially misrepresent the assets and liabilities arising from a lease.

(c) *a measurement approach*, in which options in a lease are included in the measurement of lease assets and lease liabilities using a particular method. That method could be, for example:

(i) a probability-weighted measurement method (in which the measurement of lease assets and lease liabilities reflects the probability of each possible lease term);

(ii) a probability threshold method (in which an entity includes optional periods in the lease term if the exercise of the options meets a specified threshold, for example reasonably certain, virtually certain or more likely than not); or

(iii) an economic incentive method (in which an entity includes optional periods in the lease term if an entity has an economic incentive to exercise the option).

BC154 Different views were expressed on whether optional periods should be included within an entity's determination of the lease term. Some stakeholders were of the view that payments to be made during future optional periods do not meet the definition of a liability for the lessee (or an asset for the lessor) until those options are exercised. This is because, before the exercise date, a lessee can avoid those payments by choosing to exercise a termination option or not to exercise an extension option. These stakeholders suggested limiting the lease term to the contractually committed period, ie the non-cancellable period. In addition, some stakeholders expressed concerns that including future optional periods within the lease term would not distinguish between, for example, a five-year non-cancellable lease and a three-year lease with an option to extend for two years. In their view, an entity with a five-year non-cancellable lease is in a different economic position from an entity with a three-year lease with an option to extend for two years that may or may not be exercised.

BC155 Conversely, many stakeholders thought that because options to extend or terminate leases affect the economics of those leases, there is a need to include some options when determining the lease term. If a lessee expects to exercise an option to extend the lease term, some think that including that longer lease term in the measurement of the right-of-use asset and lease liability would provide a more faithful representation of the economics of the lease. Inclusion of some renewal options is also needed to mitigate the risk of lessees inappropriately excluding lease liabilities from the balance sheet (for example, by excluding lease payments in optional periods for which the lessee has a clear economic incentive to exercise those options).

BC156 In the IASB's view, the lease term should reflect an entity's reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information. Over the course of the Leases project, the IASB considered a number of ways of determining that reasonable expectation of what the term will be. These included:

(a) requiring an entity to determine the lease term as the longest possible term that is more likely than not to occur. Many stakeholders disagreed with this approach because, in their view, it would have been complex to apply to thousands of leases (which some entities have), and it would include payments in optional periods, which many stakeholders did not view as liabilities.

(b) requiring an entity to include in the lease term optional periods for which the lessee has a significant economic incentive to exercise an option. Under this approach, an expectation of exercise alone (and without any economic incentive to do so) would not be sufficient. The IASB noted that requiring an economic incentive provides a threshold that is more objective than a threshold based solely on management's estimates or intention, and consequently would help to address concerns that other approaches would be complex to apply. However, stakeholders were concerned about the costs of implementing any new concept regarding the lease term, particularly for entities with decentralised leasing operations and large volumes of leases with diverse individual lease term clauses. These stakeholders also asked whether a significant economic incentive threshold was similar to the 'reasonably certain' threshold that existed in IAS 17. They suggested that, if the IASB viewed the 'significant economic incentive' threshold as similar to the 'reasonably certain' threshold in IAS 17, the IASB should retain the terminology in IAS 17. They argued that the IAS 17 terminology was well understood, which would help to achieve consistent application between entities.

BC157 In the light of the feedback received, the IASB decided to retain the concept in IAS 17 that the lease term used to measure a lease liability should include optional periods to the extent that it is reasonably certain that the lessee will exercise its option to extend (or not to terminate) the lease. The IASB observed that applying the concept of 'reasonably certain' requires judgement and, therefore, also decided to provide application guidance in IFRS 16 to help entities to apply this concept. Accordingly, when initially determining the lease term, an entity should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise that option. The IASB decided to include guidance on the types of facts and circumstances that an entity should consider for two reasons:

(a) to help entities identify the relevant factors, which are not confined to the contractual payments during the optional periods. For example, within the context of property leases, the IASB noted the relevance of considering the costs of finding a new location at the end of the non-cancellable period and of relocating to that new location, or the importance of the location (for example, a head office or a flagship store) to the lessee.

(b) to reduce the risk of non-substantive break clauses being inserted within contracts solely to reduce the lease term beyond what is economically reasonable for the lessee.

BC158 The IASB observed that a lessee is sometimes obliged to choose between one or more options in a lease contract, each of which will result in an outflow of economic benefits for the lessee. In such cases, a lessee considers how the arrangement is most faithfully represented in the financial statements. For example, a lease contract might contain a set of options that results in:

(a) a choice for the lessee that represents an in-substance fixed payment. This might be the case, for example, if a lessee has the choice of either exercising an option to extend a lease or purchasing the underlying asset. The set of payments that aggregate to the lowest amount (on a discounted basis) from the available realistic

options is the minimum amount that the lessee is obliged to pay. In the IASB's view, this minimum amount is an in-substance fixed payment that should be recognised as part of the cost of the right-of-use asset and as a liability by the lessee (see paragraph B42(c) of IFRS 16).

(b) a choice for the lessee that represents a guarantee provided to the lessor under which the lessee guarantees the lessor a minimum or fixed cash return regardless of whether an option is exercised. Such a situation might occur, for example, if an extension option is associated with a residual value guarantee or a termination penalty under which the lessor is guaranteed to receive an economic inflow at least equivalent to the payments that would be made by the lessee during the optional period. In the IASB's view, such an arrangement creates an economic incentive for the lessee to exercise the option to extend (or not to terminate) the lease (see paragraph B38 of IFRS 16).

BC159 Subsequent measurement of options to extend or terminate a lease is discussed in paragraphs BC184–BC187.

Discount rate (paragraph 26)

BC160 The IASB's objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced. With this in mind, the IASB decided that, if readily determinable by the lessee, a lessee should use the interest rate implicit in the lease.

BC161 The interest rate implicit in the lease is likely to be similar to the lessee's incremental borrowing rate in many cases. This is because both rates, as they have been defined in IFRS 16, take into account the credit standing of the lessee, the length of the lease, the nature and quality of the collateral provided and the economic environment in which the transaction occurs. However, the interest rate implicit in the lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor, such as any initial direct costs of the lessor. Consequently, the IASB noted that it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease.

BC162 Accordingly, IFRS 16 requires a lessee to discount the lease liability using the interest rate implicit in the lease if that rate can be readily determined. If the interest rate implicit in the lease cannot be readily determined, then the lessee should use its incremental borrowing rate. In reaching this decision, the IASB decided to define the lessee's incremental borrowing rate to take into account the terms and conditions of the lease. The IASB noted that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point when determining its incremental borrowing rate for a lease (for example, the rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases). Nonetheless, a lessee should adjust such observable rates as is needed to determine its incremental borrowing rate as defined in IFRS 16.

Lease payments

Variable lease payments (paragraph 27(a)–(b))

BC163 Some or all of the lease payments for the right to use an asset during the lease term can be variable. That variability arises if lease payments are linked to:

(a) price changes due to changes in a market rate or the value of an index. For example, lease payments might be adjusted for changes in a benchmark interest rate or a consumer price index.

(b) the lessee's performance derived from the underlying asset. For example, a lease of retail property may specify that lease payments are based on a specified percentage of sales made from that property.

(c) the use of the underlying asset. For example, a vehicle lease may require the lessee to make additional lease payments if the lessee exceeds a specified mileage.

Variable lease payments that are in-substance fixed lease payments

BC164 In-substance fixed lease payments are payments that may, in form, contain variability but that in substance are unavoidable. IFRS 16 requires a lessee to include in-substance fixed lease payments in the measurement of lease liabilities because those payments are unavoidable and, thus, are economically indistinguishable from fixed lease payments. The IASB understands that this approach is similar to the way in which entities applied IAS 17, even though IAS 17 did not include explicit requirements in this respect. In response to requests from stakeholders, IFRS 16 also includes examples in the application guidance of the types of payments that are considered to be in-substance fixed payments to help in applying the requirement.

Variable lease payments that depend on an index or a rate

BC165 For similar reasons, the IASB decided to include variable lease payments that depend on an index or a rate in the measurement of lease liabilities. Those payments meet the definition of liabilities for the lessee because they are unavoidable and do not depend on any future activity of the lessee. Any uncertainty, therefore, relates to the measurement of the liability that arises from those payments and not to the existence of that liability.

BC166 In the IASB's view, forecasting techniques could be used to determine the expected effect of changes in an index or a rate on the measurement of lease liabilities. However, forecasting changes in an index or a rate requires macroeconomic information that may not be readily available to all entities, and may result in measurement uncertainty. The IASB noted that the usefulness of the enhanced information obtained using such a forecast often might not justify the costs of obtaining it, particularly for those lessees with a high volume of leases. The IASB considered requiring a lessee to use forward rates when measuring lease liabilities if those rates are readily available. However, it decided not to do so because this would reduce comparability between those using forward rates and those not doing so. Consequently, at initial recognition, IFRS 16 requires a lessee to measure payments that depend on an index or a rate using the index or rate at the commencement date (ie a lessee does not estimate future inflation but, instead, measures lease liabilities using lease payments that assume no inflation over the remainder of the lease term).

BC167 Subsequent measurement of variable lease payments that depend on an index or a rate is discussed in paragraphs BC188–BC190.

Variable lease payments linked to future performance or use of an underlying asset

BC168 There are differing views about whether variable payments linked to future performance or use of an underlying asset meet the definition of a liability. Some think that a lessee's liability to make variable lease payments does not exist until the future event requiring the payment occurs (for example, when the underlying asset is used, or a sale is made). Others think that a lessee's obligation to make variable lease payments exists at the commencement date by virtue of the lease contract and receipt of the right-of-use asset. Consequently, they think that all variable lease payments meet the definition of a liability for the lessee because it is the amount of the liability that is uncertain, rather than the existence of that liability.

BC169 The IASB decided to exclude variable lease payments linked to future performance or use of an underlying asset from the measurement of lease liabilities. For some Board members, this decision was made solely for cost-benefit reasons. Those Board members were of the view that all variable lease payments meet the definition of a liability for the lessee. However, they

were persuaded by the feedback received from stakeholders that the costs of including variable lease payments linked to future performance or use would outweigh the benefits, particularly because of the concerns expressed about the high level of measurement uncertainty that would result from including them and the high volume of leases held by some lessees. Other Board members did not think that variable lease payments linked to future performance or use meet the definition of a liability for the lessee until the performance or use occurs. They regarded those payments to be avoidable by the lessee and, accordingly, concluded that the lessee does not have a present obligation to make those payments at the commencement date. In addition, variable lease payments linked to future performance or use could be viewed as a means by which the lessee and lessor can share future economic benefits to be derived from use of the asset.

Residual value guarantees (paragraph 27(c))

BC170 The IASB decided that a lessee should account for a residual value guarantee that it provides to the lessor as part of the lease liability (and as part of the cost of the right-of-use asset). In reaching this decision, the IASB noted that payments resulting from a residual value guarantee cannot be avoided by the lessee—the lessee has an unconditional obligation to pay the lessor if the value of the underlying asset moves in a particular way. Accordingly, any uncertainty relating to the payment of a residual value guarantee does not relate to whether the lessee has an obligation. Instead, it relates to the amount that the lessee may have to pay, which can vary in response to movements in the value of the underlying asset. In that respect, residual value guarantees are similar to variable lease payments that depend on an index or a rate for the lessee.

BC171 Therefore, the IASB decided that a lessee should estimate the amount expected to be payable to the lessor under residual value guarantees and include that amount in the measurement of the lease liability. In the IASB's view, the measurement of a residual value guarantee should reflect an entity's reasonable expectation of the amount that will be paid.

BC172 The IASB considered whether a lessee should recognise and measure residual value guarantees as separate components of a lease, because such guarantees are linked to the value of the underlying asset and may meet the definition of a derivative. However, the IASB noted that residual value guarantees are often interlinked with other terms and conditions in a lease so that accounting for the guarantees as separate components could diminish the relevance and faithful representation of the information provided. Recognising such guarantees separately could also be costly to apply.

Options to purchase the underlying asset (paragraph 27(d))

BC173 The IASB decided that purchase options should be included in the measurement of the lease liability in the same way as options to extend the term of a lease (ie the exercise price of a purchase option would be included in the measurement of a lease liability if the lessee is reasonably certain to exercise that option). This is because the IASB views a purchase option as effectively the ultimate option to extend the lease term. A lessee that has an option to extend a lease for all of the remaining economic life of the underlying asset is, economically, in a similar position to a lessee that has an option to purchase the underlying asset. Accordingly, the IASB concluded that, for the same reasons underlying the decision to include extension options, including the exercise price within the measurement of a lease liability if the lessee is reasonably certain to exercise the option provides the most useful information to users of financial statements.

Lease Incentives (Annual Improvements to IFRS Standards 2018–2020)

BC173A The Board was informed about the potential for confusion in applying IFRS 16 because of the way Illustrative Example 13 accompanying IFRS 16 had illustrated the requirements for lease incentives. Before the amendment, Illustrative Example 13 had included as part of the fact pattern a reimbursement relating to leasehold improvements; the example had not explained

clearly enough the conclusion as to whether the reimbursement would meet the definition of a lease incentive in IFRS 16.

BC173B The Board decided to remove the potential for confusion by deleting from Illustrative Example 13 the reimbursement relating to leasehold improvements. The Board concluded that little would be lost by deleting it.

Subsequent measurement of the right-of-use asset (paragraphs 29–35)

BC174 The IASB decided that, after the commencement date, a lessee should measure the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses, adjusted for remeasurements of the lease liability (see paragraph BC192). Paragraphs BC41–BC56 include a detailed discussion of the feedback received on the lessee accounting model and the basis for the IASB's decisions regarding the subsequent measurement of a lessee's right-of-use asset.

BC175 The IASB did not adopt an alternative approach whereby a lessee would be required to measure the right-of-use asset at fair value after initial measurement, because this approach would be:

(a) inconsistent with the subsequent measurement of many other non-financial assets; and

(b) more complex and costly for entities to apply than a cost-based approach, because it requires the use of both current expected cash flows and current interest rates.

Impairment of the right-of-use asset (paragraph 33)

BC176 The IASB decided that a lessee should apply the impairment requirements of IAS 36 to the right-of-use asset. In the IASB's view, this requirement enables users of financial statements to better compare assets that a lessee owns with those that it leases. In addition, it could be difficult for a lessee to implement an impairment model for right-of-use assets that is different from the model applied to other non-financial assets, particularly if a lessee is required to assess a group of assets (comprising both leased and owned assets) for impairment together.

Other measurement models for the right-of-use asset (paragraphs 34–35)

BC177 IFRS permits the revaluation of non-financial assets, such as property, plant and equipment. Accordingly, the IASB saw no reason not to allow a lessee to revalue right-of-use assets, albeit only if the lessee revalues similar classes of owned assets.

BC178 IFRS also permits investment properties to be measured at fair value. IAS 40 requires an entity to measure all investment property using the same measurement basis (either the cost model or the fair value model). This is because measuring all investment property on the same basis provides more useful information than allowing an entity to choose the measurement basis for each property. IFRS 16 has amended the scope of IAS 40 by defining investment property to include both owned investment property and investment property held by a lessee as a right-of-use asset. This results in lessees using either the cost model and disclosing fair value, or using the fair value model, depending on whether the lessee accounts for the remainder of its investment property under the cost model or the fair value model. In the IASB's view, this approach will provide useful information to users of financial statements about the fair value of investment property held by a lessee as a right-of-use asset, which is consistent with information provided about owned investment property.

BC179 Some stakeholders expressed concerns about the costs of determining the fair value of right-of-use assets (whether for disclosure or measurement purposes). The IASB acknowledged that there might be costs involved with determining the fair value of right-of-use assets, particularly for entities that are not in the property industry but sublease property, for example, because that property is not needed for use within their business. However, the IASB noted that there are two factors that will lessen the likelihood that entities that are not in the property industry will hold investment property as a right-of-use asset:

(a) IFRS 16 requires an entity to classify a sublease by reference to the right-of-use asset arising from the head lease (see paragraphs BC233–BC234). Consequently, an intermediate lessor would classify a sublease as a finance lease if it subleases the asset for all or most of the remaining term of the head lease. In those cases, the intermediate lessor would apply finance lease accounting (ie recognise a net investment in the sublease rather than the underlying right-of-use asset) and, thus, would not be required to apply the requirements of IAS 40. The IASB observed that entities that are not in the property industry that wish to reduce property costs would generally aim to secure a sublease for the entire remaining period of the head lease, which (if successful) would result in finance lease accounting.

(b) entities that are not in the property industry may not be within the scope of IAS 40 if they sublease a property under an operating lease with the intention of subsequently using the property within their own business. Such a property would not meet the definition of an investment property in IAS 40 because it would not be held solely for rentals, capital appreciation or both.

BC180 In the IASB's view it should be relatively straightforward to determine the fair value of right-of-use assets if the sublease does not contain any options or variable lease payments. Determining the fair value would involve projecting the cash flows that the entity expects to receive from subleasing the asset. The IASB concluded that, for an entity that is not in the property industry, determining these cash flows would normally be relatively straightforward because it is likely that a sublease would already be in place.

BC181 Some stakeholders asked that IAS 40 provide additional requirements on measuring the fair value of right-of-use assets if leases have variable and optional payments, or if there is no active market for the right-of-use asset. In the IASB's view, the principles in IFRS 13 *Fair Value Measurement* and IAS 40 are sufficient to help lessees to measure the fair value of those right-of-use assets. In particular, the IASB noted that paragraph 50(d) of IAS 40 explains when to include in the measurement of the right-of-use asset options and variable lease payments that are not included in the measurement of the lease liability.

Subsequent measurement of the lease liability (paragraphs 20–21 and 36–43)

BC182 The IASB decided that a lessee should measure lease liabilities similarly to other financial liabilities using an effective interest method, so that the carrying amount of the lease liability is measured on an amortised cost basis and the interest expense is allocated over the lease term.

BC183 IFRS 16 does not require or permit a lessee to measure lease liabilities at fair value after initial measurement. In the IASB's view, this approach would have been:

(a) inconsistent with the subsequent measurement of many other non-derivative financial liabilities, thus decreasing comparability for users of financial statements; and

(b) more complex and costly for entities to apply than a cost-based approach, because it requires the use of both current expected cash flows and current interest rates.

Reassessment of options (paragraph 20)

BC184 In principle, the IASB is of the view that users of financial statements receive more relevant information if lessees reassess extension, termination and purchase options on a regular basis. The resulting information is more relevant because reassessment reflects current economic conditions, and using a lease term established at the commencement date throughout the lease could be misleading.

BC185 However, requiring reassessment at each reporting date would be costly for an entity with many leases that include options. The IASB considered ways in which IFRS 16 could address that concern while still providing useful information to users of financial statements. It decided that an appropriate balance would be achieved by:

(a) requiring reassessment only upon the occurrence of a significant event or a significant change in circumstances that affects whether the lessee is reasonably certain to exercise, or not to exercise, an option to extend a lease, to terminate a lease or to purchase an underlying asset. The IASB noted that this requirement is similar in some respects to the approach taken for the impairment of long-lived assets (other than goodwill and indefinite-lived intangible assets) in IAS 36. IAS 36 does not require impairment testing at each reporting date. Instead, an entity tests for impairment when there has been an indication that the asset may be impaired.

(b) requiring reassessment only if the significant event or significant change in circumstances is within the control of the lessee. Limiting the reassessment requirement in this way means that a lessee is not required to reassess options in response to purely market-based events or changes in circumstances.

BC186 The IASB noted that an entity will need to apply judgement in identifying significant events or significant changes in circumstances that trigger reassessment and that it would be impossible to provide a list of all possible triggering events. Nonetheless, the IASB decided to provide some examples of possible triggering events to help entities apply that judgement.

BC187 The IASB considered but did not adopt the following approaches:

(a) *requiring a lessee to reassess options when there has been a change in facts or circumstances that would indicate that there is a significant change in the right-of-use asset or lease liability*. Many stakeholders thought that it could be difficult to interpret when a change in the right-of-use asset or lease liability is significant. In addition, stakeholders were concerned about both the costs of performing reassessment and, if relevant, the costs associated with demonstrating that reassessment was not required, which might be as costly as reassessing options at each reporting date.

(b) *requiring a lessee to reassess options when the lessee has, or no longer has, a significant economic incentive that would make exercise of an option reasonably certain*. Many stakeholders thought that the cost of applying this approach would exceed any benefit, because an entity might incur significant costs in continuously assessing and monitoring relevant factors that give rise to a significant economic incentive even though the lease term conclusion might not change.

Reassessment of variable lease payments that depend on an index or a rate (paragraph 42(b))

BC188 In principle the IASB is of the view that users of financial statements receive more relevant information about a lessee's lease liabilities if the lessee updates the measurement of its liabilities to reflect a change in an index or a rate used to determine lease payments (including, for example, a change to reflect changes in market rental rates following a market rent review). For example, without such remeasurement, the measurement of the lease liability for a 20-year property lease, for which lease payments are linked to an inflation index,

is unlikely to provide users of financial statements with useful information about the entity's future cash outflows relating to that lease throughout the lease term.

BC189 Some stakeholders expressed concerns about the cost of performing reassessments each time a rate or an index changes, and questioned whether the benefits for users of financial statements would outweigh the costs for lessees. For example, some stakeholders noted that the total expenses related to leases recognised in profit or loss by a lessee would be substantially the same, regardless of whether the lessee remeasures the lease liability for changes in an index or a rate.

BC190 In the light of this feedback, the IASB decided that a lessee should reassess variable lease payments that are determined by reference to an index or a rate only when there is a change in the cash flows resulting from a change in the reference index or rate (ie when the adjustment to the lease payments takes effect). The IASB noted that this approach is less complex and costly to apply than requiring a lessee to reassess variable lease payments at each reporting date. This is because a lessee would typically be expected to report its financial results more frequently than the occurrence of a contractual change in the cash flows of a lease with payments that depend on an index or a rate.

Reassessment of residual value guarantees (paragraph 42(a))

BC191 The IASB decided that lessees should reassess the amounts expected to be payable under residual value guarantees, because that provides more relevant information to users of financial statements, by reflecting current economic conditions.

Accounting for the effects of reassessing lease payments (paragraph 39)

BC192 The IASB decided that, if a lessee remeasures its lease liability to reflect changes in future lease payments, the lessee should recognise the amount of the remeasurement as an adjustment to the cost of the right-of-use asset. The IASB considered whether some changes to the measurement of the lease liability should be recognised in profit or loss because, for example, the reassessment of an option or a change in an index or a rate could be viewed as an event relating to the current period. However, the IASB decided that a lessee should recognise the remeasurement as an adjustment to the right-of-use assets for the following reasons:

(a) a change in the assessment of extension, termination or purchase options reflects the lessee's determination that it has acquired more or less of the right to use the underlying asset. Consequently, that change is appropriately reflected as an adjustment to the cost of the right-of-use asset.

(b) a change in the estimate of the future lease payments is a revision to the initial estimate of the cost of the right-of-use asset, which should be accounted for in the same manner as the initial estimated cost.

(c) the requirement to update the cost of the right-of-use asset is similar to the requirements in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*. IFRIC 1 requires an entity to adjust the cost of the related asset for a change in the estimated timing or amount of the outflow of resources associated with a change in the measurement of an existing decommissioning, restoration or similar liability.

Reassessment of the discount rate (paragraphs 41 and 43)

BC193 The IASB decided that, in most cases, an entity should not reassess the discount rate during the lease term. This approach is generally consistent with the approach applied to financial instruments accounted for using the effective interest method. The IASB noted that in other Standards in which the discount rate is required to be reassessed, it is typically because the liability to which the discount rate relates is measured on a current value measurement basis.

BC194 Nonetheless, in the IASB's view, there are some circumstances in which an entity should reassess the discount rate. Consequently, IFRS 16 requires a lessee to remeasure the lease liability using revised payments and a revised discount rate when there is a change in the lease term or a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset. In the IASB's view, in those circumstances, the economics of the lease have changed and it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of the lease liability (and right-of-use asset).

BC195 The IASB also decided that, in a floating interest rate lease, a lessee should use a revised discount rate to remeasure the lease liability when there is a change in lease payments resulting from changes in the floating interest rate. This approach is consistent with the requirements in IFRS 9 for the measurement of floating-rate financial liabilities subsequently measured at amortised cost.

Foreign currency exchange

BC196 IFRS 16 does not provide specific requirements on how a lessee should account for the effects of foreign currency exchange differences relating to lease liabilities that are denominated in a foreign currency. Consistently with other financial liabilities, a lessee's lease liability is a monetary item and consequently, if denominated in a foreign currency, is required to be remeasured using closing exchange rates at the end of each reporting period applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

BC197 Some stakeholders suggested that a lessee should recognise any foreign currency exchange differences as an adjustment to the carrying amount of the right-of-use asset. This approach would treat translation adjustments as an update to the cost of the right-of-use asset, which is initially measured on the basis of the initial measurement of the lease liability. These stakeholders are of the view that lease payments denominated in a foreign currency are in effect another form of variable lease payment, and should be accounted for similarly to variable lease payments that depend on an index or a rate. These stakeholders also questioned whether useful information will be obscured as a result of the profit or loss volatility that might arise as a result of recognising foreign currency exchange differences on a lessee's lease liability in profit or loss.

BC198 The IASB decided that any foreign currency exchange differences relating to lease liabilities denominated in a foreign currency should be recognised in profit or loss, for the following reasons:

(a) this approach is consistent with the requirements for foreign exchange differences arising from other financial liabilities (for example, loans and previous finance lease liabilities accounted for applying IAS 17).

(b) a lessee with a liability denominated in a foreign currency is exposed to foreign currency risk. Consequently, foreign currency exchange gains or losses recognised in profit or loss faithfully represent the economic effect of the lessee's currency exposure to the foreign exchange risk.

(c) if a lessee enters into derivatives to hedge its economic exposure to foreign currency risk, the recognition of foreign currency exchange differences relating to lease liabilities as an adjustment to the cost of right-of-use assets would prevent a natural offset of the economic exposure in profit or loss. This is because an entity would recognise any change in the foreign currency risk for the derivatives in profit or loss, whereas it would recognise the corresponding change in lease liabilities in the balance sheet—thus introducing volatility as a result of reducing exposure to foreign currency risk. This mismatch could distort the reported economic position of the lessee.

(d) in the IASB's view, subsequent changes to a foreign exchange rate should not have any effect on the cost of a non-monetary item. Consequently, it would be inappropriate to include such changes in the remeasurement of the right-of-use asset.

BC199 Although this approach could result in volatility in profit or loss from the recognition of foreign currency exchange differences, an entity would disclose those changes separately as foreign currency exchange gains or losses. Accordingly, it would be clear to users of financial statements that the gain or loss results solely from movements in foreign exchange rates. Because this approach is consistent with the requirements for foreign currency exchange differences in IAS 21, the IASB concluded that it was not necessary to include any specific requirements in IFRS 16.

Lease modifications (paragraphs 44–46B)

BC200 IAS 17 did not address the accounting for lease modifications. The IASB decided that it would be useful to include a general framework for accounting for lease modifications in IFRS 16 because modifications occur frequently for many types of leases.

BC201 The IASB decided to define a lease modification as a change in the scope of a lease (for example, 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, that was not part of the original terms and conditions of the lease. In defining lease modifications, the IASB differentiated between scenarios resulting in the remeasurement of existing lease assets and lease liabilities that are not lease modifications (for example, a change in lease term resulting from the exercise of an option to extend the lease when that option was not included in the original lease term) and those resulting in a lease modification (for example, a change in the lease term resulting from changes to the terms and conditions of the original lease).

BC202 The IASB decided that an entity should further distinguish between those lease modifications that, in substance, represent the creation of a new lease that is separate from the original lease and those that, in substance, represent a change in the scope of, or the consideration paid for, the existing lease. Consequently, IFRS 16 requires a lessee to account for a lease modification as a separate lease if the modification increases the scope of the lease by adding the right to use one or more underlying assets and the consideration paid for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

BC203 For those lease modifications that do not result in a separate lease, the IASB decided that a lessee should remeasure the existing lease liability using a discount rate determined at the effective date of the modification. The IASB decided that:

(a) for lease modifications that decrease the scope of a lease, a lessee should decrease the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease and recognise a corresponding gain or loss. In the IASB's view, this gain or loss appropriately reflects the economic effect of the partial or full termination of the existing lease resulting from the decrease in scope.

(b) for all other lease modifications, a lessee should make a corresponding adjustment to the carrying amount of the right-of-use asset. In these cases, the original lease is not terminated because there is no decrease in scope. The lessee continues to have the right to use the underlying asset identified in the original lease. For lease modifications that increase the scope of a lease, the adjustment to the carrying amount of the right-of-use asset effectively represents the cost of the additional right of use acquired as a result of the modification. For lease modifications that change the consideration paid for a lease, the adjustment to the carrying amount of the right-of-use asset effectively represents a change in the cost of the right-of-use asset as a result of the modification. The use of a revised discount rate in remeasuring the lease liability reflects that, in modifying the lease, there is a change in the interest rate implicit in the lease (which the discount rate is intended to approximate).

BC204 The IASB concluded that this approach results in accounting outcomes that faithfully represent the substance of a lease modification and will closely align gain or loss recognition with a corresponding change in the lessee's rights and obligations under the lease. This is because a lease gives rise to both a right-of-use asset and a lease liability. Accordingly, a lease modification can result in a change to the lessee's rights (ie a change to the right-of-use asset), a change to the lease liability, or both.

BC205 The IASB considered requiring a lessee to distinguish between changes to a lease that are substantial and those that are not substantial, in a manner similar to that required for contract modifications relating to financial liabilities within the scope of IFRS 9. This approach would require a lessee to account for the lease modification as (a) a new lease, when the change represents a substantial modification; or (b) a continuation of the original lease, when the change does not represent a substantial modification. However, the IASB did not adopt this approach because, as a result of the link to the right-of-use asset, it could result in outcomes that would not faithfully represent the differing nature of each of those changes. For example, there are scenarios in which this approach would result in the extinguishment of the original lease (and the recognition of a corresponding gain or loss in profit or loss) when the lessee continues to have all of the rights it had in the original lease after the modification.

Covid-19-related rent concessions

BC205A In May 2020 the Board provided a practical expedient that permits lessees not to assess whether rent concessions that occur as a direct consequence of the covid-19 pandemic and meet specified conditions are lease modifications and, instead, to account for those rent concessions as if they were not lease modifications. The Board provided the practical expedient in response to information about the effects of the covid-19 pandemic.

BC205B The Board was informed that many lessors are providing rent concessions to lessees as a result of the pandemic. The Board learned that lessees could find it challenging to assess whether a potentially large volume of covid-19-related rent concessions are lease modifications and, for those that are, to apply the required accounting in IFRS 16, especially in the light of the many challenges lessees face during the pandemic. Further, those challenges arising during the pandemic add to the work undertaken by lessees in implementing the new lessee accounting model in IFRS 16. The Board concluded that the practical expedient would provide relief to lessees, while enabling lessees to continue providing useful information about their leases to users of financial statements (see paragraph BC205F). To provide the relief when needed most, the Board enabled immediate application of the amendment in any financial statements—interim or annual—not authorised for issue at the date the amendment was issued.

BC205C The Board decided to permit, but not require, a lessee to apply the practical expedient. Some lessees (for example, those with systems to address changes in lease payments) may prefer to apply, or have already applied, the requirements in paragraphs 36–46 of IFRS 16 to all changes in lease contracts. A lessee that chooses to apply the practical expedient would be required by paragraph 2 of IFRS 16 to apply it consistently to all lease contracts with similar characteristics and in similar circumstances.

BC205D The Board considered the risk of the practical expedient being applied too broadly, which could result in unintended consequences. The Board therefore limited the scope of the practical expedient so that it applies only to rent concessions that occur as a direct consequence of the covid-19 pandemic and:

(a) result in revised consideration for the lease that is substantially the same as, or less than, the consideration for the lease immediately preceding the change. The Board was of the view that a rent concession that increases total payments for the lease should not be considered a direct consequence of the covid-19 pandemic, except to the extent the increase reflects only the time value of money.

(b) reduce only lease payments originally due on or before 30 June 2022.[2] The Board noted that a related increase in lease payments that extends beyond 30 June 2022 would not prevent a rent concession from meeting this condition. In contrast, if reductions in lease payments extend beyond 30 June 2022, the rent concession in its entirety would not be within the scope of the practical expedient. In developing this condition, the Board observed that the economic effects of the covid-19 pandemic could continue for some time. If the practical expedient were not limited to a particular time frame, a lessee could conclude that many future changes in lease payments would be a consequence of the covid-19 pandemic. Limiting the practical expedient to rent concessions that reduce only lease payments originally due on or before 30 June 2022 provides relief to lessees when they are expected to need it most, while being responsive to concerns from users of financial statements about comparability if lessees were to apply the practical expedient beyond when it is needed. The Board also expected the condition in paragraph 46B(b) to be easy to apply, and to help lessees in identifying rent concessions occurring as a direct consequence of the covid-19 pandemic.

(c) introduce no substantive change to other terms and conditions of the lease, considering both qualitative and quantitative factors. Consequently, if a modification to a lease incorporates other substantive changes—beyond a rent concession occurring as a direct consequence of the covid-19 pandemic—the modification in its entirety does not qualify for the practical expedient. The Board noted that, for example, a three-month rent holiday before 30 June 2022 followed by three additional months of substantially equivalent payments at the end of the lease would not constitute a substantive change to other terms and conditions of the lease.

BC205E The Board developed the practical expedient to relieve lessees from assessing whether rent concessions occurring as a direct consequence of the covid-19 pandemic are lease modifications and from applying the lease modification requirements to those concessions. The practical expedient does not otherwise interpret or change any requirements in IFRS 16. The Board observed therefore that a lessee would account for the lease liability and right-of-use asset applying the requirements in IFRS 16, which, for example, incorporate requirements in IAS 16 *Property, Plant and Equipment*. With this in mind, the Board considered how a lessee applying the practical expedient would account for three types of change in lease payments:

(a) a lessee applying the practical expedient would generally account for a forgiveness or waiver of lease payments as a variable lease payment applying paragraph 38 of IFRS 16. The lessee would also make a corresponding adjustment to the lease liability—in effect, derecognising the part of the lease liability that has been forgiven or waived.

(b) a change in lease payments that reduces payments in one period but proportionally increases payments in another does not extinguish the lessee's lease liability or change the consideration for the lease—instead, it changes only the timing of individual payments. In this case, applying paragraph 36 of IFRS 16, a lessee would continue to both recognise interest on the lease liability and reduce that liability to reflect lease payments made to the lessor.

(c) some covid-19-related rent concessions reduce lease payments, incorporating both a forgiveness or waiver of payments and a change in the timing of payments.

BC205F The Board was of the view that the information provided by a lessee that applies the practical expedient would be useful to users of financial statements, noting that the lease liability recognised would reflect the present value of future lease payments owed to the lessor. Users of financial statements supported a lessee recognising in profit or loss at the time of the

[2] In March 2021 the Board issued *Covid-19-Related Rent Concessions beyond 30 June 2021*, which amended the date in paragraph 46B(b) of IFRS 16 from 30 June 2021 to 30 June 2022 (see paragraphs BC205H–BC205J).

covid-19 pandemic the effects of a rent concession occurring as a direct consequence of the pandemic. Nonetheless, the Board acknowledged concerns from users of financial statements that the practical expedient, because it is optional, could affect comparability between lessees that apply the practical expedient and those that do not—disclosure of the effects of applying the practical expedient is therefore important to meet users' information needs. Consequently, the Board decided to require a lessee applying the practical expedient to some or all eligible contracts to disclose that fact, as well as the amount recognised in profit or loss to reflect changes in lease payments that arise from rent concessions to which the practical expedient is applied (paragraph 60A of IFRS 16).

BC205G Users of financial statements also highlighted the importance of cash flow information about covid-19-related rent concessions. The main effect on cash flows would be the reduction or absence of cash outflows for leases during the period of the rent concession. For a concession that adjusts the carrying amount of the lease liability, a lessee would disclose this effect as a non-cash change in lease liabilities applying paragraph 44A of IAS 7 *Statement of Cash Flows*. The Board noted that cash flow effects, and other information about, for example, the nature of rent concessions, would be relevant regardless of whether a lessee applies the practical expedient. The Board expected paragraphs 51 and 59 of IFRS 16 to require a lessee to disclose such information, if material.

Covid-19-related rent concessions beyond 30 June 2021

BC205H In March 2021 the Board issued *Covid-19-Related Rent Concessions beyond 30 June 2021* (the 2021 amendment), which extended the availability of the practical expedient in paragraph 46A of IFRS 16 by one year. The 2021 amendment resulted in the practical expedient applying to rent concessions for which any reduction in lease payments affects only payments originally due on or before 30 June 2022, provided the other conditions for applying the practical expedient are met.

BC205I The Board extended the availability of the practical expedient in response to stakeholder feedback about covid-19-related rent concessions being granted at the time of the 2021 amendment. The Board was informed that lessees continue to face challenges accounting for rent concessions, especially in the light of the many other challenges lessees face during the pandemic. Almost all stakeholders—including almost all users of financial statements—that provided feedback on the 2021 amendment supported extending the availability of the practical expedient. Users of financial statements agreed that the ongoing severity of the pandemic had not been envisaged when the Board originally developed the practical expedient in May 2020; they nonetheless highlighted the continued importance of limiting the availability of the practical expedient so that it can be used only when it is needed most. The Board acknowledged that lessees were no longer applying IFRS 16 for the first time, but concluded that, in all other respects, extending the scope of the practical expedient would be consistent with the Board's objectives when it originally developed the practical expedient in May 2020 (see paragraph BC205B).

BC205J The Board amended only the date within the condition in paragraph 46B(b)—it introduced neither a new practical expedient nor a new option to apply (or not apply) the practical expedient. In response to stakeholder feedback, the Board decided to highlight—in paragraph C20BC of IFRS 16—the relevance of paragraph 2 of IFRS 16 when first applying the 2021 amendment. Applying paragraph 2, a lessee that had already applied the practical expedient in paragraph 46A would be required to apply the extended scope of the practical expedient to eligible contracts with similar characteristics and in similar circumstances. Similarly, the 2021 amendment did not allow a lessee to elect to apply the practical expedient if the lessee did not apply the practical expedient to eligible rent concessions with similar characteristics and in similar circumstances, including those that reduce only lease payments due on or before 30 June 2021. At the time the Board issued the 2021 amendment, a lessee may not have established an accounting policy on applying (or not applying) the practical expedient to eligible rent concessions. Such a lessee could still decide to apply the practical expedient, however that lessee would be required to do so retrospectively and to apply it consistently to contracts with similar characteristics and in similar circumstances.

Presentation: lessee (paragraphs 47–50)

Statement of financial position (paragraphs 47–48)

BC206 The IASB decided that, if not presented separately in the balance sheet, right-of-use assets should be included within the same line item as similar owned assets. The IASB concluded that, if right-of-use assets are not presented as a line item, presenting similar leased and owned assets together would provide more useful information to users of financial statements than other approaches. This is because a lessee often uses owned assets and leased assets for the same purpose and derives similar economic benefits from the use of owned assets and leased assets.

BC207 However, the IASB noted that there are differences between a right-of-use asset and an owned asset, and that users of financial statements may want to know the carrying amount of each separately. For example, right-of-use assets may be viewed as being (a) less risky than owned assets, because a right-of-use asset may not embed residual asset risk; or (b) more risky than owned assets, because the lessee may need to replace the right-of-use asset at the end of the lease term, but may not be able to secure a similar rate for the replacement lease. Accordingly, IFRS 16 requires a lessee to provide information about the carrying amount of right-of-use assets separately from assets that are owned, either in the balance sheet or in the notes.

BC208 Similarly, the IASB decided that a lessee should present lease liabilities separately from other liabilities, either in the balance sheet or in the notes. In reaching this decision, the IASB noted that leasing is an important activity for many lessees. Although a lease liability shares many common characteristics with other financial liabilities, a lease liability is contractually related to a corresponding asset and often has features, such as options and variable lease payments, that differ from those typically found in other liabilities. Thus, presenting lease liabilities separately from other financial liabilities (along with the disclosure requirements discussed in paragraphs BC212–BC230) provides users of financial statements with information that is useful in understanding an entity's obligations arising from lease arrangements. The IASB also noted that paragraph 55 of IAS 1 requires a lessee to further disaggregate line items in the balance sheet if such presentation is relevant to an understanding of the lessee's financial position.

Statement of profit or loss and other comprehensive income (paragraph 49)

BC209 The IASB decided that a lessee should present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset in the income statement. The IASB concluded that a lessee would provide more useful information to users of financial statements by presenting interest on the lease liability together with interest on other financial liabilities and depreciation of the right-of-use asset together with other similar expenses (for example, depreciation of property, plant and equipment). Paragraphs BC41–BC56 include a discussion of the basis for the IASB's decisions relating to amounts recognised in profit or loss by a lessee.

Statement of cash flows (paragraph 50)

BC210 The IASB's decisions on the presentation of lease cash outflows are linked to the nature of the right-of-use asset and lease liability, and the presentation of expenses arising from a lease in the income statement. In the IASB's view, it would be misleading to portray payments in one manner in the income statement and in another in the statement of cash flows.

BC211 Consequently, the IASB decided that a lessee should classify the principal portion of cash repayments of the lease liability as financing activities in the statement of cash flows and classify cash payments relating to interest consistently with other interest payments. This approach is consistent with the requirements in IAS 7 *Statement of Cash Flows* for cash flows relating to financial liabilities and provides comparability between interest paid on leases and

interest paid on other financial liabilities. This approach also results in a lessee accounting for a lease consistently in the balance sheet, income statement and statement of cash flows. For example, a lessee (a) measures and presents the lease liability similarly to other financial liabilities; (b) recognises and presents interest relating to that liability in a similar manner to interest on other financial liabilities; and (c) presents cash paid relating to interest on lease liabilities similarly to interest on other financial liabilities.

Disclosure: lessee (paragraphs 51–60)

BC212 In determining the disclosures for leases, the IASB considered the following:

(a) the disclosure requirements of IAS 17;

(b) the disclosure requirements for financial liabilities in IFRS 7 *Financial Instruments: Disclosures*;

(c) the disclosure requirements for non-current assets such as property, plant and equipment;

(d) work on other related projects such as the Disclosure Initiative (a broad-based initiative to explore how disclosures in IFRS financial reporting can be improved); and

(e) feedback received on the disclosure proposals in the 2010 and 2013 Exposure Drafts.

BC213 The IASB received significant feedback regarding lessee disclosures. In particular:

(a) many lessees had significant concerns about the costs of complying with the disclosures proposed in the 2010 and 2013 Exposure Drafts. This was a particular concern for lessees with a high volume of leases with unique terms and conditions. These lessees suggested that there should be no need to expand the disclosure requirements beyond those in IAS 17 if the lessee accounting model in IFRS 16 provides the information that investors need. These lessees also argued that the proposed lessee disclosure requirements did not seem to be consistent with the IASB's efforts to address 'disclosure overload' in other projects (ie increases in the volume of disclosures and a perceived reduction in the quality and usefulness of those disclosures).

(b) in contrast, many users of financial statements thought that the detailed disclosure requirements proposed in the 2010 and 2013 Exposure Drafts would provide useful information. Over the course of the project, the IASB held meetings with investors and analysts to discuss how particular disclosures would be used in their analysis and which disclosures would be the most useful.

(c) both preparers and users of financial statements had concerns that lengthy detailed disclosure requirements could lead to the use of 'boilerplate' statements rather than the provision of useful information. These stakeholders were particularly concerned about the risk of material information being 'lost' within lengthy and complex financial statement notes. Similarly, many stakeholders suggested that IFRS 16 should explicitly state that entities should apply materiality in determining the extent to which disclosures are required.

(d) some users of financial statements noted that the most useful information would be different for different lease portfolios. These users noted that, for leases with complex terms and conditions (which, for some entities, are the leases in which users are most interested), compliance with standardised disclosure requirements often does not meet their information needs.

BC214 In response to this feedback, the IASB decided to:

(a) include an overall disclosure objective in IFRS 16 (paragraphs BC215–BC216);

(b) require a lessee to disclose quantitative information about its right-of-use assets, and expenses and cash flows related to leases (paragraphs BC217–BC223); and

(c) require a lessee to disclose any additional information that is necessary to satisfy the overall disclosure objective, and to supplement this requirement with a list of user information needs that any additional disclosures should address (paragraphs BC224–BC227).

Overall disclosure objective (paragraph 51)

BC215 Consistently with other recently issued Standards, the IASB decided that IFRS 16 should specify an overall objective for lessee disclosures. In the IASB's view, a clear objective should improve the interpretation and implementation of the disclosure requirements. This is because a lessee is required to assess whether the overall quality and informational value of its lease disclosures are sufficient to meet the stated objective.

BC216 The IASB considered stakeholder suggestions that an explicit statement about materiality would be useful in applying the lessee disclosure requirements. However, such statements are not included in other Standards. The concept of materiality in the *Conceptual Framework* and in IAS 1 is pervasive across IFRS and applies to the requirements in IFRS 16 in the same way that it applies to the requirements in all other Standards. The IASB thought that including a statement about materiality within the disclosure requirements in IFRS 16 might be interpreted as implying that materiality does not apply to the disclosure requirements in other Standards, because materiality is not explicitly mentioned in those Standards. The IASB is of the view that implicit in the overall disclosure objective is the notion that the level of detail provided in disclosures should reflect the significance of a lessee's leasing activities to its financial statements. The IASB concluded that guidance on applying the overall disclosure objective would be helpful to lessees but noted that such guidance is already provided in paragraphs 30A and 31 of IAS 1.

Disclosures about right-of-use assets, and expenses and cash flows related to leases (paragraph 53)

BC217 The IASB decided that there are particular items of information that, if material, should be disclosed by lessees to meet the information needs of users of financial statements. The IASB noted the importance of comparable information being provided by different lessees and that comparability could be achieved by including some specific disclosure requirements in IFRS 16. These disclosure requirements relate to the information that users of financial statements have identified as being most useful to their analyses and, consequently, that they would like to have for all lease portfolios that are material to an entity. Consequently, IFRS 16 requires a lessee to disclose:

(a) the carrying amount of right-of-use assets, and depreciation charge for those assets, split by class of underlying asset. This information is useful in understanding the nature of a lessee's leasing activities and in comparing entities that lease their assets with those that purchase them.

(b) interest expense on lease liabilities. Together with the disclosure of the carrying amount of lease liabilities separately from other liabilities (see paragraph BC208), this disclosure provides information about a lessee's lease obligations and finance costs.

(c) the expenses related to short-term leases and leases of low-value assets accounted for applying paragraph 6 of IFRS 16, and the expense related to variable lease payments not included in the measurement of lease liabilities. These disclosures

provide information about lease payments for which assets and liabilities are not recognised in the balance sheet.

(d) total cash outflow for leases. This disclosure was identified by users of financial statements as providing the most useful information about lease cash flows and is expected to help in forecasting future lease payments.

(e) additions to right-of-use assets. This disclosure provides comparable information about capital expenditure on leased and owned assets.

(f) gains and losses arising from sale and leaseback transactions. This disclosure helps to better understand the unique characteristics of sale and leaseback transactions and the effect that such transactions have on a lessee's financial performance.

(g) income from subleasing right-of-use assets. This disclosure is useful because, along with the information about expenses related to leases discussed above, it provides a complete depiction of the overall income statement effect of an entity's leasing activities.

Maturity analysis (paragraph 58)

BC218 IFRS 16 requires a lessee to disclose a maturity analysis for lease liabilities applying paragraphs 39 and B11 of IFRS 7.

BC219 Users of financial statements identified the main objective of a maturity analysis as being to help them understand liquidity risk and estimate future cash flows. The IASB's view is that the requirements of IFRS 7 achieve this objective, and also provide a lessee with the flexibility to present the maturity analysis that is most relevant to its particular lease portfolio.

BC220 The IASB considered whether IFRS 16 should instead include more prescriptive requirements for a maturity analysis similar to that required by IAS 17 (for example, by requiring a lessee to disclose undiscounted lease payments in each of the first five years and a total for the periods thereafter). Feedback from users of financial statements relating to the maturity analysis requirements of IAS 17 was generally positive. In particular, the prescriptive nature of the requirement ensured that different lessees provided information that was comparable.

BC221 Applying IFRS 7 to lease liabilities requires lessees to apply judgement in selecting time bands for the maturity analysis. The IASB thinks that, in a scenario in which disclosing undiscounted cash flows for each of the first five years and a total for the periods thereafter provides the most useful information to users of financial statements, the requirements of IFRS 7 should lead a lessee to disclose this level of detail. In contrast, in a scenario in which an alternative (and possibly more detailed) set of time bands provides the most useful information to users of financial statements, the requirements of IFRS 7 should lead a lessee to disclose that alternative and more useful set of time bands. For example, for a portfolio of 15–20 year leases, the requirements of IFRS 7 should lead a lessee to provide a more detailed maturity analysis than a single amount for the years beyond the fifth year.

BC222 In addition, the IASB is of the view that it is appropriate to apply the same maturity analysis disclosure requirements to lease liabilities as those applied to other financial liabilities. This is because the lessee accounting model in IFRS 16 is based on the premise that a lease liability is a financial liability (for the reasons described in paragraphs BC46–BC51).

BC223 The IASB decided not to require the disclosure of a maturity analysis of non-lease components. The IASB thinks that users of financial statements would find information about the maturities of any contractual commitments of an entity useful, regardless of the nature of the entity's rights under the contract. However, the IASB noted that it could be misleading to require the disclosure of contractual commitments for services that are embedded within a lease without also requiring the disclosure of contractual commitments for services that are

provided as part of other contracts. The IASB decided that adding such a disclosure requirement would be beyond the scope of the Leases project.

Additional disclosures (paragraph 59)

BC224 Many leases contain more complex features, which can include variable payments, termination and extension options and residual value guarantees. These features of a lease are often determined on the basis of the individual circumstances of the parties to the contract and, in some cases, are particularly complex or are unique to the particular contract. The feedback received from stakeholders demonstrated that, for these features of a lessee's lease portfolio, a standard disclosure requirement for all entities is unlikely to meet the needs of users of financial statements.

BC225 With respect to these more complex features, IFRS 16 requires a lessee to disclose any material entity-specific information that is necessary in order to meet the disclosure objective and is not covered elsewhere in the financial statements. IFRS 16 supplements this requirement with a list of user information needs that any additional disclosures should address, and with illustrative examples of disclosures that a lessee might provide in complying with the additional disclosure requirements. The IASB noted that these examples are not exhaustive. Nonetheless, the IASB thinks that the illustrative examples are useful in demonstrating that judgement should be applied in determining the most useful and relevant disclosures, which will depend on a lessee's individual circumstances. In the IASB's view, this approach facilitates the provision of more relevant and useful disclosures by (a) discouraging the use of generic or 'boilerplate' statements; and (b) enabling a lessee to apply judgement to identify the information that is relevant to users of financial statements and focus its efforts on providing that information.

BC226 The IASB acknowledged that, for lessees with many complex, unique or otherwise significant lease arrangements, there are likely to be incremental costs associated with the additional disclosure requirements in paragraph 59 of IFRS 16. However, the IASB thinks that:

(a) the measurement requirements in IFRS 16 are simplified in several ways that are expected to reduce the cost of applying IFRS 16 for a lessee, but also mean that users of financial statements need additional information to understand any significant features that are excluded from the measurement of lease liabilities. For example, a lessee is not required to include payments during optional periods unless those payments are reasonably certain to occur (see paragraphs BC152–BC159). Similarly, a lessee is not required to reassess variable lease payments unless they depend on an index or a rate and there is a change in future lease payments resulting from a change in the reference index or rate (see paragraphs BC188–BC190).

(b) many lessees will not need to provide any additional disclosures as a result of these requirements. This is because the disclosures required by paragraphs 53 and 58 of IFRS 16 are expected to provide sufficient information for those leases that do not have complex or unique features. In the IASB's view, it is appropriate that greater cost will be required in preparing lease disclosures for entities whose leasing activity is particularly complex or unique.

BC227 The IASB considered requiring disclosure of specific information about these more complex features. Such information could have included, for example, the basis and terms and conditions on which variable lease payments and options are determined. However, lessees informed the IASB that this information would be difficult to capture in a meaningful way, particularly for large or diverse lease portfolios. Some users of financial statements also expressed concerns that such an approach could lead to 'boilerplate' compliance statements, which generally do not provide useful information. The approach taken enables lessees to determine the best way to provide information while considering both the costs of providing that information and the information needs of users of financial statements.

Presentation of lessee disclosures in the notes to the financial statements (paragraphs 52 and 54)

BC228 IFRS 16 requires a lessee to disclose information about its leases in a single note or separate section in its financial statements, and to present quantitative information in a tabular format, unless another format is more appropriate. On the basis of feedback from users of financial statements, the IASB thinks that this presentation best conveys an overall understanding of a lessee's lease portfolio and improves the transparency of the information. In the IASB's view, presenting all lessee disclosures in a single note or separate section will often be the most effective way to present information about leases in the systematic manner required by paragraph 113 of IAS 1.

Other approaches considered for lessee disclosure

BC229 Rather than creating specific lease disclosure requirements, the IASB considered an alternative approach whereby a lessee would be required to disclose information about its right-of-use assets applying the disclosure requirements for property, plant and equipment in IAS 16, and information about its lease liabilities applying the disclosure requirements for financial liabilities in IFRS 7. Those supporting this approach thought that it would be consistent with the lessee accounting model in IFRS 16.

BC230 Although noting that there are significant similarities between right-of-use assets and other assets and between lease liabilities and other financial liabilities, the IASB did not adopt this approach because:

(a) it would not provide specific information to users of financial statements about some features of a lessee's lease portfolio that are common in lease arrangements (such as variable payments, options to extend or terminate leases and residual value guarantees). Similarly, it would not provide information about some right-of-use assets and lease liabilities that are not recognised in the balance sheet (such as those arising from short-term leases and leases of low-value assets) as a consequence of some of the simplifications that have been introduced in IFRS 16.

(b) information about a lessee's lease portfolio might be obscured by being included within different disclosures about different types of assets and liabilities. Consequently, this approach might compromise the transparency and usefulness of lease information for users of financial statements.

Lessor: accounting (paragraphs 61–97)

BC231 Paragraphs BC57–BC66 discuss the basis for the IASB's decision to substantially carry forward the IAS 17 lessor accounting requirements. The IASB also decided to carry forward substantially all of the language used in the IAS 17 lessor accounting requirements (with the exception of editorial amendments). Consequently, the significant differences between the lessor accounting requirements in IFRS 16 and those in IAS 17 are primarily a direct consequence of the lessee accounting model in IFRS 16.

Subleases

BC232 IFRS 16 requires an intermediate lessor to account for a head lease and a sublease as two separate contracts, applying both the lessee and lessor accounting requirements. The IASB concluded that this approach is appropriate because in general each contract is negotiated separately, with the counterparty to the sublease being a different entity from the counterparty to the head lease. Accordingly, for an intermediate lessor, the obligations that arise from the head lease are generally not extinguished by the terms and conditions of the sublease.

Classification (paragraph B58)

BC233 The IASB decided that, when classifying a sublease, an intermediate lessor should evaluate the lease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset. This is because:

(a) an intermediate lessor (ie the lessor in a sublease) does not own the underlying asset and does not recognise that underlying asset in its balance sheet. In the IASB's view, the intermediate lessor's accounting should be based on the asset that the intermediate lessor controls (ie the right-of-use asset) and not the underlying asset that is controlled by the head lessor.

(b) an intermediate lessor's risks associated with a right-of-use asset can be converted into credit risk by entering into a sublease, the term of which covers most or all of the term of the head lease. Accounting for such a sublease as a finance lease (by classifying it by reference to the right-of-use asset) would reflect that risk, because the intermediate lessor would recognise the net investment in the sublease (a receivable) rather than a right-of-use asset.

(c) if a sublease is for all of the remaining term of the corresponding head lease, the intermediate lessor no longer has the right to use the underlying asset. In the IASB's view, it is appropriate for an intermediate lessor in such a case to derecognise the right-of-use asset and recognise the net investment in the sublease.

BC234 The IASB observed that, in classifying a sublease by reference to the right-of-use asset arising from the head lease, an intermediate lessor will classify more subleases as finance leases than it would have done if those same subleases were classified by reference to the underlying asset. Accordingly, a lessor may classify similar leases (for example, those with a similar lease term for a similar underlying asset) differently depending on whether the lessor owns or leases the underlying asset. However, the IASB concluded that any difference in classification reflects real economic differences. The intermediate lessor only has a right to use the underlying asset for a period of time. If the sublease is for all of the remaining term of the head lease, the intermediate lessor has in effect transferred that right to another party. In contrast, in an operating lease of an owned asset, the lessor would expect to derive economic benefits from the underlying asset at the end of the lease term.

Presentation

BC235 IFRS 16 does not include requirements relating to the presentation of subleases. This is because the IASB decided that specific requirements were not warranted because there is sufficient guidance elsewhere in IFRS. In particular, applying the requirements for offsetting in IAS 1, an intermediate lessor should not offset assets and liabilities arising from a head lease and a sublease of the same underlying asset, unless the financial instruments requirements for offsetting are met. The IASB considered whether to create an exception that would permit or require an intermediate lessor to offset assets and liabilities arising from a head lease and a sublease of the same underlying asset. However, the IASB noted that the exposures arising from those assets and liabilities are different from the exposures arising from a single net lease receivable or lease liability, and concluded that presenting these on a net basis could provide misleading information about an intermediate lessor's financial position, because it could obscure the existence of some transactions.

BC236 For the same reasons, the IASB also decided that an intermediate lessor should not offset lease income and lease expenses relating to a head lease and a sublease of the same underlying asset, unless the requirements for offsetting in IAS 1 are met.

Initial direct costs (paragraphs 69 and 83)

BC237 IFRS 16 defines initial direct costs consistently with the definition of incremental costs of obtaining a contract in IFRS 15. Defining initial direct costs in this way means that the costs incurred by a lessor to obtain a lease are accounted for consistently with costs incurred to obtain other contracts with customers.

Lease modifications (paragraphs 79–80 and 87)

BC238 IFRS 16 requires a lessor—like a lessee—to account for a modification to a finance lease as a separate lease if:

(a) the modification increases the scope of the lease by adding the right for the lessee to use one or more underlying assets; and

(b) the consideration received for the lease increases by an amount commensurate with the stand-alone price for the increase in scope.

This is because, in the IASB's view, such a modification in substance represents the creation of a new lease that is separate from the original lease. This requirement is substantially aligned with equivalent requirements in IFRS 15 that require a seller to account for modifications that add distinct goods or services as separate contracts if those additional goods or services are priced commensurately with their stand-alone selling price.

BC239 For modifications to a finance lease that are not accounted for as a separate lease, IFRS 16 requires a lessor to account for the modification applying IFRS 9 (unless the lease modification would have been classified as an operating lease if the modification had been in effect at the inception date). The IASB expects that this approach will not result in any substantive change to previous lessor accounting for modifications of finance leases. This is because, although IAS 17 did not include requirements relating to lease modifications, the IASB understands that a lessor generally applied an approach that was consistent with the requirements in IFRS 9 (or the equivalent requirements in IAS 39 *Financial Instruments: Recognition and Measurement*) to the net investment in a finance lease.

BC240 IFRS 16 requires a lessor to account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease. This approach is consistent with the approach required by IFRS 15 if, at the time of a contract modification (that is accounted for as a separate contract), the remaining goods or services to be transferred are distinct from the goods or services already transferred. It is also expected that this approach will not result in any substantive change to previous lessor accounting.

Covid-19-related rent concessions

BC240A In 2020, when the Board provided lessees with a practical expedient for rent concessions occurring as a direct consequence of the covid-19 pandemic (see paragraphs BC205A–BC205G), the Board considered whether to provide similar practical relief for lessors. Lessors informed the Board that, like lessees, they face many practical challenges associated with large volumes of covid-19-related rent concessions. Having considered the feedback, the Board decided not to provide a practical expedient for lessors for the following reasons:

(a) IFRS 16 does not specify how a lessor accounts for a change in lease payments that is not a lease modification—this is a consequence of the Board's decision to substantially carry forward the lessor accounting requirements in IAS 17 when it developed IFRS 16 (see paragraphs BC57–BC66). Consequently, to ensure consistency in financial reporting, a practical expedient for lessors would have to include new recognition and measurement requirements. Such requirements might not effectively address all of the practical challenges identified by lessors, and might

have unintended consequences. Such requirements would also take time to develop, preventing a practical expedient from being provided in time to be useful.

(b) Any practical expedient would adversely affect the comparability of, and interaction between, the lessor accounting requirements in IFRS 16 and related requirements in other Standards, thus impairing the quality of information provided to users of financial statements. For example, the lessor accounting requirements in IFRS 16 interact with:

(i) IFRS 9 for finance leases. A lessor applies IFRS 9 in accounting for particular finance lease modifications and, therefore, the accounting for those modifications is aligned with the accounting for modifications to similar financial assets within the scope of IFRS 9.

(ii) IFRS 15 for operating leases. The application of IFRS 16 to operating lease modifications results in outcomes similar to those that result from the application of IFRS 15 to particular service contracts, and the definitions of a modification in IFRS 16 and IFRS 15 are similar.

(c) Although acknowledging the practical challenges lessors face during the pandemic, the Board noted that, unlike lessees, lessors have not recently implemented a new accounting model for their leases.

(d) The Board was of the view that accounting for covid-19-related rent concessions using the existing lessor accounting requirements provides useful information to users of financial statements.

Lessor: classification of leases—leases of land and buildings (2003 and 2009 amendments to IAS 17) (paragraphs B55–B57)

Land element in long-term leases

BCZ241 In 2009, the IASB amended the IAS 17 requirements for classification of the land element in long-term leases. IAS 17 had previously stated that a lease of land with an indefinite economic life would normally be classified as an operating lease. However, in 2009, the IASB removed that statement from IAS 17, having concluded that it might lead to a classification of land that does not reflect the substance of the transaction.

BCZ242 In reaching this conclusion the IASB had considered the example of a 999-year lease of land and buildings. It had noted that, for such a lease, significant risks and rewards associated with the land during the lease term would have been transferred by the lessor despite there being no transfer of title.

BCZ243 The IASB had also noted that the lessor in leases of this type will typically be in a position economically similar to an entity that sold the land and buildings. The present value of the residual value of the property in a lease with a term of several decades would be negligible. The IASB had concluded that the accounting for the land element as a finance lease in such circumstances would be consistent with the economic position of the lessor.

BCZ244 The IASB replaced the previous guidance with a statement (now in paragraph B55 of IFRS 16) that, in determining whether the land element is an operating lease or a finance lease, an important consideration is that land normally has an indefinite economic life.

Allocation of lease payments between land and buildings

BCZ245 In 2003, the IASB introduced into IAS 17 the requirement for a lessor to assess the classification of the land element of a lease separately from the buildings element. The Exposure Draft of the 2003 amendments had further proposed that, whenever necessary for

the purposes of classification, the lease payments should be allocated between the land and building elements in proportion to their relative fair values at the inception of the lease. However, respondents to that Exposure Draft had questioned whether the relevant fair values were the fair values of the underlying land and buildings or the fair values of the leasehold interests in the land and buildings.

BCZ246 In redeliberating that Exposure Draft, the IASB noted that an allocation of the lease payments by reference to the relative fair values of the underlying land and buildings would not reflect the fact that land often has an indefinite economic life, and therefore would be expected to maintain its value beyond the lease term. In contrast, the future economic benefits of a building are likely to be used up, at the least to some extent, over the lease term. Therefore, it would be reasonable to expect that the lease payments relating to the building would be set at a level that enabled the lessor not only to make a return on initial investment, but also to recoup the value of the building used up over the term of the lease. In the case of land, the lessor would not normally need compensation for using up the land.

BCZ247 Therefore, the IASB decided to clarify in the 2003 amendments that the allocation of the lease payments is weighted to reflect their role in compensating the lessor, and not by reference to the relative fair values of the underlying land and buildings. In other words, the weighting should reflect the leasehold interest in the land element and the buildings element of the lease at the inception date. In the extreme case that a building is fully depreciated over the lease term, the lease payments would need to be weighted to provide a return plus the full depreciation of the building's value at the inception of the lease. The leasehold interest in the land would, assuming a residual value that equals its value at the inception of the lease, have a weighting that reflects only a return on the initial investment. These clarifications are now in paragraph B56 of IFRS 16.

Impracticability of split between land and buildings

BCZ248 When amending IAS 17 in 2003, the IASB considered how to treat leases for which it is not possible to measure the two elements reliably (for example, because similar land and buildings are not sold or leased separately). One possibility would be to classify the entire lease as a finance lease. However, the IASB noted that it may be apparent from the circumstances that classifying the entire lease as a finance lease is not representationally faithful. In view of this, the IASB decided that when it is not possible to measure the two elements reliably, the entire lease should be classified as a finance lease unless it is clear that both elements should be classified as an operating lease. This requirement is now in paragraph B56 of IFRS 16.

Exception to the requirement to separate the land and buildings elements

BCZ249 When amending IAS 17 in 2003, the IASB discussed whether to allow or require an exception from the requirement to separate the land and buildings elements in cases in which the present value of the land element at the inception of the lease is small in relation to the value of the entire lease. In such cases the benefits of separating the lease into two elements and accounting for each separately may not outweigh the costs. The IASB noted that generally accepted accounting principles in Australia, Canada and the US allow or require such leases to be classified and accounted for as a single unit, with finance lease treatment being used when the relevant criteria are met. The IASB decided to allow land and buildings to be treated as a single unit when the land element is immaterial. This exception is now in paragraph B57 of IFRS 16.

BCZ250 Some stakeholders requested guidance on how small the relative value of the land element needs to be in relation to the total value of the lease. The IASB decided not to introduce a bright line such as a specific percentage threshold. The IASB decided that the normal concepts of materiality should apply.

Lessor: disclosure (paragraphs 89–97)

BC251 IFRS 16 enhances the previous lessor disclosure requirements in IAS 17 to enable users of financial statements to better evaluate the amount, timing and uncertainty of cash flows arising from a lessor's leasing activities. The enhancements are in response to views expressed by some stakeholders that the lessor accounting model in IAS 17 did not provide sufficient information relating to all elements of a lessor's leasing activities. In particular, some investors and analysts requested additional information about a lessor's exposure to residual asset risk.

Table of income (paragraphs 90–91)

BC252 IFRS 16 requires a lessor to disclose information about the different components of lease income recognised during the reporting period. This requirement is similar to the requirement in IFRS 15 for an entity to disclose a disaggregation of revenue recognised during the reporting period into categories.

Information about residual asset risk (paragraph 92(b))

BC253 Academic research, outreach performed and feedback received throughout the project highlighted that the main concern associated with lessor disclosure in IAS 17 was the lack of information about a lessor's exposure to credit risk (associated with the lease payments receivable from the lessee) and asset risk (associated with the lessor's residual interest in the underlying asset). Particularly for leases classified as operating leases, lessors could retain significant residual asset risk and little, if any, information was generally available about that exposure to risk in the financial statements.

BC254 A decline in the market value of, for example, leased equipment and vehicles at a rate greater than the rate the lessor projected when pricing the lease would adversely affect the profitability of the lease. Uncertainty about the residual value of the underlying asset at the end of the lease is often a lessor's primary risk. Accordingly, IFRS 16 requires a lessor to disclose information about how it manages its risk associated with any rights it retains in the underlying asset. The IASB also noted that disclosing information about residual asset risk will also provide users of financial statements with useful information about the distribution of risk for a lessor between credit risk relating to lease payments receivable and residual asset risk related to the interest in the underlying asset.

BC255 The IASB considered requiring a lessor to disclose the fair value of residual assets at each reporting date. However, the IASB concluded that such a requirement could be onerous for lessors. Although it is fundamental to a lessor's business that the lessor manage its exposure to residual asset risk, the IASB thought that the costs associated with having to disclose, and have audited, fair value information about residual assets would outweigh the benefit for users of financial statements.

Information about assets subject to operating leases (paragraphs 95–96)

BC256 The IASB observed that a lessor accounts for assets leased under operating leases similarly to owned assets that are held and used (for example, in the lessor's operations). However, leased and owned assets are typically used for different purposes—ie leased assets generate rental income rather than contributing towards any other revenue-generating activity of the lessor. For that reason, the IASB concluded that users of financial statements would benefit from obtaining information about leased assets that generate rental income separately from owned assets held and used by the lessor. Consequently, IFRS 16 requires a lessor to disaggregate each class of property, plant and equipment into assets subject to operating leases and assets not subject to operating leases.

Maturity analyses (paragraphs 94 and 97)

BC257 IFRS 16 requires a lessor to disclose a maturity analysis of the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years following the reporting date and a total of the amounts for the remaining years.

BC258 The IASB noted that this requirement would provide more information about a lessor's liquidity risk than previous requirements in IAS 17 (which had, instead, required a maturity analysis showing lease payments due in three bands: within one year, in the second to fifth years and after five years). In the IASB's view, a more detailed maturity analysis will enable users of financial statements to more accurately forecast future lease cash flows and estimate liquidity risk. The IASB does not expect the incremental cost (compared to the IAS 17 requirements) to be significant because lessors typically needed the same information to provide the disclosures required by IAS 17. The IASB also noted that some lessors had already disclosed a maturity analysis relating to lease payments to be received in more detail than was required by IAS 17.

Changes in net investment in finance leases (paragraph 93)

BC259 IFRS 16 requires a lessor to provide a qualitative and quantitative explanation of the significant changes in the net investment in finance leases during the reporting period to allow users of financial statements to understand these significant changes. On the basis of the feedback received, the IASB concluded that this information is useful to users of financial statements and is not otherwise available.

Sale and leaseback transactions (paragraphs 98–103)

BC260 In a sale and leaseback transaction, one entity (the seller-lessee) transfers an asset to another party (the buyer-lessor) and leases back that same asset. IAS 17 included specific requirements on sale and leaseback transactions and the IASB decided that it would be helpful to continue to include specific requirements for sale and leaseback transactions in IFRS 16.

When a sale occurs

BC261 The IASB decided that, within the context of a sale and leaseback transaction, the transfer of an asset is accounted for as a sale only if the transfer meets the requirements in IFRS 15 for the transfer of an asset. In the IASB's view, applying the recognition requirements of IFRS 15 to sale and leaseback transactions will be beneficial for both preparers and users of financial statements because it will increase comparability between sales entered into as part of sale and leaseback transactions and all other sales. The IASB observed that, in considering whether a transaction should be accounted for as a sale and leaseback transaction, an entity should consider not only those transactions structured in the form of a legal sale and leaseback, but should also consider other forms of transactions for which the economic effect is the same as a legal sale and leaseback (for example, a sale and leaseback transaction may be structured in the form of a lease and leaseback).

BC262 In reaching its decisions on sale and leaseback transactions, the IASB noted that:

(a) the presence of a leaseback (ie the seller-lessee obtaining the right to use the underlying asset for a period of time) does not, in isolation, preclude the seller-lessee from concluding that it has transferred the underlying asset to the buyer-lessor. This is because a lease is different from the purchase or sale of the underlying asset, in that a lease does not transfer control of the underlying asset to the lessee; instead, it transfers the right to control the use of the underlying asset for the period of the lease. Consequently, if there are no features in a sale and leaseback transaction that prevent sale accounting, the buyer-lessor is considered to obtain control of the underlying asset, and immediately transfer the right to control the use of that asset to the seller-lessee for the lease term. The fact that the buyer-lessor purchases the

underlying asset from the entity that is the lessee in the subsequent leaseback does not change the buyer-lessor's ability to obtain control of the underlying asset.

(b) many lessors purchase from a third party an asset that will be the subject of a lease only when the terms and conditions of the lease have already been negotiated. The lessor may not receive physical possession of the asset until the end of the lease term (for example, a vehicle could be delivered directly by a manufacturer to the lessee, even though the lessor purchases the vehicle from the manufacturer). Similarly, the buyer-lessor may not receive physical possession of the underlying asset in a sale and leaseback transaction until the end of the lease term. In the IASB's view, these circumstances do not, in isolation, preclude the seller-lessee from concluding that it has transferred the underlying asset to the buyer-lessor. In both cases, the IASB concluded that it is appropriate for the lessor to be deemed to control the asset immediately before the commencement date (if the sale of the underlying asset otherwise meets the requirements in IFRS 15 for the transfer of an asset).

(c) IFRS 15 states that if an entity has a right to repurchase an asset (a call option), the customer does not obtain control of the asset, because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from the asset, even though the customer may have physical possession of the asset. Consequently, if the seller-lessee has a substantive repurchase option with respect to the underlying asset, then no sale has occurred.

BC263 The IASB considered, but did not adopt, an alternative approach whereby IFRS 16 would require a higher threshold than the IFRS 15 threshold for recognising a sale within the context of a sale and leaseback transaction because many stakeholders expressed concerns about such an approach. In particular, they questioned the rationale for having a higher threshold for sale accounting in a sale and leaseback transaction than for any other sale. Some were also of the view that different thresholds for achieving sale accounting in IFRS 15 and IFRS 16 would not be operational. The IASB also noted that some of the structuring concerns relating to sale and operating leaseback transactions that had existed under IAS 17 would be substantially reduced by the lessee accounting model in IFRS 16, which requires the recognition of lease assets and lease liabilities by the seller-lessee.

BC264 The IASB considered whether to include additional application guidance in IFRS 16 regarding the determination of whether there is a sale in a sale and leaseback transaction. Such guidance would be intended to help entities to apply the IFRS 15 requirements relating to the satisfaction of performance obligations to sale and leaseback transactions. However, the IASB concluded that this was not necessary because, in its view, the principles in IFRS 15 can be applied appropriately and consistently to sale and leaseback transactions without any further guidance.

BC265 The IASB also decided that, if the transfer of the asset does not meet the requirements for a transfer in IFRS 15, then no sale is recognised by the seller-lessee and no purchase is recognised by the buyer-lessor. Instead, the seller-lessee and buyer-lessor will account for any amounts received or paid relating to the leaseback as a financial asset or a financial liability applying IFRS 9. This is because such a transaction represents, in substance, a financing arrangement.

Gain or loss on a sale and leaseback

BC266 The IASB decided that the gain or loss recognised by a seller-lessee on a completed sale in a sale and leaseback transaction should reflect the amount that relates to the rights transferred to the buyer-lessor. In reaching this decision, the IASB considered requiring the sale element of the transaction (ie the sale of the underlying asset) to be accounted for applying IFRS 15 because, from a legal standpoint, the seller-lessee will often have sold the entire underlying asset to the buyer-lessor. However, from an economic standpoint, the seller-lessee has sold only its interest in the value of the underlying asset at the end of the leaseback—it has retained its right to use the asset for the duration of the leaseback. The seller-lessee had

already obtained that right to use the asset at the time that it purchased the asset—the right of use is an embedded part of the rights that an entity obtains when it purchases, for example, an item of property, plant and equipment. Accordingly, in the IASB's view, recognising the gain that relates to the rights transferred to the buyer-lessor appropriately reflects the economics of the transaction.

BC267 The lease payments and the sale price in a sale and leaseback transaction are typically interdependent because they are negotiated as a package. For example, the sale price might be more than the fair value of the asset because the leaseback rentals are above a market rate; conversely the sale price might be less than the fair value because the leaseback rentals are below a market rate. Accounting for the transaction using those amounts could result in the misstatement of gains or losses on disposal of the asset for the seller-lessee and the misstatement of the carrying amount of the asset for the buyer-lessor. Consequently, IFRS 16 requires that if the sale consideration or leaseback rentals are not at market rates, any below-market terms should be accounted for as a prepayment of lease payments and any above-market terms should be accounted for as additional financing provided by the buyer-lessor to the seller-lessee. Similarly, IFRS 16 requires the seller-lessee to measure the right-of-use asset as a proportion of the asset retained as a result of the leaseback—consequently any off-market terms are effectively accounted for in measuring the gain or loss on sale.

Temporary exception arising from interest rate benchmark reform

BC267A In April 2020 the Board published the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* (2020 Exposure Draft), which proposed amendments to specific requirements in IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 to address issues that might affect financial reporting during the reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate. The term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark as described in paragraph 6.8.2 of IFRS 9 (the reform). The Board issued the final amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 in August 2020 (Phase 2 amendments). Paragraphs BC5.287–BC5.293 of the Basis for Conclusions on IFRS 9 and paragraphs BC289–BC295 of the Basis for Conclusions on IAS 39 discuss the background to these amendments.

BC267B In developing the Phase 2 amendments, the Board also considered the potential effects of the reform on the financial statements of an entity applying the requirements of IFRS Standards, other than IFRS 9 and IAS 39. The Board specifically considered the potential effects arising in the context of IFRS 16.

BC267C Some leases include lease payments that are referenced to an interest rate benchmark that is subject to the reform as described in paragraph 6.8.2 of IFRS 9. IFRS 16 requires a lessee to include variable lease payments referenced to an interest rate benchmark in the measurement of the lease liability.

BC267D Applying IFRS 16, modifying a lease contract to change the basis for determining the variable lease payments meets the definition of a lease modification because a change in the calculation of the lease payments would change the original terms and conditions determining the consideration for the lease.

BC267E IFRS 16 requires that an entity accounts for a lease modification by remeasuring the lease liability by discounting the revised lease payments using a revised discount rate. That revised discount rate would be determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

BC267F However, in the Board's view, reassessing the lessee's entire incremental borrowing rate when the modification is limited to what is required by the reform (ie when the conditions in paragraph 105 of IFRS 16 are met) would not reflect the economic effects of the modified lease. Such a requirement might also impose additional cost on preparers, particularly when leases that are referenced to a benchmark rate that is subject to the reform are expected to be amended at different times. This is because preparers would have to determine a new incremental borrowing rate at the effective date of each such lease modification.

BC267G For the reasons set out in paragraph BC5.306 of the Basis for Conclusions to IFRS 9, the Board provided a practical expedient to account for a lease modification required by the reform applying paragraph 42 of IFRS 16. This practical expedient requires remeasurement of the lease liability using a discount rate that reflects the change to the basis for determining the variable lease payments as required by the reform. This practical expedient would apply to all lease modifications that change the basis for determining future lease payments that are required as a result of the reform (see paragraphs 5.4.6 and 5.4.8 of IFRS 9). For this purpose, consistent with the amendments to IFRS 9, a lease modification required by the reform is a lease modification that satisfies two conditions—the modification is necessary as a direct consequence of the reform and the new basis for determining the lease payments is economically equivalent to the previous basis (ie the basis immediately preceding the modification).

BC267H The practical expedient provided for lease modifications applies only to the lease modifications required by the reform. If lease modifications in addition to those required by the reform are made, an entity is required to apply the requirements in IFRS 16 to account for all modifications made at the same time, including those required by the reform.

BC267I In contrast to the amendments for financial assets and financial liabilities in IFRS 9 (see paragraph 5.4.9 of IFRS 9), the Board decided not to specify the order of accounting for lease modifications required by the reform and other lease modifications. This is because the accounting outcome would not differ regardless of the order in which an entity accounts for lease modifications required by the reform and other lease modifications.

BC267J The Board also considered that, from the perspective of a lessor, lease payments included in the measurement of the net investment in a finance lease may include variable lease payments that are referenced to an interest rate benchmark. The Board decided not to amend the requirements for accounting for modifications to lease contracts from the lessor's perspective. The Board did not make such amendments because, for finance leases, a lessor is required to apply the requirements in IFRS 9 to a lease modification, so the amendments in paragraphs 5.4.5–5.4.9 of IFRS 9 would apply when those modifications are required by the reform. For operating leases, the Board decided that applying the requirements in IFRS 16 for lessors will provide useful information about the modification in terms and conditions required by the reform in the light of the mechanics of the operating lease accounting model.

Effective date and early application (paragraph C1)

BC268 In determining the effective date of IFRS 16, the IASB considered feedback received from preparers about the amount of time they would need to implement the requirements of IFRS 16 in the light of the transition requirements. The IASB also considered feedback received from both users and preparers of financial statements about the interaction of IFRS 16 with the implementation of other recently issued Standards (most notably IFRS 9 and IFRS 15).

BC269 The IASB acknowledged that users of financial statements would generally prefer the effective date of IFRS 16 to be 1 January 2018. This is because users would prefer IFRS 16 to have the same effective date as IFRS 9 and IFRS 15—this would avoid accounting uncertainty arising from entities implementing new Standards over a number of years. Users of financial statements also noted that, in their view, the effective date of IFRS 16 should be as soon as possible in the light of the significant improvements in financial reporting that will result from the implementation of IFRS 16. Consequently, they did not support a period of three years between publication of IFRS 16 and the effective date.

BC270 However, almost all preparers that provided feedback indicated that an effective date of 1 January 2018 would not give them adequate time to implement IFRS 16, IFRS 9 and IFRS 15. The majority of preparers reported that they would need approximately three years to implement the requirements of IFRS 16 between publication and the effective date.

BC271 The IASB concluded that implementation of IFRS 16 by 1 January 2018 would not be achievable for all preparers taking into consideration that entities are also required to implement IFRS 9 and IFRS 15 in that period of time. Consequently, the IASB decided that an entity is required to apply IFRS 16 for annual reporting periods beginning on or after 1 January 2019.

BC272 The IASB also decided to permit early application of IFRS 16 for entities that apply IFRS 15 on or before the date of initial application of IFRS 16. In reaching this decision, the IASB noted that early application would allow any entity that wishes to apply IFRS 16 at the same time as IFRS 9 and IFRS 15 to do so. The IASB also noted that early application might be beneficial to an entity that adopts IFRS for the first time between the publication of IFRS 16 and its effective date. However, the IASB decided to limit early application of IFRS 16 to entities that also apply IFRS 15. This is because some of the requirements of IFRS 16 depend on an entity also applying the requirements of IFRS 15 (and not the Standards that were superseded by IFRS 15).

Transition (paragraphs C2–C20)

Definition of a lease (paragraphs C3–C4)

BC273 The IASB decided that an entity is not required to reassess whether contracts are, or contain, leases on transition to IFRS 16. Consequently, an entity can choose to apply the requirements of IFRS 16 to all existing contracts that met the definition of a lease applying the requirements of IAS 17 and IFRIC 4. Similarly, an entity does not need to apply IFRS 16 to existing contracts that did not meet the definition of a lease applying the requirements of IAS 17 and IFRIC 4.

BC274 Preparers provided feedback that it could be costly for them to reassess all of their existing contracts using the definition of a lease requirements in IFRS 16. The IASB observed that it envisages only a limited number of scenarios in which application of the lease definition requirements in IFRIC 4 would result in a different outcome from the application of the lease definition guidance in IFRS 16. The IASB identified a small population of contracts that would be classified as leases applying IFRIC 4 but as service contracts applying IFRS 16, and none for which the converse is expected to be true. The IASB expects that the consequence of an entity not reassessing its existing contracts applying the lease definition requirements in IFRS 16 would be the recognition of slightly more leases on transition to IFRS 16 than would otherwise be the case. On this basis, the IASB concluded that the costs of requiring entities to reassess existing contracts applying the lease definition guidance in IFRS 16 would not be justified.

Lessees (paragraphs C5–C13)

BC275 The IASB decided that, on transition, a lessee should apply IFRS 16 using either of the following methods:

(a) retrospectively to each prior reporting period presented applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*; or

(b) retrospectively with the cumulative effect of initially applying IFRS 16 recognised as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. The IASB decided that, applying this approach, a lessee is permitted to apply some optional practical expedients on a lease-by-lease basis (see paragraphs BC282–BC287).

BC276 The IASB decided not to require a full retrospective approach for all lessees because the costs of such an approach could be significant and would be likely to outweigh the benefits. A full retrospective approach would require entities to determine the carrying amounts of all leases in existence at the earliest comparative period as if those leases had always been accounted for applying IFRS 16 and to restate comparative information. That could be impracticable for entities that have thousands of leases. Nonetheless, the IASB did not wish to prohibit entities from applying a full retrospective approach, because that approach would provide better information to users of financial statements than other approaches. Consequently, the IASB decided to permit entities to choose to apply IFRS 16 fully retrospectively with restatement of comparative information.

BC277 The IASB also rejected a prospective approach (ie applying IFRS 16 only to leases that commence after the date of transition). Although such an approach would be the least costly for preparers to apply, the information provided would not be beneficial for users of financial statements, particularly for entities that enter into long-term operating leases. For example, some entities enter into operating leases with lease terms of 20 to 30 years. For such entities, a user would not obtain the full benefits of IFRS 16 or full comparability of lease accounting for up to 30 years after implementing the new requirements, because the accounting for leases during that period would not be consistent. This is because right-of-use assets and lease liabilities would not be recognised for leases that were previously classified as operating leases applying IAS 17.

Retrospective application with the cumulative effect recognised at the date of initial application

BC278 In the 2010 and 2013 Exposure Drafts, the IASB had proposed simplifying the full retrospective approach by introducing a number of practical expedients on transition (some of which are included in IFRS 16). However, feedback from preparers indicated that, although helpful, the practical expedients proposed in the 2010 and 2013 Exposure Drafts would mitigate little of the implementation challenge of a retrospective transition approach. Furthermore, although users of financial statements find the trend information from restated comparative periods useful, many also acknowledged that the costs of full retrospective application with restatement of comparative information would be significant for many lessees and might not be justified.

BC279 In the light of this feedback, the IASB decided to allow an entity to apply IFRS 16 retrospectively (with some practical expedients), with the cumulative effect of initially applying IFRS 16 recognised at the date of initial application (referred to as the ‘cumulative catch-up’ transition method). The IASB observed that the cumulative catch-up transition method responds to feedback from stakeholders by eliminating the need to restate financial information in comparative periods on transition and thereby reducing costs. The cost of restating comparative data could be significant because the implementation of IFRS 16 affects a number of elements of the financial statements.

BC280 Because comparative information will not be restated under the cumulative catch-up transition method, the IASB decided to require additional disclosures to help users of financial statements to understand the effect of applying IFRS 16 for the first time. Consequently, IFRS 16 requires an entity using the cumulative catch-up transition method to disclose information on transition about leases that were previously classified as operating leases. This disclosure requirement replaces the requirements of paragraph 28(f) of IAS 8—ie a lessee applying the cumulative catch-up transition method is not required to disclose the amount of the adjustment to each financial statement line item that is normally required by IAS 8 on initial application of a new Standard.

BC281 The IASB observed that the cumulative catch-up transition method and the required disclosures mean that a lessee does not need to operate two different sets of accounting requirements at any point. Consequently, the IASB concluded that this approach would substantially reduce the overall cost of implementing IFRS 16 while enabling information to be provided to users of financial statements to explain the effect of the change in accounting for leases previously classified as operating leases.

Leases previously classified as operating leases

BC282 To reduce the costs of implementing IFRS 16, the IASB decided to introduce a number of additional practical expedients relating to leases previously classified as operating leases for a lessee that adopts the cumulative catch-up transition method.

Right-of-use assets (paragraph C8(b))

BC283 Determining the measurement of the right-of-use asset under a retrospective approach could be onerous, because it would require a lessee to determine the initial measurement of the lease liability for leases that may have commenced many years before transition to IFRS 16. Consequently, the 2010 Exposure Draft proposed that the right-of-use asset should be measured at an amount equal to the lease liability on transition, adjusted for any impairment. However, many stakeholders noted that this approach would increase lease-related costs artificially in the years immediately following transition to IFRS 16 (because the depreciation charge would typically be higher than if IFRS 16 had always been applied). These stakeholders thought that the artificial increase in the depreciation charge immediately after transition would distort the financial information provided to users of financial statements.

BC284 In response to this feedback, the 2013 Exposure Draft proposed that a lessee calculate right-of-use assets in a similar manner to a full retrospective approach, but using information available at the date of transition. However, many preparers thought that the cost of capturing historical information, such as lease start dates and historical payment schedules, would still be significant—particularly for entities with a high volume of leases.

BC285 On the basis of the feedback received, the IASB concluded that it is not possible to provide one method of measuring the right-of-use asset on transition that would (a) avoid an artificial higher expense related to leases following initial application of IFRS 16; and (b) address the cost concerns of preparers. Consequently, the IASB decided to permit lessees to choose, on a lease-by-lease basis, how to measure the right-of-use asset on transition to IFRS 16. Paragraph C8(b) permits a lessee either to measure the right-of-use asset as if IFRS 16 had always been applied or to measure the right-of-use asset at an amount equal to the lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments).

BC286 Although acknowledging that a choice of approach could result in reduced comparability, the IASB concluded that permitting a choice of measurement approaches for the right-of-use asset on transition to IFRS 16 should be largely ‘self-policing’ in terms of application. This is because the effect of the less costly option (measuring the right-of-use asset equal to the lease liability, adjusted by the amount of any previously recognised prepaid or accrued lease payments) is an increase in operating expense (ie higher depreciation) for the remainder of the term of the lease. The IASB concluded that a lessee is expected to select the less costly option only for leases for which the costs of applying a more accurate transition approach outweigh the benefit of achieving a ‘correct’ post-transition income statement. The IASB expects this to apply to leases that are high in volume but low in value but not to leases such as long-term leases of property or large equipment.

Other practical expedients

BC287 To further ease the costs on transition, the IASB also decided to allow a lessee to elect to use one or more of the following practical expedients.

Practical expedient	**Rationale**
Portfolio approach	
A lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics.	The IASB expects that permitting a lessee to apply a single discount rate to a portfolio of similar leases on transition will provide cost savings to lessees and will not have a significant effect on reported information. For leases for which the right-of-use asset is measured at an amount equal to the lease liability (adjusted by the amount of any previously recognised prepaid or accrued lease payments) on the date of initial application (see paragraph BC285), this practical expedient will enable a lessee to apply the transition requirements collectively to portfolios of leases of similar assets in similar economic environments with the same end date.
Previously recognised onerous lease provisions	
A lessee may rely on its assessment of whether leases are onerous applying IAS 37 immediately before the date of initial application and adjust 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. This approach is an alternative to performing an impairment review.	It could be costly for a lessee to perform an impairment review of each of its right-of-use assets on transition to IFRS 16. In addition, any onerous operating lease liability identified applying IAS 37 is likely to reflect impairment of the right-of-use asset. Accordingly, the IASB concluded that this practical expedient will provide a cost saving to lessees on initial application of IFRS 16 without any significant effect on reported information.
Leases for which the lease term ends within 12 months	
A lessee may elect not to apply the requirements of IFRS 16 to leases for which the term ends within 12 months of the date of initial application.	For a lessee that does not restate its comparative information, leases for which the term ends within 12 months of the date of initial application are very similar in effect to those captured by the short-term lease exemption and thus similar considerations apply (see paragraphs BC87–BC97). In addition, feedback from lessees indicated that this practical expedient will provide a significant cost saving on initial application of IFRS 16.

continued…

Practical expedient	Rationale
Initial direct costs	
A lessee may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.	The IASB expects that including initial direct costs in the measurement of right-of-use assets would not have a significant effect on reported information. Consequently, the IASB decided that the cost for lessees of requiring initial direct costs to be identified and included in the measurement of right-of-use assets would outweigh the benefits in terms of reported information.
Use of hindsight	
A lessee may use hindsight in applying IFRS 16, for example, in determining the lease term if the contract contains options to extend or terminate the lease.	Permitting lessees to apply hindsight on transition to IFRS 16 will result in useful information, particularly with respect to areas of judgement such as the determination of lease term for contracts that contain options to extend or terminate a lease. Feedback from stakeholders also indicated that permitting the use of hindsight will make initial application of IFRS 16 somewhat simpler for lessees.

Leases previously classified as finance leases (paragraph C11)

BC288 The lessee accounting model in IFRS 16 is similar to the accounting requirements for finance leases in IAS 17. Consequently, IFRS 16 does not contain detailed transition requirements for leases previously classified as finance leases if a lessee elects to apply the cumulative catch-up transition approach. For these leases, IFRS 16 requires a lessee to measure the carrying amount of the right-of-use asset and the lease liability at the date of initial application of IFRS 16 as the carrying amount of the lease asset and lease liability immediately before that date applying the finance lease accounting requirements in IAS 17.

Lessors (paragraphs C14–C15)

BC289 The lessor accounting requirements in IFRS 16 are substantially unchanged from those in IAS 17. Consequently, the IASB decided that a lessor is not required to make any adjustments on transition and should account for its leases applying IFRS 16 from the date of initial application (except for intermediate lessors in a sublease—see paragraphs BC290–BC291).

BC290 Subleases that were classified by an intermediate lessor as operating leases applying IAS 17 may be classified as finance leases applying IFRS 16. This is because IFRS 16 requires an intermediate lessor to evaluate the classification of a sublease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset as was required by IAS 17. If an intermediate lessor were to continue to apply previous operating lease accounting to these subleases, it would recognise the right-of-use asset arising from the head lease, despite the fact that, in effect, it no longer has a right to use the underlying asset. The IASB thought that this could be misleading for users of financial statements.

BC291 Consequently, IFRS 16 requires an intermediate lessor to reassess a sublease that was classified as an operating lease applying IAS 17 at the date of initial application to determine whether the sublease should be classified as an operating lease or a finance lease applying IFRS 16, and to account for it accordingly.

Sale and leaseback transactions before the date of initial application (paragraphs C16–C18)

BC292 In response to feedback from stakeholders, the IASB decided to provide transition requirements for sale and leaseback transactions that are consistent with the general transition requirements for all leases. Consequently, a seller-lessee should not perform any retrospective accounting specific to the sale element of a sale and leaseback transaction on transition to IFRS 16. A seller-lessee is required to account for the leaseback on transition to IFRS 16 in the same way as it accounts for any other lease that is in existence at the date of initial application.

BC293 The IASB considered requiring a lessee to reassess historic sale and leaseback transactions to determine whether the transfer would have been accounted for as a sale applying IFRS 15. However, the IASB concluded that the costs of performing the reassessment would not be justified.

BC294 The IASB also decided that a seller-lessee should apply the approach to gain or loss recognition on sale and leaseback transactions in IFRS 16 (described in paragraph BC266) only to sale and leaseback transactions entered into after the date of initial application of IFRS 16. The IASB concluded that the costs of applying a retrospective approach would outweigh the benefits in terms of reported information.

Consequential amendments

Investment property

BC295 IFRS 16 amends the scope of IAS 40 by defining investment property to include both owned investment property and investment property held by a lessee as a right-of-use asset. A summary of the IASB's considerations in developing the amendments to the scope of IAS 40 is described in paragraphs BC178–BC181.

Business combinations

BC296 The IASB decided that when the acquiree in a business combination is a lessee, the acquirer should measure the acquiree's lease liability at the present value of the remaining lease payments as if the acquired lease were a new lease at the date of acquisition. The acquiree's right-of-use asset should be measured at an amount equal to the lease liability, with an adjustment for any off-market terms present in the lease.

BC297 The IASB considered whether an acquirer should be required to follow the general principle in IFRS 3 *Business Combinations* and measure the acquiree's right-of-use assets and lease liabilities at fair value on the date of acquisition. However, in the IASB's view, the costs associated with measuring lease assets and lease liabilities at fair value would outweigh the benefits because obtaining fair value information might be difficult and, thus, costly. The IASB also noted that, when the acquiree is a lessee, the requirements of IFRS 3 (as amended by IFRS 16) for the measurement of lease assets and lease liabilities would result in the recognition of a net carrying amount for the lease at the date of acquisition that approximates the fair value of the lease at that date.

BC298 The IASB also considered whether to require an acquirer to recognise assets and liabilities relating to any off-market terms if an acquiree is the lessee in a lease for which either the short-term lease or low-value asset lease exemptions described in paragraph 5 of IFRS 16 are applied. Such a requirement would be consistent with the general principles of IFRS 3, under which assets and liabilities relating to contracts with off-market terms are recognised separately in the balance sheet and not subsumed within goodwill on acquisition. However, the IASB observed that the effect of any such off-market terms would rarely be material for short-term leases and leases of low-value assets. Consequently, it decided not to include this requirement in IFRS 3.

Transition for first-time adopters of IFRS

BC299 The IASB considered whether the transition relief for lessees in paragraphs C2–C19 of IFRS 16 should also apply to lessees applying IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

BC300 The IASB decided that a first-time adopter of IFRS should be permitted to apply some of the transition reliefs available to an existing IFRS preparer. This is because first-time adopters will face issues similar to those faced by existing IFRS preparers, and the transition requirements provide relief when first applying the requirements of IFRS 16. However, the IASB decided that a first-time adopter is not permitted to apply those transition reliefs that depend upon the lease having previously been accounted for applying IAS 17. This is because the IASB is not aware of, nor is it possible to consider, the accounting for leases required by every other GAAP. The amounts recognised in accordance with other GAAPs could be significantly different from the amounts recognised applying IAS 17 and IFRS 16.

BC301 The IASB also decided that a first-time adopter should apply IFRS 16 at the date of transition to IFRSs as defined in IFRS 1. Accordingly, a first-time adopter is not able to apply the transition relief provided in IFRS 16, which permits a lessee not to restate comparative information. A first-time adopter is required to restate comparative information applying IFRS 1 for all elements of its financial statements. For this reason, the IASB concluded that it would be inconsistent and impractical for a first-time adopter to not restate comparative information about leases in its first IFRS financial statements.

BC302 The IASB also decided not to permit a first-time adopter of IFRS to apply the transition relief in IFRS 16 for leases classified as finance leases applying IAS 17. The transition relief in IFRS 16 requires an IFRS preparer to measure the carrying amount of the right-of-use asset and the lease liability at the date of initial application of IFRS 16 as the carrying amount immediately before that date applying IAS 17. The rationale for this requirement is that the requirements of IAS 17 for leases classified as finance leases were similar to the requirements of IFRS 16. However, as described in paragraph BC300 above, the IASB cannot consider the accounting required by every other GAAP for leases that would have been classified as finance leases applying IAS 17. Consequently, the IASB concluded that carrying forward a first-time adopter's previous accounting could be misleading to users of financial statements, and could result in a lack of comparability with other IFRS preparers, perhaps for many years after first implementing IFRS.

Comparison with FASB decisions

BC303 The IASB and the FASB reached different decisions about the lessee accounting model. The differences largely affect leases that were previously classified as operating leases. There are a number of other differences between IFRS 16 and the decisions made by the FASB, primarily because of the different decisions reached on the lessee accounting model. The following paragraphs set out the main differences between IFRS 16 and the decisions made by the FASB.

Lessee accounting model

BC304 IFRS 16 applies a single lessee accounting model, which views all leases recognised in the balance sheet as providing finance. The IASB's reasons are explained in paragraphs BC41–BC56. The FASB decided upon a dual lessee accounting model that requires a lessee to classify leases in a similar manner to the previous US GAAP requirements for distinguishing between operating leases and capital leases. Under the FASB lessee accounting model, a lessee:

(a) accounts for finance leases (ie leases previously classified as capital leases) similarly to the IASB model; and

(b) accounts for operating leases by:

(i) recognising right-of-use assets and lease liabilities;

(ii) measuring lease liabilities in the same way as they would be measured applying IFRS 16, but without a requirement to reassess variable lease payments;

(iii) recognising a single lease expense typically on a straight-line basis over the lease term; and

(iv) presenting total cash paid within operating activities in the statement of cash flows.

Subleases

BC305 IFRS 16 requires an intermediate lessor to classify a sublease as either an operating lease or a finance lease by reference to the right-of-use asset arising from the head lease and not by reference to the underlying asset. The IASB's reasons are explained in paragraphs BC233–BC234. The FASB decided to require an intermediate lessor to determine the classification of the sublease by reference to the underlying asset.

Sale and leaseback transactions

BC306 In a sale and leaseback transaction, IFRS 16 requires a seller-lessee to recognise only the amount of any gain or loss on sale that relates to the rights transferred to the buyer-lessor. The IASB's reasons are explained in paragraph BC266. The FASB decided to require a seller-lessee to account for any gain or loss on sale consistently with the guidance that would apply to any other sale of an asset.

Presentation, disclosure and transition

BC307 There are a number of differences between the presentation, disclosure and transition requirements of IFRS 16 and the decisions made by the FASB. These differences are primarily a consequence of either the differences between the lessee accounting models or differences between other requirements of IFRS and US GAAP that are relevant to leases (for example, differences in the general disclosure requirements applicable to financial liabilities).

Recognition exemption for leases of low-value assets

BC308 IFRS 16 permits a lessee not to apply the recognition requirements to leases for which the underlying asset is of low value. The IASB's reasons are explained in paragraphs BC98–BC104. The FASB decided not to include such an exemption.

Reassessment of variable lease payments

BC309 IFRS 16 requires a lessee to reassess variable lease payments that depend on an index or a rate when there is a change in the future lease payments resulting from a change in the reference index or rate. The IASB's reasons are explained in paragraphs BC188–BC190. The FASB decided not to include any requirements to reassess variable lease payments.

Lessor accounting

BC310 Both the IASB and the FASB decided to substantially carry forward the previous lessor accounting requirements in IAS 17 and Topic 840 respectively. Consequently, there are a number of differences between the lessor accounting requirements in IFRS 16 and the decisions made by the FASB that are effectively carried forward from previous lessor accounting requirements.

Dissenting Opinion

Dissent of Wei-Guo Zhang

DO1 Mr Zhang supports the lessee accounting requirements in IFRS 16. However, Mr Zhang voted against publication of IFRS 16 for the following reasons:

(a) firstly, Mr Zhang does not support retaining a dual accounting model for lessors while requiring a single accounting model for lessees; and

(b) secondly, Mr Zhang disagrees with the recognition exemption for leases of low-value assets.

Lessor accounting

DO2 Mr Zhang agrees with the right-of-use lessee accounting model and believes that it should be applied symmetrically to lessor accounting. Mr Zhang is of the view that a lessor should recognise a lease receivable and a residual asset for all leases for which a lessee recognises a lease liability and a right-of-use asset. He believes that it is conceptually inconsistent to require a single accounting model for lessees while retaining a dual accounting model for lessors.

DO3 Mr Zhang agrees with the IASB's view set out in paragraphs BC35–BC36 that a lessor's right to receive lease payments arising from a lease is a financial asset. Mr Zhang believes that this financial asset should be reflected as such in a lessor's financial statements, and thus Mr Zhang disagrees with the conclusions reached in paragraphs BC57–BC66 regarding the costs and benefits of changing the lessor accounting model in IAS 17. This is because the nature of the risks associated with a financial asset are different from those of the underlying asset, and information about those different risks is of great importance to users of a lessor's financial statements.

DO4 Additionally, Mr Zhang is concerned about the complexity and potential for misapplication of the dual lessor accounting model. Mr Zhang acknowledges that this dual model is consistent with the requirements in IAS 17. However, Mr Zhang notes that one of the biggest criticisms of IAS 17 was the potential for complexity and structuring inherent in a dual model. Mr Zhang believes that two transactions that are economically the same could be structured in a way that results in those transactions being accounted for differently under the dual lessor accounting model.

Leases of low-value assets

DO5 Mr Zhang also disagrees with the recognition exemption for leases of low-value assets of a lessee because he does not believe that these leases should be treated differently from a lessee's other leases.

DO6 Mr Zhang believes that the recognition exemption for leases of low-value assets is unnecessary. This is because, in his view, the materiality guidance in IFRS and the recognition exemption for short-term leases in IFRS 16 should be sufficient to identify those leases for which the costs of recognising assets and liabilities would outweigh the benefits. When leases of low-value assets are material in the aggregate, Mr Zhang believes that recognising assets and liabilities has significant benefit. Mr Zhang also thinks that the costs of recognising assets and liabilities would be mitigated because an entity would have a record of leases of low-value assets for internal control purposes. The only incremental cost might be the cost associated with applying a discount rate to the lease payments.

DO7 Mr Zhang believes that the recognition exemption has the potential to set an inappropriate precedent by implying that the materiality guidance in IFRS is insufficient to capture contracts for which the costs of applying IFRS outweigh the benefits. Mr Zhang believes that a similar

argument could be used to justify many other exemptions from applying the requirements in IFRS.

DO8 Mr Zhang also notes that the recognition exemption for leases of low-value assets could create the same tension between leasing and buying low-value assets that existed applying the requirements of IAS 17. Mr Zhang is concerned that entities that require material amounts of low-value assets would be incentivised to lease those assets rather than buy them in order to achieve off balance sheet accounting.

DO9 Finally, Mr Zhang is concerned about the operationality of determining whether an asset is of 'low value'. Mr Zhang notes that paragraph BC100 states that 'at the time of reaching decisions about the exemption in 2015, 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.' Mr Zhang does not think that this reference to US$5,000 is appropriate. He notes that the same asset, when new, can have a different value in different markets, and that the value of a particular asset, when new, can change over time. Moreover, many countries or regions use different currencies, and exchange rates for those currencies change over time. Mr Zhang acknowledges that the exemption is optional and, thus, that entities are not required to apply the exemption. Nonetheless, Mr Zhang is of the view that stating a quantitative amount based on a particular currency may cause difficulties in applying the exemption among entities in different jurisdictions over time.

Dissent of Nick Anderson and Zachary Gast from *Covid-19-Related Rent Concessions beyond 30 June 2021*

DO1 Messrs Anderson and Gast voted against the publication of *Covid-19-Related Rent Concessions beyond 30 June 2021*. They are concerned that an extension to the period during which the practical expedient is available will further impede comparability between lessees that apply the practical expedient and those that do not. They note that support from users of financial statements for *Covid-19-Related Rent Concessions* (the 2020 amendment) was predicated on limiting the practical expedient to a specific time frame that the amendment will extend by 12 months. They also note that one key reason the Board developed the 2020 amendment was because, at that time, lessees were applying IFRS 16 for the first time and that this is no longer the case.

Appendix
Amendments to the Basis for Conclusions on other Standards

This appendix describes the amendments to the Basis for Conclusions on other Standards that the IASB made when it finalised IFRS 16.

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The amendments contained in this appendix when this Standard was issued in 2016 have been incorporated into the Basis for Conclusions on the relevant Standards.

Illustrative Examples

Hong Kong Financial Reporting Standard 16

Leases

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CONTENTS

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IFRS 16 *Leases*
Illustrative Examples

These examples accompany, but are not part of, IFRS 16. They illustrate aspects of IFRS 16 but are not intended to provide interpretative guidance.

IE1 These examples portray hypothetical situations illustrating how an entity might apply some of the requirements in IFRS 16 to particular aspects of a lease (or other contracts) on the basis of the limited facts presented. The analysis in each example is not intended to represent the only manner in which the requirements could be applied, nor are the examples intended to apply only to the specific industry illustrated. Although some aspects of the examples may be present in actual fact patterns, all relevant facts and circumstances of a particular fact pattern would need to be evaluated when applying IFRS 16.

Identifying a lease (paragraphs 9–11 and B9–B30)

IE2 The following examples illustrate how an entity determines whether a contract is, or contains, a lease.

Example 1—Rail cars

Example 1A: a contract between Customer and a freight carrier (Supplier) provides Customer with the use of 10 rail cars of a particular type for five years. The contract specifies the rail cars; the cars are owned by Supplier. Customer determines when, where and which goods are to be transported using the cars. When the cars are not in use, they are kept at Customer's premises. Customer can use the cars for another purpose (for example, storage) if it so chooses. However, the contract specifies that Customer cannot transport particular types of cargo (for example, explosives). If a particular car needs to be serviced or repaired, Supplier is required to substitute a car of the same type. Otherwise, and other than on default by Customer, Supplier cannot retrieve the cars during the five-year period.

The contract also requires Supplier to provide an engine and a driver when requested by Customer. Supplier keeps the engines at its premises and provides instructions to the driver detailing Customer's requests to transport goods. Supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers (ie if other customers require the transportation of goods to destinations close to the destination requested by Customer and within a similar timeframe, Supplier can choose to attach up to 100 rail cars to the engine).

The contract contains leases of rail cars. Customer has the right to use 10 rail cars for five years.

There are 10 identified cars. The cars are explicitly specified in the contract. Once delivered to Customer, the cars can be substituted only when they need to be serviced or repaired (see paragraph B18). The engine used to transport the rail cars is not an identified asset because it is neither explicitly specified nor implicitly specified in the contract.

Customer has the right to control the use of the 10 rail cars throughout the five-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the cars over the five-year period of use. Customer has exclusive use of the cars throughout the period of use, including when they are not being used to transport Customer's goods.

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Example 1—Rail cars

(b) Customer has the right to direct the use of the cars because the conditions in paragraph B24(a) exist. The contractual restrictions on the cargo that can be transported by the cars are protective rights of Supplier and define the scope of Customer's right to use the cars. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose the cars are used by being able to decide when and where the rail cars will be used and which goods are transported using the cars. Customer also determines whether and how the cars will be used when not being used to transport its goods (for example, whether and when they will be used for storage). Customer has the right to change these decisions during the five-year period of use.

Although having an engine and driver (controlled by Supplier) to transport the rail cars is essential to the efficient use of the cars, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the rail cars are used. Consequently, Supplier does not control the use of the cars during the period of use.

Example 1B: the contract between Customer and Supplier requires Supplier to transport a specified quantity of goods by using a specified type of rail car in accordance with a stated timetable for a period of five years. The timetable and quantity of goods specified are equivalent to Customer having the use of 10 rail cars for five years. Supplier provides the rail cars, driver and engine as part of the contract. The contract states the nature and quantity of the goods to be transported (and the type of rail car to be used to transport the goods). Supplier has a large pool of similar cars that can be used to fulfil the requirements of the contract. Similarly, Supplier can choose to use any one of a number of engines to fulfil each of Customer's requests, and one engine could be used to transport not only Customer's goods, but also the goods of other customers. The cars and engines are stored at Supplier's premises when not being used to transport goods.

The contract does not contain a lease of rail cars or of an engine.

The rail cars and the engines used to transport Customer's goods are not identified assets. Supplier has the substantive right to substitute the rail cars and engine because:

(a) Supplier has the practical ability to substitute each car and the engine throughout the period of use (see paragraph B14(a)). Alternative cars and engines are readily available to Supplier and Supplier can substitute each car and the engine without Customer's approval.

(b) Supplier would benefit economically from substituting each car and the engine (see paragraph B14(b)). There would be minimal, if any, cost associated with substituting each car or the engine because the cars and engines are stored at Supplier's premises and Supplier has a large pool of similar cars and engines. Supplier benefits from substituting each car or the engine in contracts of this nature because substitution allows Supplier to, for example, (i) use cars or an engine to fulfil a task for which the cars or engine are already positioned to perform (for example, a task at a rail yard close to the point of origin) or (ii) use cars or an engine that would otherwise be sitting idle because they are not being used by a customer.

Accordingly, Customer does not direct the use, nor have the right to obtain substantially all of the economic benefits from use, of an identified car or an engine. Supplier directs the use of the rail cars and engine by selecting which cars and engine are used for each particular delivery and obtains substantially all of the economic benefits from use of the rail cars and engine. Supplier is only providing freight capacity.

Example 2—Concession space

A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period. The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer: Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.

The contract does not contain a lease.

Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:

(a) Supplier has the practical ability to change the space used by Customer throughout the period of use (see paragraph B14(a)). There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.

(b) Supplier would benefit economically from substituting the space (see paragraph B14(b)). There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

Example 3—Fibre-optic cable

Example 3A: Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use three specified, physically distinct dark fibres within a larger cable connecting Hong Kong to Tokyo. Customer makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (ie Customer 'lights' the fibres and decides what data, and how much data, those fibres will transport). If the fibres are damaged, Supplier is responsible for the repairs and maintenance. Supplier owns extra fibres, but can substitute those for Customer's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

The contract contains a lease of dark fibres. Customer has the right to use the three dark fibres for 15 years.

There are three identified fibres. The fibres are explicitly specified in the contract and are physically distinct from other fibres within the cable. Supplier cannot substitute the fibres other than for reasons of repairs, maintenance or malfunction (see paragraph B18).

Customer has the right to control the use of the fibres throughout the 15-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the fibres over the 15-year period of use. Customer has exclusive use of the fibres throughout the period of use.

(b) Customer has the right to direct the use of the fibres because the conditions in paragraph B24(a) exist. Customer makes the relevant decisions about how and for what purpose the fibres are used by deciding (i) when and whether to light the fibres and (ii) when and how much output the fibres will produce (ie what data, and how much data, those fibres will transport). Customer has the right to change these decisions during the 15-year period of use.

Although Supplier's decisions about repairing and maintaining the fibres are essential to their efficient use, those decisions do not give Supplier the right to direct how and for what purpose the fibres are used. Consequently, Supplier does not control the use of the fibres during the period of use.

Example 3B: Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of three fibre strands within the cable (the cable contains 15 fibres with similar capacities). Supplier makes decisions about the transmission of data (ie Supplier lights the fibres, makes decisions about which fibres are used to transmit Customer's traffic and makes decisions about the electronic equipment that Supplier owns and connects to the fibres).

The contract does not contain a lease.

Supplier makes all decisions about the transmission of its customers' data, which requires the use of only a portion of the capacity of the cable for each customer. The capacity portion that will be provided to Customer is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable (see paragraph B20). Consequently, Customer does not have the right to use an identified asset.

Example 4—Retail unit

Customer enters into a contract with a property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.

Customer is granted the right to use Retail Unit A. Supplier can require Customer to relocate to another retail unit. In that case, Supplier is required to provide Customer with a retail unit of similar quality and specifications to Retail Unit A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favourable to cover the costs of relocating Customer and other tenants in the retail space. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise.

The contract requires Customer to use Retail Unit A to operate its well-known store brand to sell its goods during the hours that the larger retail space is open. Customer makes all of the decisions about the use of the retail unit during the period of use. For example, Customer decides on the mix of goods sold from the unit, the pricing of the goods sold and the quantities of inventory held. Customer also controls physical access to the unit throughout the five-year period of use.

The contract requires Customer to make fixed payments to Supplier, as well as variable payments that are a percentage of sales from Retail Unit A.

Supplier provides cleaning and security services, as well as advertising services, as part of the contract.

The contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years.

Retail Unit A is an identified asset. It is explicitly specified in the contract. Supplier has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Supplier's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise (see paragraph B16).

Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.

(b) Customer has the right to direct the use of Retail Unit A because the conditions in paragraph B24(a) exist. The contractual restrictions on the goods that can be sold from Retail Unit A, and when Retail Unit A is open, define the scope of Customer's right to use Retail Unit A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

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Example 4—Retail unit

Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

Example 5—Truck rental

Customer enters into a contract with Supplier for the use of a truck for one week to transport cargo from New York to San Francisco. Supplier does not have substitution rights. Only cargo specified in the contract is permitted to be transported on this truck for the period of the contract. The contract specifies a maximum distance that the truck can be driven. Customer is able to choose the details of the journey (speed, route, rest stops, etc.) within the parameters of the contract. Customer does not have the right to continue using the truck after the specified trip is complete.

The cargo to be transported, and the timing and location of pick-up in New York and delivery in San Francisco, are specified in the contract.

Customer is responsible for driving the truck from New York to San Francisco.

The contract contains a lease of a truck. Customer has the right to use the truck for the duration of the specified trip.

There is an identified asset. The truck is explicitly specified in the contract, and Supplier does not have the right to substitute the truck.

Customer has the right to control the use of the truck throughout the period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the truck over the period of use. Customer has exclusive use of the truck throughout the period of use.

(b) Customer has the right to direct the use of the truck because the conditions in B24(b)(i) exist. How and for what purpose the truck will be used (ie the transportation of specified cargo from New York to San Francisco within a specified timeframe) is predetermined in the contract. Customer directs the use of the truck because it has the right to operate the truck (for example, speed, route, rest stops) throughout the period of use. Customer makes all of the decisions about the use of the truck that can be made during the period of use through its control of the operations of the truck.

Because the duration of the contract is one week, this lease meets the definition of a short-term lease.

Example 6—Ship

Example 6A: Customer enters into a contract with a ship owner (Supplier) for the transportation of cargo from Rotterdam to Sydney on a specified ship. The ship is explicitly specified in the contract and Supplier does not have substitution rights. The cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported on the ship and the dates of pickup and delivery.

Supplier operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. Customer is prohibited from hiring another operator for the ship or operating the ship itself during the term of the contract.

The contract does not contain a lease.

There is an identified asset. The ship is explicitly specified in the contract and Supplier does not have the right to substitute that specified ship.

Customer has the right to obtain substantially all of the economic benefits from use of the ship over the period of use. Its cargo will occupy substantially all of the capacity of the ship, thereby preventing other parties from obtaining economic benefits from use of the ship.

However, Customer does not have the right to control the use of the ship because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the ship is used. How and for what purpose the ship will be used (ie the transportation of specified cargo from Rotterdam to Sydney within a specified timeframe) is predetermined in the contract. Customer has no right to change how and for what purpose the ship is used during the period of use. Customer has no other decision-making rights about the use of the ship during the period of use (for example, it does not have the right to operate the ship) and did not design the ship. Customer has the same rights regarding the use of the ship as if it were one of many customers transporting cargo on the ship.

Example 6B: Customer enters into a contract with Supplier for the use of a specified ship for a five-year period. The ship is explicitly specified in the contract and Supplier does not have substitution rights.

Customer decides what cargo will be transported, and whether, when and to which ports the ship will sail, throughout the five-year period of use, subject to restrictions specified in the contract. Those restrictions prevent Customer from sailing the ship into waters at a high risk of piracy or carrying hazardous materials as cargo.

Supplier operates and maintains the ship and is responsible for the safe passage of the cargo on board the ship. Customer is prohibited from hiring another operator for the ship of the contract or operating the ship itself during the term of the contract.

The contract contains a lease. Customer has the right to use the ship for five years.

There is an identified asset. The ship is explicitly specified in the contract, and Supplier does not have the right to substitute that specified ship.

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Example 6—Ship

Customer has the right to control the use of the ship throughout the five-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the ship over the five-year period of use. Customer has exclusive use of the ship throughout the period of use.

(b) Customer has the right to direct the use of the ship because the conditions in paragraph B24(a) exist. The contractual restrictions about where the ship can sail and the cargo to be transported by the ship define the scope of Customer's right to use the ship. They are protective rights that protect Supplier's investment in the ship and Supplier's personnel. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the ship is used throughout the five-year period of use because it decides whether, where and when the ship sails, as well as the cargo it will transport. Customer has the right to change these decisions throughout the five-year period of use.

Although the operation and maintenance of the ship are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the ship is used. Instead, Supplier's decisions are dependent upon Customer's decisions about how and for what purpose the ship is used.

Example 7—Aircraft

Customer enters into a contract with an aircraft owner (Supplier) for the use of an explicitly specified aircraft for a two-year period. The contract details the interior and exterior specifications for the aircraft.

There are contractual and legal restrictions in the contract on where the aircraft can fly. Subject to those restrictions, Customer determines where and when the aircraft will fly, and which passengers and cargo will be transported on the aircraft. Supplier is responsible for operating the aircraft, using its own crew. Customer is prohibited from hiring another operator for the aircraft or operating the aircraft itself during the term of the contract.

Supplier is permitted to substitute the aircraft at any time during the two-year period and must substitute the aircraft if it is not working. Any substitute aircraft must meet the interior and exterior specifications in the contract. There are significant costs involved in outfitting an aircraft in Supplier's fleet to meet Customer's specifications.

The contract contains a lease. Customer has the right to use the aircraft for two years.

There is an identified asset. The aircraft is explicitly specified in the contract and, although Supplier can substitute the aircraft, its substitution right is not substantive because the conditions in paragraph B14(b) do not exist. Supplier's substitution right is not substantive because of the significant costs involved in outfitting another aircraft to meet the specifications required by the contract such that Supplier is not expected to benefit economically from substituting the aircraft.

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Example 7—Aircraft

Customer has the right to control the use of the aircraft throughout the two-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the aircraft over the two-year period of use. Customer has exclusive use of the aircraft throughout the period of use.

(b) Customer has the right to direct the use of the aircraft because the conditions in paragraph B24(a) exist. The restrictions on where the aircraft can fly define the scope of Customer's right to use the aircraft. Within the scope of its right of use, Customer makes the relevant decisions about how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where and when the aircraft travels as well as the passengers and cargo it will transport. Customer has the right to change these decisions throughout the two-year period of use.

Although the operation of the aircraft is essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the aircraft is used. Consequently, Supplier does not control the use of the aircraft during the period of use and Supplier's decisions do not affect Customer's control of the use of the aircraft.

Example 8—Contract for shirts

Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality and quantity of shirts for a three-year period. The type, quality and quantity of shirts are specified in the contract.

Supplier has only one factory that can meet the needs of Customer. Supplier is unable to supply the shirts from another factory or source the shirts from a third party supplier. The capacity of the factory exceeds the output for which Customer has contracted (ie Customer has not contracted for substantially all of the capacity of the factory).

Supplier makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfil with the output of the factory that is not used to fulfil Customer's contract.

The contract does not contain a lease.

The factory is an identified asset. The factory is implicitly specified because Supplier can fulfil the contract only through the use of this asset.

Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier could decide to use the factory to fulfil other customer contracts during the period of use.

Customer also does not control the use of the factory because it does not have the right to direct the use of the factory. Customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. Customer's rights are limited to specifying output from the factory in the contract with Supplier. Customer has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used (ie Supplier has the right to decide the production level at which to run the factory and which customer contracts to fulfil with the output produced).

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Example 8—Contract for shirts

Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the factory, or that Customer does not have the right to direct the use of the factory, would be sufficient in isolation to conclude that Customer does not control the use of the factory.

Example 9—Contract for energy/power

Example 9A: a utility company (Customer) enters into a contract with a power company (Supplier) to purchase all of the electricity produced by a new solar farm for 20 years. The solar farm is explicitly specified in the contract and Supplier has no substitution rights. The solar farm is owned by Supplier and the energy cannot be provided to Customer from another asset. Customer designed the solar farm before it was constructed—Customer hired experts in solar energy to assist in determining the location of the farm and the engineering of the equipment to be used. Supplier is responsible for building the solar farm to Customer's specifications, and then operating and maintaining it. There are no decisions to be made about whether, when or how much electricity will be produced because the design of the asset has predetermined those decisions. Supplier will receive tax credits relating to the construction and ownership of the solar farm, while Customer receives renewable energy credits that accrue from use of the solar farm.

The contract contains a lease. Customer has the right to use the solar farm for 20 years.

There is an identified asset because the solar farm is explicitly specified in the contract, and Supplier does not have the right to substitute the specified solar farm.

Customer has the right to control the use of the solar farm throughout the 20-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the solar farm over the 20-year period of use. Customer has exclusive use of the solar farm; it takes all of the electricity produced by the farm over the 20-year period of use as well as the renewable energy credits that are a by-product from use of the solar farm. Although Supplier will receive economic benefits from the solar farm in the form of tax credits, those economic benefits relate to the ownership of the solar farm rather than the use of the solar farm and, thus, are not considered in this assessment.

(b) Customer has the right to direct the use of the solar farm because the conditions in paragraph B24(b)(ii) exist. Neither Customer, nor Supplier, decides how and for what purpose the solar farm is used during the period of use because those decisions are predetermined by the design of the asset (ie the design of the solar farm has, in effect, programmed into the asset any relevant decision-making rights about how and for what purpose the solar farm is used throughout the period of use). Customer does not operate the solar farm; Supplier makes the decisions about the operation of the solar farm. However, Customer's design of the solar farm has given it the right to direct the use of the farm. Because the design of the solar farm has predetermined how and for what purpose the asset will be used throughout the period of use, Customer's control over that design is substantively no different from Customer controlling those decisions.

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Example 9—Contract for energy/power

Example 9B: Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for three years. The power plant is owned and operated by Supplier. Supplier is unable to provide power to Customer from another plant. The contract sets out the quantity and timing of power that the power plant will produce throughout the period of use, which cannot be changed in the absence of extraordinary circumstances (for example, emergency situations). Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices. Supplier designed the power plant when it was constructed some years before entering into the contract with Customer—Customer had no involvement in that design.

The contract does not contain a lease.

There is an identified asset because the power plant is explicitly specified in the contract, and Supplier does not have the right to substitute the specified plant.

Customer has the right to obtain substantially all of the economic benefits from use of the identified power plant over the three-year period of use. Customer will take all of the power produced by the power plant over the three-year period of use.

However, Customer does not have the right to control the use of the power plant because it does not have the right to direct its use. Customer does not have the right to direct how and for what purpose the plant is used. How and for what purpose the plant is used (ie whether, when and how much power the plant will produce) is predetermined in the contract. Customer has no right to change how and for what purpose the plant is used during the period of use. Customer has no other decision-making rights about the use of the power plant during the period of use (for example, it does not operate the power plant) and did not design the plant. Supplier is the only party that can make decisions about the plant during the period of use by making the decisions about how the plant is operated and maintained. Customer has the same rights regarding the use of the plant as if it were one of many customers obtaining power from the plant.

Example 9C: Customer enters into a contract with Supplier to purchase all of the power produced by an explicitly specified power plant for 10 years. The contract states that Customer has rights to all of the power produced by the plant (ie Supplier cannot use the plant to fulfil other contracts).

Customer issues instructions to Supplier about the quantity and timing of the delivery of power. If the plant is not producing power for Customer, it does not operate.

Supplier operates and maintains the plant on a daily basis in accordance with industry-approved operating practices.

The contract contains a lease. Customer has the right to use the power plant for 10 years.

There is an identified asset. The power plant is explicitly specified in the contract and Supplier does not have the right to substitute the specified plant.

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Example 9—Contract for energy/power

Customer has the right to control the use of the power plant throughout the 10-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the power plant over the 10-year period of use. Customer has exclusive use of the power plant; it has rights to all of the power produced by the power plant throughout the 10-year period of use.

(b) Customer has the right to direct the use of the power plant because the conditions in paragraph B24(a) exist. Customer makes the relevant decisions about how and for what purpose the power plant is used because it has the right to determine whether, when and how much power the plant will produce (ie the timing and quantity, if any, of power produced) throughout the period of use. Because Supplier is prevented from using the power plant for another purpose, Customer's decision-making about the timing and quantity of power produced, in effect, determines when, and whether, the plant produces output.

Although the operation and maintenance of the power plant are essential to its efficient use, Supplier's decisions in this regard do not give it the right to direct how and for what purpose the power plant is used. Consequently, Supplier does not control the use of the power plant during the period of use. Instead, Supplier's decisions are dependent upon Customer's decisions about how and for what purpose the power plant is used.

Example 10—Contract for network services

Example 10A: Customer enters into a contract with a telecommunications company (Supplier) for network services for two years. The contract requires Supplier to supply network services that meet a specified quality level. In order to provide the services, Supplier installs and configures servers at Customer's premises—Supplier determines the speed and quality of data transportation in the network using the servers. Supplier can reconfigure or replace the servers when needed to continuously provide the quality of network services defined in the contract. Customer does not operate the servers or make any significant decisions about their use.

The contract does not contain a lease. Instead, the contract is a service contract in which Supplier uses the equipment to meet the level of network services determined by Customer.

There is no need to assess whether the servers installed at Customer's premises are identified assets. This assessment would not change the analysis of whether the contract contains a lease because Customer does not have the right to control the use of the servers.

Customer does not control the use of the servers because Customer's only decision-making rights relate to deciding upon the level of network services (the output of the servers) before the period of use—the level of network services cannot be changed during the period of use without modifying the contract. For example, even though Customer produces the data to be transported, that activity does not directly affect the configuration of the network services and, thus, it does not affect how and for what purpose the servers are used.

Supplier is the only party that can make relevant decisions about the use of the servers during the period of use. Supplier has the right to decide how data is transported using the servers, whether to reconfigure the servers and whether to use the servers for another purpose. Accordingly, Supplier controls the use of the servers in providing network services to Customer.

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Example 10—Contract for network services

Example 10B: Customer enters into a contract with an information technology company (Supplier) for the use of an identified server for three years. Supplier delivers and installs the server at Customer's premises in accordance with Customer's instructions, and provides repair and maintenance services for the server, as needed, throughout the period of use. Supplier substitutes the server only in the case of malfunction. Customer decides which data to store on the server and how to integrate the server within its operations. Customer can change its decisions in this regard throughout the period of use.

The contract contains a lease. Customer has the right to use the server for three years.

There is an identified asset. The server is explicitly specified in the contract. Supplier can substitute the server only if it is malfunctioning (see paragraph B18).

Customer has the right to control the use of the server throughout the three-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the server over the three-year period of use. Customer has exclusive use of the server throughout the period of use.

(b) Customer has the right to direct the use of the server (because the conditions in paragraph B24(a) exist). Customer makes the relevant decisions about how and for what purpose the server is used because it has the right to decide which aspect of its operations the server is used to support and which data it stores on the server. Customer is the only party that can make decisions about the use of the server during the period of use.

Leases of low-value assets and portfolio application (paragraphs 5–6, B1 and B3–B8)

IE3 The following example illustrates how a lessee might (a) apply paragraphs B3–B8 of IFRS 16 to leases of low-value assets; and (b) determine portfolios of leases to which it would apply the requirements in IFRS 16.

Example 11—Leases of low-value assets and portfolio application

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

(a) *leases of real estate (both office buildings and warehouses).*

(b) *leases of manufacturing equipment.*

(c) *leases of company cars, both for sales personnel and senior management and of varying quality, specification and value.*

(d) *leases of trucks and vans used for delivery purposes, of varying size and value.*

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

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

(g) *leases of office equipment:*

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

  (ii) *water dispensers; and*

  (iii) *high-capacity multifunction photocopier devices.*

Leases of low-value assets

Lessee determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are individually of low value:

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

(b) leases of office furniture and water dispensers.

Lessee elects to apply the requirements in paragraph 6 of IFRS 16 in accounting for all of those leases.

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

Portfolio application

As a result, Lessee applies the recognition and measurement requirements in IFRS 16 to its leases of real estate, manufacturing equipment, company cars, trucks and vans, servers and high-capacity multifunction photocopier devices. In doing so, Lessee groups its company cars, trucks and vans into portfolios.

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Example 11—Leases of low-value assets and portfolio application

Lessee's company cars are leased under a series of master lease agreements. Lessee uses eight different types of company car, which vary by price and are assigned to staff on the basis of seniority and territory. Lessee has a master lease agreement for each different type of company car. The individual leases within each master lease agreement are all similar (including similar start and end dates), but the terms and conditions generally vary from one master lease agreement to another. Because the individual leases within each master lease agreement are similar to each other, Lessee reasonably expects that applying the requirements of IFRS 16 to each master lease agreement would not result in a materially different effect than applying the requirements of IFRS 16 to each individual lease within the master lease agreement. Consequently, Lessee concludes that it can apply the requirements of IFRS 16 to each master lease agreement as a portfolio. In addition, Lessee concludes that two of the eight master lease agreements are similar and cover substantially similar types of company cars in similar territories. Lessee reasonably expects that the effect of applying IFRS 16 to the combined portfolio of leases within the two master lease agreements would not differ materially from applying IFRS 16 to each lease within that combined portfolio. Lessee, therefore, concludes that it can further combine those two master lease agreements into a single lease portfolio.

Lessee's trucks and vans are leased under individual lease agreements. There are 6,500 leases in total. All of the truck leases have similar terms, as do all of the van leases. The truck leases are generally for four years and involve similar models of truck. The van leases are generally for five years and involve similar models of van. Lessee reasonably expects that applying the requirements of IFRS 16 to portfolios of truck leases and van leases, grouped by type of underlying asset, territory and the quarter of the year within which the lease was entered into, would not result in a materially different effect from applying those requirements to each individual truck or van lease. Consequently, Lessee applies the requirements of IFRS 16 to different portfolios of truck and van leases, rather than to 6,500 individual leases.

Allocating consideration to components of a contract (paragraphs 12–16 and B32–B33)

IE4 The following example illustrates the allocation of consideration in a contract to lease and non-lease components by a lessee.

Example 12—Lessee allocation of consideration to lease and non-lease components of a contract

Lessor leases a bulldozer, a truck and a long-reach excavator to Lessee to be used in Lessee's mining operations for four years. Lessor also agrees to maintain each item of equipment throughout the lease term. The total consideration in the contract is CU600,000[(a)], payable in annual instalments of CU150,000, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. The variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. The consideration includes the cost of maintenance services for each item of equipment.

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Example 12—Lessee allocation of consideration to lease and non-lease components of a contract

Lessee accounts for the non-lease components (maintenance services) separately from each lease of equipment applying paragraph 12 of IFRS 16. Lessee does not elect the practical expedient in paragraph 15 of IFRS 16. Lessee considers the requirements in paragraph B32 of IFRS 16 and concludes that the lease of the bulldozer, the lease of the truck and the lease of the long-reach excavator are each separate lease components. This is because:

(a) Lessee can benefit from use of each of the three items of equipment on its own or together with other readily available resources (for example, Lessee could readily lease or purchase an alternative truck or excavator to use in its operations); and

(b) although Lessee is leasing all three items of equipment for one purpose (ie to engage in mining operations), the machines are neither highly dependent on, nor highly interrelated with, each other. Lessee's ability to derive benefit from the lease of each item of equipment is not significantly affected by its decision to lease, or not lease, the other equipment from Lessor.

Consequently, Lessee concludes that there are three lease components and three non-lease components (maintenance services) in the contract. Lessee applies the guidance in paragraphs 13–14 of IFRS 16 to allocate the consideration in the contract to the three lease components and the non-lease components.

Several suppliers provide maintenance services for a similar bulldozer and a similar truck. Accordingly, there are observable standalone prices for the maintenance services for those two items of leased equipment. Lessee is able to establish observable stand-alone prices for the maintenance of the bulldozer and the truck of CU32,000 and CU16,000, respectively, assuming similar payment terms to those in the contract with Lessor. The long-reach excavator is highly specialised and, accordingly, other suppliers do not lease or provide maintenance services for similar excavators. Nonetheless, Lessor provides four-year maintenance service contracts to customers that purchase similar long-reach excavators from Lessor. The observable consideration for those four-year maintenance service contracts is a fixed amount of CU56,000, payable over four years, and a variable amount that depends on the hours of work performed in maintaining the long-reach excavator. That variable payment is capped at 2 per cent of the replacement cost of the long-reach excavator. Consequently, Lessee estimates the stand-alone price of the maintenance services for the long-reach excavator to be CU56,000 plus any variable amounts. Lessee is able to establish observable stand-alone prices for the leases of the bulldozer, the truck and the long-reach excavator of CU170,000, CU102,000 and CU224,000, respectively.

Lessee allocates the fixed consideration in the contract (CU600,000) to the lease and non-lease components as follows:

CU	Bulldozer	Truck	Long-reach excavator	Total
Lease	170,000	102,000	224,000	**496,000**
Non-lease				**104,000**
Total fixed consideration				**600,000**

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Example 12—Lessee allocation of consideration to lease and non-lease components of a ontract
Lessee allocates all of the variable consideration to the maintenance of the long-reach excavator, and, thus, to the non-lease components of the contract. Lessee then accounts for each lease component applying the guidance in IFRS 16, treating the allocated consideration as the lease payments for each lease component.
(a) In these Illustrative Examples, currency amounts are denominated in 'currency units' (CU).

Lessee measurement (paragraphs 18–41 and B34–B41)

IE5 The following example illustrates how a lessee measures right-of-use assets and lease liabilities. It also illustrates how a lessee accounts for a change in the lease term.

Example 13—Measurement by a lessee and accounting for a change in the lease term

Part 1—Initial measurement of the right-of-use asset and the lease liability

Lessee enters into a 10-year lease of a floor of a building, with an option to extend for five years. Lease payments are CU50,000 per year during the initial term and CU55,000 per year during the optional period, all payable at the beginning of each year. To obtain the lease, Lessee incurs initial direct costs of CU20,000, of which CU15,000 relates to a payment to a former tenant occupying that floor of the building and CU5,000 relates to a commission paid to the real estate agent that arranged the lease. As an incentive to Lessee for entering into the lease, Lessor agrees to reimburse to Lessee the real estate commission of CU5,000.

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

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

At the commencement date, Lessee makes the lease payment for the first year, incurs initial direct costs, receives the lease incentive from Lessor and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

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

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000
Right-of-use asset	CU20,000	
Cash (initial direct costs)		CU20,000

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Example 13—Measurement by a lessee and accounting for a change in the lease term

Cash (lease incentive)	CU5,000	
Right-of-use asset		CU5,000

Part 2—Subsequent measurement and accounting for a change in the lease term

In the sixth year of the lease, Lessee acquires Entity A. Entity A has been leasing a floor in another building. The lease entered into by Entity A contains a termination option that is exercisable by Entity A. Following the acquisition of Entity A, Lessee needs two floors in a building suitable for the increased workforce. To minimise costs, Lessee (a) enters into a separate eight-year lease of another floor in the building leased that will be available for use at the end of Year 7 and (b) terminates early the lease entered into by Entity A with effect from the beginning of Year 8.

Moving Entity A's staff to the same building occupied by Lessee creates an economic incentive for Lessee to extend its original lease at the end of the non-cancellable period of 10 years. The acquisition of Entity A and the relocation of Entity A's staff is a significant event that is within the control of Lessee and affects whether Lessee is reasonably certain to exercise the extension option not previously included in its determination of the lease term. This is because the original floor has greater utility (and thus provides greater benefits) to Lessee than alternative assets that could be leased for a similar amount to the lease payments for the optional period—Lessee would incur additional costs if it were to lease a similar floor in a different building because the workforce would be located in different buildings. Consequently, at the end of Year 6, Lessee concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Entity A.

Lessee's incremental borrowing rate at the end of Year 6 is 6 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a nine-year term, and with similar collateral. Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

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Example 13—Measurement by a lessee and accounting for a change in the lease term

The right-of-use asset and the lease liability from Year 1 to Year 6 are as follows.

	Lease liability				Right-of-use asset		
Year	Beginning balance CU	Lease payment CU	5% interest expense CU	Ending balance CU	Beginning balance CU	Depreciation charge CU	Ending balance CU
1	**355,391**	-	17,770	**373,161**	**420,391**	(42,039)	**378,352**
2	**373,161**	(50,000)	16,158	**339,319**	**378,352**	(42,039)	**336,313**
3	**339,319**	(50,000)	14,466	**303,785**	**336,313**	(42,039)	**294,274**
4	**303,785**	(50,000)	12,689	**266,474**	**294,274**	(42,039)	**252,235**
5	**266,474**	(50,000)	10,823	**227,297**	**252,235**	(42,039)	**210,196**
6	**227,297**	(50,000)	8,865	**186,162**	**210,196**	(42,039)	**168,157**

At the end of the sixth year, before accounting for the change in the lease term, the lease liability is CU186,162 (the present value of four remaining payments of CU50,000, discounted at the original interest rate of 5 per cent per annum). Interest expense of CU8,865 is recognised in Year 6. Lessee's right-of-use asset is CU168,157.

Lessee remeasures the lease liability at the present value of four payments of CU50,000 followed by five payments of CU55,000, all discounted at the revised discount rate of 6 per cent per annum, which is CU378,174. Lessee increases the lease liability by CU192,012, which represents the difference between the remeasured liability of CU378,174 and its previous carrying amount of CU186,162. The corresponding adjustment is made to the right-of-use asset to reflect the cost of the additional right of use, recognised as follows.

Right-of-use asset	CU192,012	
Lease liability		CU192,012

Following the remeasurement, the carrying amount of Lessee's right-of-use asset is CU360,169 (ie CU168,157 + CU192,012). From the beginning of Year 7 Lessee calculates the interest expense on the lease liability at the revised discount rate of 6 per cent per annum.

The right-of-use asset and the lease liability from Year 7 to Year 15 are as follows.

	Lease liability				Right-of-use asset		
Year	Beginning balance CU	Lease payment CU	6% interest expense CU	Ending balance CU	Beginning balance CU	Depreciation charge CU	Ending balance CU
7	**378,174**	(50,000)	19,690	**347,864**	**360,169**	(40,019)	**320,150**
8	**347,864**	(50,000)	17,872	**315,736**	**320,150**	(40,019)	**280,131**
9	**315,736**	(50,000)	15,944	**281,680**	**280,131**	(40,019)	**240,112**
10	**281,680**	(50,000)	13,901	**245,581**	**240,112**	(40,019)	**200,093**
11	**245,581**	(55,000)	11,435	**202,016**	**200,093**	(40,019)	**160,074**
12	**202,016**	(55,000)	8,821	**155,837**	**160,074**	(40,019)	**120,055**

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Example 13—Measurement by a lessee and accounting for a change in the lease term

13	**155,837**	(55,000)	6,050	**106,887**	**120,055**	(40,019)	**80,036**
14	**106,887**	(55,000)	3,113	**55,000**	**80,036**	(40,018)	**40,018**
15	**55,000**	(55,000)	-	**-**	**40,018**	(40,018)	**-**

Variable lease payments (paragraphs 27, 39, 42(b) and 43)

IE6 The following example illustrates how a lessee accounts for variable lease payments that depend on an index and variable lease payments not included in the measurement of the lease liability.

Example 14—Variable lease payments dependent on an index and variable lease payments linked to sales

Example 14A—Lessee enters into a 10-year lease of property with annual lease payments of CU50,000, payable at the beginning of each year. The contract specifies that lease payments will increase every two years on the basis of the increase in the Consumer Price Index for the preceding 24 months. The Consumer Price Index at the commencement date is 125. This example ignores any initial direct costs. The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

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

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

During the first two years of the lease, Lessee recognises in aggregate the following related to the lease.

Interest expense	CU33,928	
Lease liability		CU33,928
Depreciation charge	CU81,078 (CU405,391 ÷ 10 × 2 years)	

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Example 14—Variable lease payments dependent on an index and variable lease payments linked to sales

Right-of-use asset		CU81,078

At the beginning of the second year, Lessee makes the lease payment for the second year and recognises the following.

Lease liability	CU50,000	
Cash		CU50,000

At the beginning of the third year, before accounting for the change in future lease payments resulting from a change in the Consumer Price Index and making the lease payment for the third year, the lease liability is CU339,319 (the present value of eight payments of CU50,000 discounted at the interest rate of 5 per cent per annum = CU355,391 + CU33,928 – CU50,000).

At the beginning of the third year of the lease the Consumer Price Index is 135.

The payment for the third year, adjusted for the Consumer Price Index, is CU54,000 (CU50,000 × 135 ÷ 125). Because there is a change in the future lease payments resulting from a change in the Consumer Price Index used to determine those payments, Lessee remeasures the lease liability to reflect those revised lease payments, ie the lease liability now reflects eight annual lease payments of CU54,000.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of CU54,000 discounted at an unchanged discount rate of 5 per cent per annum, which is CU366,464. Lessee increases the lease liability by CU27,145, which represents the difference between the remeasured liability of CU366,464 and its previous carrying amount of CU339,319. The corresponding adjustment is made to the right-of-use asset, recognised as follows.

Right-of-use asset	CU27,145	
Lease liability		CU27,145

At the beginning of the third year, Lessee makes the lease payment for the third year and recognises the following.

Lease liability	CU54,000	
Cash		CU54,000

Example 14B—Assume the same facts as Example 14A except that Lessee is also required to make variable lease payments for each year of the lease, which are determined as 1 per cent of Lessee's sales generated from the leased property.

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in Example 14A. This is because the additional variable lease payments are linked to future sales and, thus, do not meet the definition of lease payments. Consequently, those payments are not included in the measurement of the asset and liability.

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Example 14—Variable lease payments dependent on an index and variable lease payments linked to sales

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000

Lessee prepares financial statements on an annual basis. During the first year of the lease, Lessee generates sales of CU800,000 from the leased property.

Lessee incurs an additional expense related to the lease of CU8,000 (CU800,000 × 1 per cent), which Lessee recognises in profit or loss in the first year of the lease.

Lease modifications (paragraphs 44–46)

IE7 Examples 15–19 illustrate the requirements of IFRS 16 regarding lease modifications for a lessee.

Example 15—Modification that is a separate lease

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

Lessee accounts for the modification as a separate lease, separate from the original 10-year lease. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the lease is commensurate with the stand-alone price of the additional right-of-use adjusted to reflect the circumstances of the contract. In this example, the additional underlying asset is the new 3,000 square metres of office space. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space. Lessee does not make any adjustments to the accounting for the original lease of 2,000 square metres of office space as a result of this modification.

Example 16—Modification that increases the scope of the lease by extending the contractual lease term

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 7, Lessee and Lessor agree to amend the original lease by extending the contractual lease term by four years. The annual lease payments are unchanged (ie CU100,000 payable at the end of each year from Year 7 to Year 14). Lessee's incremental borrowing rate at the beginning of Year 7 is 7 per cent per annum.

At the effective date of the modification (at the beginning of Year 7), Lessee remeasures the lease liability based on: (a) an eight-year remaining lease term, (b) annual payments of CU100,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified lease liability equals CU597,130. The lease liability immediately before the modification (including the recognition of the interest expense until the end of Year 6) is CU346,511. Lessee recognises the difference between the carrying amount of the modified lease liability and the carrying amount of the lease liability immediately before the modification (CU250,619) as an adjustment to the right-of-use asset.

Example 17—Modification that decreases the scope of the lease

Lessee enters into a 10-year lease for 5,000 square metres of office space. The annual lease payments are CU50,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to reduce the space to only 2,500 square metres of the original space starting from the end of the first quarter of Year 6. The annual fixed lease payments (from Year 6 to Year 10) are CU30,000. Lessee's incremental borrowing rate at the beginning of Year 6 is 5 per cent per annum.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU30,000 and (c) Lessee's incremental borrowing rate of 5 per cent per annum. This equals CU129,884.

Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset on the basis of the remaining right-of-use asset (ie 2,500 square metres corresponding to 50 per cent of the original right-of-use asset).

50 per cent of the pre-modification right-of-use asset (CU184,002) is CU92,001. Fifty per cent of the pre-modification lease liability (CU210,618) is CU105,309. Consequently, Lessee reduces the carrying amount of the right-of-use asset by CU92,001 and the carrying amount of the lease liability by CU105,309. Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (CU105,309 – CU92,001 = CU13,308) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lessee recognises the difference between the remaining lease liability of CU105,309 and the modified lease liability of CU129,884 (which equals CU24,575) as an adjustment to the right-of-use asset reflecting the change in the consideration paid for the lease and the revised discount rate.

Example 18—Modification that both increases and decreases the scope of the lease

Lessee enters into a 10-year lease for 2,000 square metres of office space. The annual lease payments are CU100,000 payable at the end of each year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease to (a) include an additional 1,500 square metres of space in the same building starting from the beginning of Year 6 and (b) reduce the lease term from 10 years to eight years. The annual fixed payment for the 3,500 square metres is CU150,000 payable at the end of each year (from Year 6 to Year 8). Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum.

The consideration for the increase in scope of 1,500 square metres of space is not commensurate with the stand-alone price for that increase adjusted to reflect the circumstances of the contract. Consequently, Lessee does not account for the increase in scope that adds the right to use an additional 1,500 square metres of space as a separate lease.

The pre-modification right-of-use asset and the pre-modification lease liability in relation to the lease are as follows.

	Lease liability				Right-of-use asset		
	Beginning balance	**6% interest expense**	**Lease payment**	**Ending balance**	**Beginning balance**	**Depreciation charge**	**Ending balance**
Year	**CU**	**CU**	**CU**	**CU**	**CU**	**CU**	**CU**
1	**736,009**	44,160	(100,000)	**680,169**	**736,009**	(73,601)	**662,408**
2	**680,169**	40,810	(100,000)	**620,979**	**662,408**	(73,601)	**588,807**
3	**620,979**	37,259	(100,000)	**558,238**	**588,807**	(73,601)	**515,206**
4	**558,238**	33,494	(100,000)	**491,732**	**515,206**	(73,601)	**441,605**
5	**491,732**	29,504	(100,000)	**421,236**	**441,605**	(73,601)	**368,004**
6	**421,236**				**368,004**		

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability on the basis of: (a) a three-year remaining lease term, (b) annual payments of CU150,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. The modified liability equals CU393,647, of which (a) CU131,216 relates to the increase of CU50,000 in the annual lease payments from Year 6 to Year 8 and (b) CU262,431 relates to the remaining three annual lease payments of CU100,000 from Year 6 to Year 8.

Decrease in the lease term

At the effective date of the modification (at the beginning of Year 6), the pre-modification right-of-use asset is CU368,004. Lessee determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset for the original 2,000 square metres of office space (ie a remaining three-year lease term rather than the original five-year lease term). The remaining right-of-use asset for the original 2,000 square metres of office space is CU220,802 (ie CU368,004 ÷ 5 × 3 years).

At the effective date of the modification (at the beginning of Year 6), the pre-modification lease liability is CU421,236. The remaining lease liability for the original 2,000 square metres of office space is CU267,301 (ie present value of three annual lease payments of CU100,000, discounted at the original discount rate of 6 per cent per annum).

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Example 18—Modification that both increases and decreases the scope of the lease

Consequently, Lessee reduces the carrying amount of the right-of-use asset by CU147,202 (CU368,004 – CU220,802), and the carrying amount of the lease liability by CU153,935 (CU421,236 – CU267,301). Lessee recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset (CU153,935 – CU147,202 = CU6,733) as a gain in profit or loss at the effective date of the modification (at the beginning of Year 6).

Lease liability		CU153,935	
	Right-of-use asset		CU147,202
	Gain		CU6,733

At the effective date of the modification (at the beginning of Year 6), Lessee recognises the effect of the remeasurement of the remaining lease liability reflecting the revised discount rate of 7 per cent per annum, which is CU4,870 (CU267,301 – CU262,431), as an adjustment to the right-of-use asset.

Lease liability		CU4,870	
	Right-of-use asset		CU4,870

Increase in the leased space

At the commencement date of the lease for the additional 1,500 square metres of space (at the beginning of Year 6), Lessee recognises the increase in the lease liability related to the increase in scope of CU131,216 (ie present value of three annual lease payments of CU50,000, discounted at the revised interest rate of 7 per cent per annum) as an adjustment to the right-of-use asset.

Right-of-use asset		CU131,216	
	Lease liability		CU131,216

The modified right-of-use asset and the modified lease liability in relation to the modified lease are as follows.

	Lease liability				**Right-of-use asset**		
	Beginning balance	**7% interest expense**	**Lease payment**	**Ending balance**	**Beginning balance**	**Depreciation charge**	**Ending balance**
Year	**CU**	**CU**	**CU**	**CU**	**CU**	**CU**	**CU**
6	**393,647**	27,556	(150,000)	**271,203**	**347,148**	(115,716)	**231,432**
7	**271,203**	18,984	(150,000)	**140,187**	**231,432**	(115,716)	**115,716**
8	**140,187**	9,813	(150,000)	**-**	**115,716**	(115,716)	**-**

Example 19—Modification that is a change in consideration only

Lessee enters into a 10-year lease for 5,000 square metres of office space. At the beginning of Year 6, Lessee and Lessor agree to amend the original lease for the remaining five years to reduce the lease payments from CU100,000 per year to CU95,000 per year. The interest rate implicit in the lease cannot be readily determined. Lessee's incremental borrowing rate at the commencement date is 6 per cent per annum. Lessee's incremental borrowing rate at the beginning of Year 6 is 7 per cent per annum. The annual lease payments are payable at the end of each year.

At the effective date of the modification (at the beginning of Year 6), Lessee remeasures the lease liability based on: (a) a five-year remaining lease term, (b) annual payments of CU95,000 and (c) Lessee's incremental borrowing rate of 7 per cent per annum. Lessee recognises the difference between the carrying amount of the modified liability (CU389,519) and the lease liability immediately before the modification (CU421,236) of CU31,717 as an adjustment to the right-of-use asset.

Subleases (paragraph B58)

IE8 Examples 20–21 illustrate the application of the requirements in IFRS 16 for an intermediate lessor that enters into a head lease and a sublease of the same underlying asset.

Example 20—Sublease classified as a finance lease

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

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

The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease. The intermediate lessor classifies the sublease as a finance lease, having considered the requirements in paragraphs 61–66 of IFRS 16.

When the intermediate lessor enters into the sublease, the intermediate lessor:

(a) derecognises the right-of-use asset relating to the head lease that it transfers to the sublessee and recognises the net investment in the sublease;

(b) recognises any difference between the right-of-use asset and the net investment in the sublease in profit or loss; and

(c) retains the lease liability relating to the head lease in its statement of financial position, which represents the lease payments owed to the head lessor.

During the term of the sublease, the intermediate lessor recognises both finance income on the sublease and interest expense on the head lease.

Example 21—Sublease classified as an operating lease

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

Sublease—At commencement of the head lease, the intermediate lessor subleases the 5,000 square metres of office space for two years to a sublessee.

The intermediate lessor classifies the sublease by reference to the right-of-use asset arising from the head lease. The intermediate lessor classifies the sublease as an operating lease, having considered the requirements in paragraphs 61–66 of IFRS 16.

When the intermediate lessor enters into the sublease, the intermediate lessor retains the lease liability and the right-of-use asset relating to the head lease in its statement of financial position.

During the term of the sublease, the intermediate lessor:

(a) recognises a depreciation charge for the right-of-use asset and interest on the lease liability; and

(b) recognises lease income from the sublease.

Lessee disclosure (paragraphs 59 and B49–B50)

IE9 Example 22 illustrates how a lessee with different types of lease portfolios might comply with the disclosure requirements described in paragraphs 59 and B49 of IFRS 16 about variable lease payments. This example shows only current period information. IAS 1 *Presentation of Financial Statements* requires an entity to present comparative information.

Example 22—Variable payment terms

Lessee with a high volume of leases with some consistent payment terms

Example 22A: a retailer (Lessee) operates a number of different branded retail stores—A, B, C and D. Lessee has a high volume of property leases. Lessee's group policy is to negotiate variable payment terms for newly established stores. Lessee concludes that information about variable lease payments is relevant to users of its financial statements and is not available elsewhere in its financial statements. In particular, Lessee concludes that information about the proportion of total lease payments that arise from variable payments, and the sensitivity of those variable lease payments to changes in sales, is the information that is relevant to users of its financial statements. This information is similar to that reported to Lessee's senior management about variable lease payments.

Some of the property leases within the group contain variable payment terms that are linked to sales generated from the store. Variable payment terms are used, when possible, in newly established stores in order to link rental payments to store cash flows and minimise fixed costs. Fixed and variable rental payments by store brand for the period ended 31 December 20X0 are summarised below.

	Stores	Fixed payments	Variable payments	Total payments	Estimated annual impact on total brand rent of a 1% increase in sales
	No.	CU	CU	CU	%
Brand A	4,522	3,854	120	3,974	0.03%
Brand B	965	865	105	970	0.11%
Brand C	124	26	163	189	0.86%
Brand D	652	152	444	596	0.74%
	6,263	**4,897**	**832**	**5,729**	**0.15%**

Refer to the management commentary for store information presented on a like-for-like basis and to Note X for segmental information applying IFRS 8 *Operating Segments* relating to Brands A–D.

Example 22B: a retailer (Lessee) has a high volume of property leases of retail stores. Many of these leases contain variable payment terms linked to sales from the store. Lessee's group policy sets out the circumstances in which variable payment terms are used and all lease negotiations must be approved centrally. Lease payments are monitored centrally. Lessee concludes that information about variable lease payments is relevant to users of its financial statements and is not available elsewhere in its financial statements. In particular, Lessee concludes that information about the different types of contractual terms it uses with respect to variable lease payments, the effect of those terms on its financial performance and the sensitivity of variable lease payments to changes in sales is the information that is relevant to users of its financial statements. This is similar to the information that is reported to Lessee's senior management about variable lease payments.

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Example 22—Variable payment terms

Many of the property leases within the group contain variable payment terms that are linked to the volume of sales made from leased stores. These terms are used, when possible, in order to match lease payments with stores generating higher cash flows. For individual stores, up to 100 per cent of lease payments are on the basis of variable payment terms and there is a wide range of sales percentages applied. In some cases, variable payment terms also contain minimum annual payments and caps.

Lease payments and terms for the period ended 31 December 20X0 are summarised below.

	Stores	Fixed payments	Variable payments	Total payments
	No.	CU	CU	CU
Fixed rent only	1,490	1,153	-	1,153
Variable rent with no minimum	986	-	562	562
Variable rent with minimum	3,089	1,091	1,435	2,526
	5,565	**2,244**	**1,997**	**4,241**

A 1 per cent increase in sales across all stores in the group would be expected to increase total lease payments by approximately 0.6–0.7 per cent. A 5 per cent increase in sales across all stores in the group would be expected to increase total lease payments by approximately 2.6–2.8 per cent.

Lessee with a high volume of leases with a wide range of different payment terms

Example 22C: a retailer (Lessee) has a high volume of property leases of retail stores. These leases contain a wide range of different variable payment terms. Lease terms are negotiated and monitored by local management. Lessee concludes that information about variable lease payments is relevant to users of its financial statements and is not available elsewhere in its financial statements. Lessee concludes that information about how its property lease portfolio is managed is the information that is relevant to users of its financial statements. Lessee also concludes that information about the expected level of variable lease payments in the coming year (similar to that reported internally to senior management) is also relevant to users of its financial statements.

Many of the property leases within the group contain variable payment terms. Local management are responsible for store margins. Accordingly, lease terms are negotiated by local management and contain a wide range of payment terms. Variable payment terms are used for a variety of reasons, including minimising the fixed cost base for newly established stores or for reasons of margin control and operational flexibility. Variable lease payment terms vary widely across the group:

(a) the majority of variable payment terms are based on a range of percentages of store sales;

(b) lease payments based on variable terms range from 0–20 per cent of total lease payments on an individual property; and

(c) some variable payment terms include minimum or cap clauses.

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Example 22—Variable payment terms

The overall financial effect of using variable payment terms is that higher rental costs are incurred by stores with higher sales. This facilitates the management of margins across the group.

Variable rent expenses are expected to continue to represent a similar proportion of store sales in future years.

IE10 Example 23 illustrates how a lessee with different types of lease portfolios might comply with the disclosure requirements described in paragraphs 59 and B50 of IFRS 16 about extension options and termination options. This example shows only current period information. IAS 1 requires an entity to present comparative information.

Example 23—Extension options and termination options

Lessee with a high volume of leases, that have a wide range of different terms and conditions, which are not managed centrally

Example 23A: Lessee has a high volume of equipment leases with a wide range of different terms and conditions. Lease terms are negotiated and monitored by local management. Lessee concludes that information about how it manages the use of termination and extension options is the information that is relevant to users of its financial statements and is not available elsewhere in its financial statements. Lessee also concludes that information about (a) the financial effect of reassessing options and (b) the proportion of its short-term lease portfolio resulting from leases with annual break clauses is also relevant to users of its financial statements.

Extension and termination options are included in a number of equipment leases across the group. Local teams are responsible for managing their leases and, accordingly, lease terms are negotiated on an individual basis and contain a wide range of different terms and conditions. Extension and termination options are included, when possible, to provide local management with greater flexibility to align its need for access to equipment with the fulfilment of customer contracts. The individual terms and conditions used vary across the group.

The majority of extension and termination options held are exercisable only by Lessee and not by the respective lessors. In cases in which Lessee is not reasonably certain to use an optional extended lease term, payments associated with the optional period are not included within lease liabilities.

During 20X0, the financial effect of revising lease terms to reflect the effect of exercising extension and termination options was an increase in recognised lease liabilities of CU489.

In addition, Lessee has a number of lease arrangements containing annual break clauses at no penalty. These leases are classified as short-term leases and are not included within lease liabilities. The short-term lease expense of CU30 recognised during 20X0 included CU27 relating to leases with an annual break clause.

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Example 23—Extension options and termination options

Lessee with a high volume of leases with some consistent terms and options

Example 23B: a restaurateur (Lessee) has a high volume of property leases containing penalty-free termination options that are exercisable at the option of Lessee. Lessee's group policy is to have termination options in leases of more than five years, whenever possible. Lessee has a central property team that negotiates leases. Lessee concludes that information about termination options is relevant to users of its financial statements and is not available elsewhere in its financial statements. In particular, Lessee concludes that information about (a) the potential exposure to future lease payments that are not included in the measurement of lease liabilities and (b) the proportion of termination options that have been exercised historically is the information that is relevant to users of its financial statements. Lessee also notes that presenting this information on the basis of the same restaurant brands for which segment information is disclosed applying IFRS 8 is relevant to users of its financial statements. This is similar to the information that is reported to Lessee's senior management about termination options.

Many of the property leases across the group contain termination options. These options are used to limit the period to which the group is committed to individual lease contracts and to maximise operational flexibility in terms of opening and closing individual restaurants. For most leases of restaurants, recognised lease liabilities do not include potential future rental payments after the exercise date of termination options because Lessee is not reasonably certain to extend the lease beyond that date. This is the case for most leases for which a longer lease period can be enforced only by Lessee and not by the landlord, and for which there is no penalty associated with the option.

Potential future rental payments relating to periods following the exercise date of termination options are summarised below.

Business segment	Lease liabilities recognised (discounted)	Potential future lease payments not included in lease liabilities (undiscounted)		
		Payable during 20X1–20X5	Payable during 20X6–20Y0	Total
	CU	CU	CU	CU
Brand A	569	71	94	165
Brand B	2,455	968	594	1,562
Brand C	269	99	55	154
Brand D	1,002	230	180	410
Brand E	914	181	321	502
	5,209	**1,549**	**1,244**	**2,793**

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Example 23—Extension options and termination options

The table below summarises the rate of exercise of termination options during 20X0.

Business segment	Termination option exercisable during 20X0	Termination option not exercised	Termination option exercised
	No. of leases	No. of leases	No. of leases
Brand A	33	30	3
Brand B	86	69	17
Brand C	19	18	1
Brand D	30	5	25
Brand E	66	40	26
	234	**162**	**72**

Example 23C: Lessee has a high volume of large equipment leases containing extension options that are exercisable by Lessee during the lease. Lessee's group policy is to use extension options to align, when possible, committed lease terms for large equipment with the initial contractual term of associated customer contracts, whilst retaining flexibility to manage its large equipment and reallocate assets across contracts. Lessee concludes that information about extension options is relevant to users of its financial statements and is not available elsewhere in its financial statements. In particular, Lessee concludes that (a) information about the potential exposure to future lease payments that are not included in the measurement of lease liabilities and (b) information about the historical rate of exercise of extension options is the information that is relevant to users of its financial statements. This is similar to the information that is reported to Lessee's senior management about extension options.

Many of the large equipment leases across the group contain extension options. These terms are used to maximise operational flexibility in terms of managing contracts. These terms are not reflected in measuring lease liabilities in many cases because the options are not reasonably certain to be exercised. This is generally the case when the underlying large equipment has not been allocated for use on a particular customer contract after the exercise date of an extension option. The table below summarises potential future rental payments relating to periods following the exercise dates of extension options.

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Example 23—Extension options and termination options

Business segment	Lease liabilities recognised (discounted)	Potential future lease payments not included in lease liabilities (discounted)	Historical rate of exercise of extension options
	CU	CU	%
Segment A	569	799	52%
Segment B	2,455	269	69%
Segment C	269	99	75%
Segment D	1,002	111	41%
Segment E	914	312	76%
	5,209	**1,590**	**67%**

Sale and leaseback transactions (paragraphs 98–103)

IE11 Example 24 illustrates the application of the requirements in paragraphs 99–102 of IFRS 16 for a seller-lessee and a buyer-lessor.

Example 24—Sale and leaseback transaction

An entity (Seller-lessee) sells a building to another entity (Buyer-lessor) for cash of CU2,000,000. Immediately before the transaction, the building is carried at a cost of CU1,000,000. At the same time, Seller-lessee enters into a contract with Buyer-lessor for the right to use the building for 18 years, with annual payments of CU120,000 payable at the end of each year. The terms and conditions of the transaction are such that the transfer of the building by Seller-lessee satisfies the requirements for determining when a performance obligation is satisfied in IFRS 15 Revenue from Contracts with Customers*. Accordingly, Seller-lessee and Buyer-lessor account for the transaction as a sale and leaseback. This example ignores any initial direct costs.*

The fair value of the building at the date of sale is CU1,800,000. Because the consideration for the sale of the building is not at fair value, Seller-lessee and Buyer-lessor make adjustments to measure the sale proceeds at fair value. The amount of the excess sale price of CU200,000 (CU2,000,000 – CU1,800,000) is recognised as additional financing provided by Buyer-lessor to Seller-lessee.

The interest rate implicit in the lease is 4.5 per cent per annum, which is readily determinable by Seller-lessee. The present value of the annual payments (18 payments of CU120,000, discounted at 4.5 per cent per annum) amounts to CU1,459,200, of which CU200,000 relates to the additional financing and CU1,259,200 relates to the lease—corresponding to 18 annual payments of CU16,447 and CU103,553, respectively.

Buyer-lessor classifies the lease of the building as an operating lease.

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Example 24—Sale and leaseback transaction

Seller-lessee

At the commencement date, Seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right of use retained by Seller-lessee, which is CU699,555. This is calculated as: CU1,000,000 (the carrying amount of the building) ÷ CU1,800,000 (the fair value of the building) × CU1,259,200 (the discounted lease payments for the 18-year right-of-use asset).

Seller-lessee recognises only the amount of the gain that relates to the rights transferred to Buyer-lessor of CU240,355 calculated as follows. The gain on sale of building amounts to CU800,000 (CU1,800,000 – CU1,000,000), of which:

(a) CU559,645 (CU800,000 ÷ CU1,800,000 × CU1,259,200) relates to the right to use the building retained by Seller-lessee; and

(b) CU240,355 (CU800,000 ÷ CU1,800,000 × (CU1,800,000 – CU1,259,200)) relates to the rights transferred to Buyer-lessor.

At the commencement date, Seller-lessee accounts for the transaction as follows.

Cash	CU2,000,000	
Right-of-use asset	CU699,555	
Building		CU1,000,000
Financial liability		CU1,459,200
Gain on rights transferred		CU240,355

Buyer-lessor

At the commencement date, Buyer-lessor accounts for the transaction as follows.

Building	CU1,800,000	
Financial asset	CU200,000 (18 payments of CU16,447, discounted at 4.5 per cent per annum)	
Cash		CU2,000,000

After the commencement date, Buyer-lessor accounts for the lease by treating CU103,553 of the annual payments of CU120,000 as lease payments. The remaining CU16,447 of annual payments received from Seller-lessee are accounted for as (a) payments received to settle the financial asset of CU200,000 and (b) interest revenue.

Appendix
Amendments to guidance on other Standards

This appendix describes the amendments to guidance on other Standards that the IASB made when it finalised IFRS 16.

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The amendments contained in this appendix when this Standard was issued in 2016 have been incorporated into the guidance on the relevant Standards.