



## **IFRS 16 Leases**

**February 2017**

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## Background

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IFRS 16 *Leases* will be replacing IAS 17 *Leases*, the current leasing standard. In addition, IFRS 16 will supersede:

- IFRIC 4 *Determining whether an Arrangement Contains a Lease*;
- SIC-15 *Operating Leases – Incentives*; and
- SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

Under IAS 17, lessees and lessors classify leases as either finance leases or operating leases and accounts for these two types of leases differently.

IFRS 16 introduces a new approach to lessee accounting whereby a lessee recognizes assets and liabilities for the rights and obligations created by all leases. This is in contrast to IAS 17 where only finance leases (and not operating leases) resulted in recognizing assets and liabilities. IFRS 16 requires a lessee to recognize 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.

IAS 17 was criticized for its lack of transparency of a lessee's financial leverage and capital employed. As such, the new standard aims to create a more faithful representation of a lessee's assets and liabilities together with enhanced disclosures.

Companies that previously classified their leases as operating leases will experience an increase in both assets and liabilities. Additionally, IFRS 16 replaces the straight-line operating lease expense as currently allowed under IAS 17 with a depreciation charge for the lease asset and an interest expense on the lease liability. This will result in a front-loaded lease expense that reduces over the life of the lease. Thus, the new standard impacts the statement of financial position, statement of comprehensive income, statement of cash flow and financial ratios.

IFRS 16 substantially retains the lessor accounting requirements from IAS 17. However, IFRS 16 will require enhanced disclosure by lessors on their risk exposure.

The new standard is effective for annual periods beginning on or after January 1, 2019. Early adoption is permitted for entities that apply IFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of this standard.

This guide should be used in conjunction and with consideration of the complete IFRS 16 standard.

## Purpose and Scope

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The purpose of IFRS 16 is to help users of financial statements to assess the effect of leases on the financial position, financial performance and cash flows of an entity. It does this by ensuring that lessees and lessors recognize, measure, present and disclose their leasing transactions faithfully.

IFRS 16 will apply to all leases<sup>1</sup>, except for:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- Leases of biological assets within the scope of IAS 41 *Agriculture* held by a lessee;
- Service concession arrangements within the scope of IFRIC 12 *Service Concession Arrangements*;
- Licenses of intellectual property granted by a lessor within the scope of IFRS 15; and
- 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.

A lessee may, but is not required to, apply this standard to the lease of intangible assets other than those described in the last bullet point above.

## Impact of New Leasing Standard on Lessees<sup>2</sup>

The standard will have the biggest impact on entities that accounted for their leases under IAS 17 as operating leases (i.e., they were off-balance sheet leases). The impact on these entities are as follows:

### Statement of Financial Position

Entities will have more assets (lease assets) but also more debt (lease liabilities). The net effect may be a reduction in equity initially because the carrying amount of leased assets (depreciated on a straight line basis) typically reduce quicker than lease liabilities where interest may be a higher portion of lease payments in the first years of the lease term.

### Statement of Profit or Loss and Comprehensive Income

The lease expense will be front-loaded even though the lease payments are constant throughout the lease term (i.e., interest on the lease liability will decrease over the lease term, similar to other debt and depreciation will remain constant). This is in contrast to IAS 17 where operating lease payments were smoothed over the lease term.

### Statement of Cash Flow

Total cash flows will remain unchanged but a reallocation between operating activities and financing activities will result because repayments on the lease liability will be included in financing activities. Lease payments made for the interest portion of the lease liability will be classified in accordance with other interest paid as either operating, investing or financing activities in accordance with IAS 7 *Statement of Cash Flows*.

### Financial Metrics



The new accounting requirements in IFRS 16 will have an impact on key financial metrics of the entity due to the movement of off-balance sheet leases to the balance sheet.

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<sup>1</sup> All leases includes leases of right-of-use assets in a sublease, as discussed in the *Sublease Classification* section of this guide.

<sup>2</sup> The following summary of information has been adapted from: "Effects Analysis – IFRS 16 Leases" released by the International Accounting Standards Board (IASB) in January 2016.

The impact of these changes on the financial ratios of an entity include, but are not limited to the following:

Impact	Balance Sheet	Profit/Loss	Ratios
	Financial assets Financial liabilities	EBITDA Operating profit Finance costs	Debt/Equity Leverage
	Net Assets	Earnings per share (in early years)	Current ratio Asset turnover Interest coverage

## Recognition Exemptions

A lessee may elect not to apply the new leasing requirements in IFRS 16 in the following situations:

- a) Short-term leases ( $\leq 12$  months); and
- b) Leases where the underlying asset, in a new condition, is of low value<sup>3</sup> (e.g. tablet and personal computers, small items of office furniture and telephones).

What is considered “low value” is based on judgement since the standard does not specify a guideline. However, the Basis of Conclusions for IFRS 16 provides that when applying the exemption for underlying assets of low value, when they are new, the entity may use USD\$5,000 or less as a guideline.

It is also noted that the outcome of the low value assessment of an underlying asset should not be affected by the size, nature or circumstances of the lessee. That is, it is only based on the value of the leased asset, not the size or nature of the entity that leased the asset.

Since this exception is based on the individual asset value, an entity may lease a large number of assets which individually have a low value yet in total are significant and reflected off-balance sheet.

If a lessee elects to apply the above exemptions, it recognizes the associated lease payments as an expense on either:

- A straight-line basis over the lease term; or
- Another systematic basis if it is more representative of the pattern of the lessee’s benefit.

The election for short-term leases should be made by class of underlying asset (i.e., a grouping of assets of a similar nature and use in the entity’s operations) to which the right-of-use relates. The election for low value leases should be made on a lease-by-lease basis.

Per IFRS 16.B5, a low value underlying asset exists only if:

- a) The lessee can benefit from its use on its own or together with other resources that are readily available to the lessee; AND
- b) It is not highly dependent on, or highly interrelated with, other assets.

<sup>3</sup> 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.



**Example of Leases of Low-value Assets (Adapted IFRS 16.IE3 Example 11)**

A Credit Union has leases for a number of assets they include:

- Leases of office buildings.
- Leases of company cars for senior management, the cars are of varying quality, specification and value.
- Leases of IT equipment for use by employees, including laptop computers, desktop computers and printers, tablets and smart phones.
- Leases of servers with the option to add modules to increase storage capacity of the servers.
- Leases of office equipment, including office furniture (i.e., chairs, desks and office partitions) and multifunction photocopiers.

**Assessment:** The Credit Union determines that the leases of IT equipment and office furniture qualify as leases of low-value assets on the basis that the underlying assets, when new, are individually of low value, not dependent or interrelated with other assets and can be used on their own. The Credit Union elects to apply the recognition exemption in IFRS 16 to account for these leases.

The additional modules may be considered low value individually. However, it would not qualify as a lease of low-value assets since it highly interrelated with the server (i.e., the Credit Union would not lease the modules without also leasing the servers).

The Credit Union would apply the recognition and measurement requirements in IFRS 16 to the office buildings and company cars.

**Identifying a Lease**

**Assessment of Whether a Contract Contains a Lease or Not**

a) *When should this assessment be made?*

An entity is required to assess whether a contract is, or contains a lease at the inception of the contract.

There is a difference between the inception date of the contract and the commencement date of the lease as follows:

Inception Date of the Contract	Commencement Date of the Lease
Is the earlier of the date of: <ul style="list-style-type: none"> <li>▪ A lease agreement; and</li> <li>▪ A commitment by the parties to the principal terms and conditions of the lease.</li> </ul>	The date on which a lessor makes an underlying asset available for use by a lessee.

b) *When Does a Lease Exist?*

A lease exists where the contract grants the right to control the use of an identified asset for a period of time in exchange for consideration.

Per IFRS 16.B9, control over the use of an identified asset for a period of time is conveyed when, the customer has both of the following throughout the period of use:

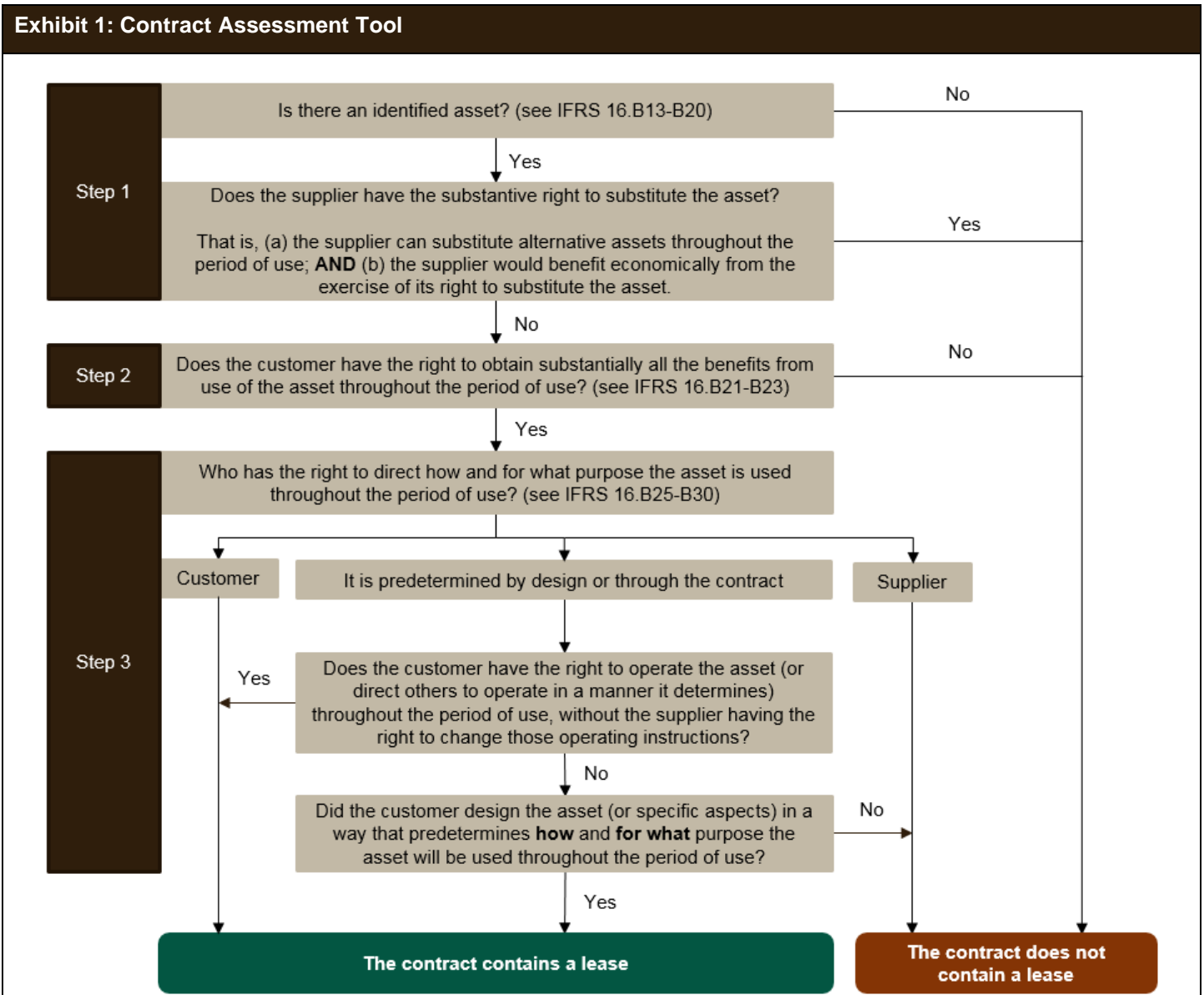
- a) The right to obtain substantially all of the economic benefits from use of the identified asset; and
- b) The right to direct the use of the identified asset.

**Note!** One of the major impacts to lessees is recognizing previously classified operating leases that were “off-balance” sheet as “on-balance sheet”. Additionally, lessees will be required to assess all leases and whether they meet the new lease definition. Depending on the volume of leases an entity holds, this may require a substantial effort to analyze and collect the data to apply the requirements of IFRS 16. This may include implementing new systems and processes to gather the required data or it may involve the entity revisiting existing lease contracts to facilitate changes in the terms and conditions in order to help minimize the impact of transition.

Entities need to be aware of the changes to accounting for leases under IFRS 16 in order to effectively plan for a successful transition.

The following diagram provides an overview of the thought process used by an entity when assessing whether a contract contains a lease or not.

**Exhibit 1: Contract Assessment Tool**





## Key Elements of a Lease

Based on the above, the following three questions must be answered to assess whether the key elements of a lease exist. All three must be present for a lease to exist:

**Step 1:** Is there an identified asset?

**Step 2:** Does the customer have the right to obtain substantially all the economic benefits from use?

**Step 3:** Who has the right to direct the use?

Each of these elements will now be discussed in more detail.

### **Step 1: Identified Asset**

A contract only contains a lease only if there is an identified asset. Typically the asset is specified in a contract, by either being:

- Explicitly specified; or
- Implicitly specified at the time the asset is made available for use.

#### *a) What if a capacity portion of an asset is identified?*

Per IFRS 16.B20, a capacity portion of an asset is an identified asset if it is physically distinct (e.g. a floor of a building). A portion of an asset that is not physically distinct (e.g. 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.

#### *b) What is the impact of substantive substitution rights?*

When a supplier has the substantive right to substitute the asset throughout the period of use, a customer does not have the right to use an identified asset, even if an asset is specified. IFRS 16.B14 discusses that such a right is substantive only if both of the following exist:

- a) The supplier has the practical ability to substitute alternative assets throughout the period of use (i.e., the customer cannot stop the supplier from substituting the asset and alternative assets could be easily provided or 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, that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset.

A supplier's substitution right is not substantive when the supplier can only substitute the asset on or after either a particular date or the occurrence of a specified event. This is because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

The assessment of a supplier's substantive substitution right should be based on facts and circumstances at the inception of the contract and exclude consideration of future events that are considered **not likely** to occur. IFRS 16.B16 discusses unlikely future events to exclude from the analysis, which can include (but are not limited to):

- An agreement by a future customer paying above market rate for use of the asset;
- New technology which is substantially undeveloped at inception;
- A substantial difference between the customer's intended use or the performance of the asset over the period of use versus likely use/performance at inception; and
- A substantial difference between the market price of the asset during the period of use, and the market price at inception of the contract.

c) *Does the asset's location impact whether a substitution right is substantive?*

Yes. If the asset is not in the supplier's possession, the costs of substitution would likely be higher. Therefore, the costs to substitute the asset would likely exceed the benefits and a substantive substitution right would not exist.

IFRS 16.B19 allows a customer to presume that any substitution right is not substantive if the customer cannot readily determine whether the supplier has a substantive substitution right.

d) *What if the supplier has a right or obligation to substitute the asset for repairs and maintenance; or if the asset is not operating properly; or if a technical upgrade becomes available?*

These rights do not preclude the customer from having the right to use an identified asset. Even though the supplier has the contractual right to substitute the asset at any time, these substitution rights are not substantive because the right does not change the substance of the contract.

**Examples of Identified Asset with Substantive Substitution Rights** (Adapted from IFRS.16IE 2 Example 1)

**Example 1:**

AV Building Supplies ("AV") operates home and building supplies warehouses across Canada. AV has a lumber contract with a supplier located in the interior British Columbia. AV requires their lumber to be transported to their various warehouses and lumber yards by rail transport. During the year, AV entered into a contract with a freight carrier, Dynamic Logistics ("DL"), to provide AV with the use of 10 flatbed rail cars for five years. The contract specifies the rail cars. The cars are owned by DL. AV determines when, where and which goods are to be transported using the cars. AV can use the cars for another purpose if it so chooses. If a particular car needs to be serviced or repaired, DL is required to substitute a car of the same type.

**Assessment:** In this case, the 10 rail cars are the identified asset. AV has the ability to direct the use of the cars and obtains substantially all of the economic benefits from their use during the rental period. The supplier does not have substantive substitution rights as it is required to substitute the cars only when they require maintenance and repairs. Therefore, the contract likely contains a lease.

**Example 2:**

Assume AV and DL enter into a contract where AV requires DL to transport its lumber using DL's rail cars for a period of five years. DL provides the rail cars, and has a large pool of the particular type of rail cars which is required to fulfill the contract with AV.

**Assessment:** In this case, DL has a large pool of similar rail cars and DL can substitute them at any point in time as it chooses to fulfill its obligations under the contract. Hence, DL has a substantive substitution right and the contract does not contain a lease.

**Step 2: Right to Obtain Substantially All of the Economic Benefits from Use**

To control the use of an identified asset, a customer is required to have the rights to obtain substantially all of the economic benefits from use of the asset throughout the period of use (e.g. by having exclusive use of the asset throughout that period).

a) *What is the economic benefits from the use of an asset?*

The economic benefits from use of an asset include the primary output and by-products (e.g. potential cash flows) from the asset. The customer may have use of the asset directly or indirectly (e.g. by using, holding or sub-leasing the asset).

**Example of Primary Output and By-products** (Adapted from IFRS 16.IE2 Example 9)

Green Utilities (“Green”), a utility company, enters into a contract with Southern Ontario Power Company (“SPC”) to purchase all of the electricity produced by a new solar farm for period of 20 years. The solar farm is owned by SPC. Prior to SPC building the solar farm, Green used its solar experts in developing the design which SPC used to build the solar farm to Green’s specifications. As a result of building the solar farm, SPC will receive tax credits as owner of the solar farm. On the other hand, Green will receive renewable energy credits that accrue from the use of the solar farm.

Does the Green have the right to obtain substantially all of the economic benefits from use?

**Assessment:** Yes, Green obtains the right to obtain economic benefits from use – that is, Green has the exclusive use of the solar farm (purchase of all electricity produced for the 20-years period); and Green has the right to the renewable energy credits (a by-product from using the solar farm).

Although SPC receives tax credits, they are considered economic benefits that relate to the ownership of the solar farm rather than the use of the solar farm. Therefore, they are not considered in this assessment.

A contract may define a specific scope of a customer's right to use the asset. For example, it may:

- Limit the use of a motor vehicle to only one particular territory during the period of use;
- Specify that a customer can drive a motor vehicle only up to a particular number of miles during the period of use.

b) *How does that impact the assessment of whether the customer has rights to substantially all of the economic benefits from use of the asset?*

In such a situation, the entity considers the economic benefits that result from use of the asset within the defined scope of the customer's right to use the asset. With respect to the bullet points above, this means the customer considers only the economic benefits from use of the motor vehicle within that territory or permitted mileage, and not beyond. Thus, it may be able to conclude that the customer obtains substantially all of the economic benefits within the defined scope of use.

c) *What if a contract requires a customer to pay the supplier or another party a substantial portion of the cash flows derived from use of an asset as consideration? Does that mean the customer is not entitled to substantially all the economic benefits from use of the asset?*

No. The cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from use of the asset.

**Example of Payment of Cash Flows to the Supplier** (Adapted from IFRS 16.IE2 Example 4)

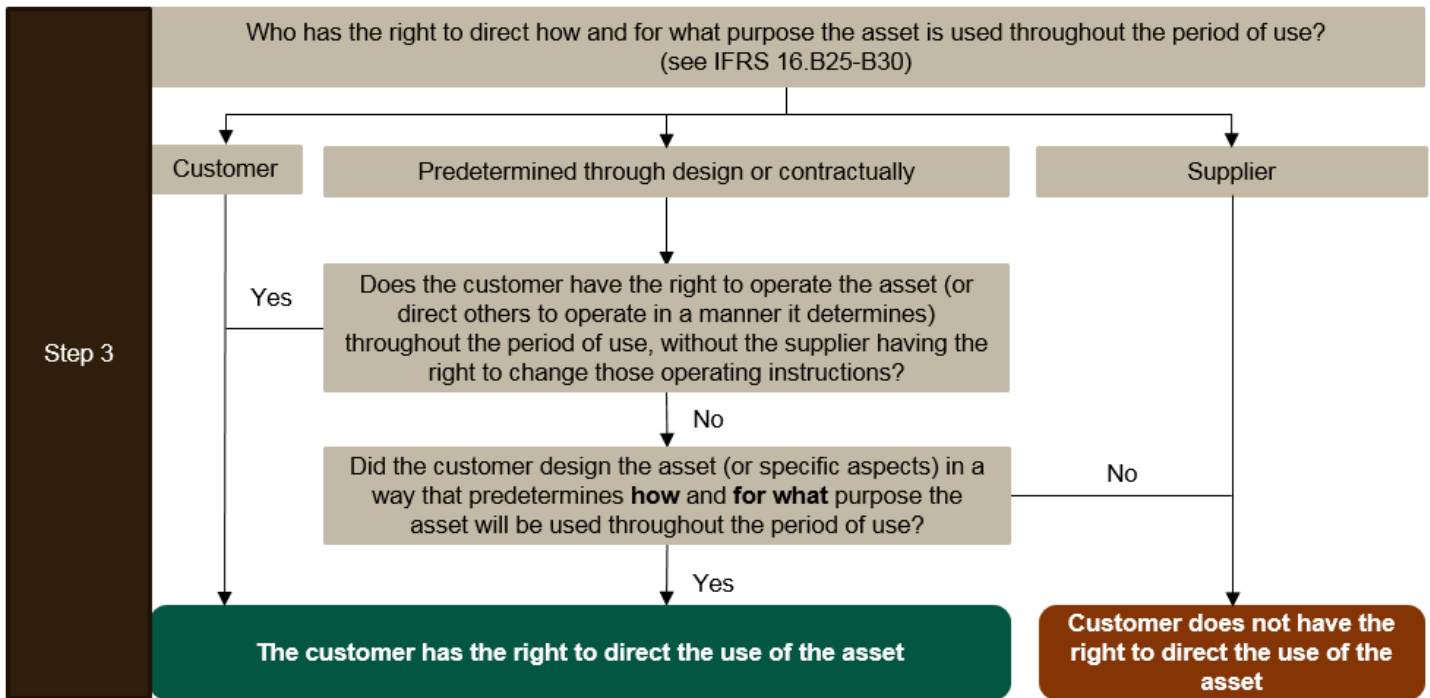
A customer is required to pay a property owner a fixed payments and a percentage of sales from the use of a retail space for a five-year period.

Does the customer have the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use?

**Assessment:** Although the customer is required to pay the supplier a percentage of sales from use of retail space as consideration for that use, this would not prevent the customer from having the right to obtain substantially all of the economic benefits from use of the space. This is because the cash flow from sales are considered to be economic benefits the customer obtains from using the space, a portion of which it then pays to the supplier as consideration for the right to use that space.

**Step 3: Right to Direct the Use**

As noted in Exhibit 1, the following decision tree helps to determine whether the customer has the right to direct the use of the asset:



Examples of decision-making rights that allows the customer to direct how and for what purpose the asset is used, include the rights to change:

- a) the type of output that is produced by the asset (e.g. using a shipping container to transport goods or for storage);
- b) when the output is produced (e.g. when an item of machinery will be used);
- c) where the output is produced (e.g. where an item of equipment is used); and
- d) whether the output is produced, and the quantity of that output (e.g. whether to produce energy from a power plant and how much energy to produce from that power plant)

Examples of decision-making rights that do not grant the right to change how and for what purpose the asset is used, include the rights that limit decisions to operating and maintaining the asset. Therefore, such rights can be held by the customer or supplier. 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.

**Examples of Rights to Substantially all Economic Benefits and to Direct the Use of the Asset** (Adapted from IFRS 16.IE 2 Example 10)

**Example 1:**

InTech Business Solutions (“InTech”) enters into a contract with Expert Communications (“Expert”) for the use of an identified server for three years. Expert delivers and installs the server at InTech’s office based on InTech’s instructions, and provides repair and maintenance services for the server, as needed, throughout the contract. Expert can substitute the server only in the case of a malfunction. InTech makes decisions with respect to the data to store on the server and which area of its operations the server will support. InTech has the ability to change how and for what purpose the server is used throughout the contract.

**Assessment:** This contract contains a lease because:

- a) The server is specifically stated in the contract and is the identified asset. Expert can substitute the server only if it is malfunctioning.
- b) InTech has the right to control the use of the server throughout the three-year lease period because:
  - It obtains substantially all of the economic benefits from use of the server over the lease term. InTech has exclusive rights to use of the server over the lease term.
  - It directs the use of the server. InTech makes the relevant decisions about how and for what purpose the server is used (i.e., right to decide what operations the server supports and which data it stores on the server). In addition, the customer is the only party that can make decisions about the use of the server during the period of use.

**Example 2:**

Assume InTech and Expert entered into a contract for network services. Per the contract, Expert will supply a specified quality of network services for a two-years period. To meet the quality level specified, Expert installs and configures the servers at InTech’s office space. That is, Expert determines the speed and quality of the local area network using the servers. Expert has the ability to continuously update or reconfigure the servers when needed to ensure that the quality of network services is met. InTech does not operate the servers or make any significant decisions about their use.

**Assessment:** The contract does not contain a lease because InTech does not have the right to control the use of the servers. InTech’s only decision-making rights relate to specifying the quality level which is determined prior to the period of use and cannot be changed without amending the contract. Expert determines the use of the servers during the period of use. Therefore, there is no need to assess whether the servers are identified assets since the key element of control does not exist. Since the contract does not contain a lease, the payments are expensed as incurred.

*Impact of Protective Rights on the Customer’s Ability to Direct the Use of the Identified Asset*

Protective rights are those terms and conditions included in a contract designed to protect the supplier’s interest in the asset or other assets, to protect its personnel or to ensure the lessor’s compliance with laws or regulations.

For example, a contract may:

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

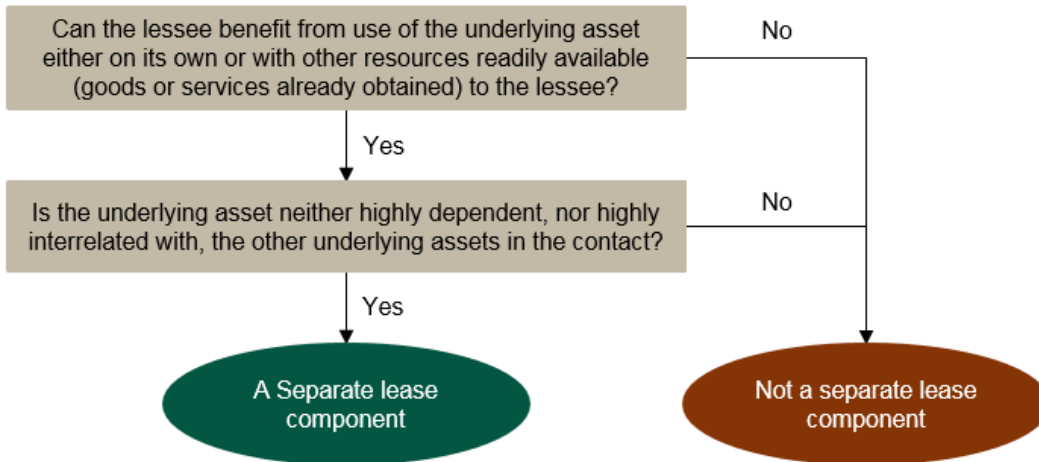
Protective rights do not prevent the lessee from having the right to direct the use of the asset, rather they are used to determine the scope of the lessee’s right-of-use. As a result, their presence do not prevent a contract from containing a lease.

## Separating Components of a Contract

A contract may contain a number of lease components and some non-lease components.

### Lease Component

The following decision tree can be used to determine whether the right to use an underlying asset is a separate lease component:



### Non-lease Component

Amounts payable by the lessee for activities and costs (i.e., administrative fees) that do not transfer a good or service to the lessee or that do not meet the definition of a lease; however, they form part of the total consideration that may be allocated to the non-lease components as discussed below.

Where a lease has two or more separate lease components, an entity has a choice as follows:

- Account for each lease component within the contract as a lease separately from non-lease components of the contract. The non-lease components are accounted for by applying other applicable standards.
- Apply the practical expedient allowed by IFRS 16.15 whereby it does not separate non-lease components from lease components, and instead accounts for any lease component and associated non-lease components as a single lease component. This practical expedient does not apply to embedded derivatives.

The practical expedient will reduce cost and complexity for some leases and should not create significant issues for comparability. It is anticipated that a lessee is not expected to apply the practical expedient for contracts with significant service components because that would increase the lease liability for those contracts. It is expected that lessee's will apply the practical expedient when the non-lease components are relatively small.

a) *How is the consideration allocated to each lease or non-lease component if the practical expedient is not selected?*

When an entity separates lease and non-lease components, it allocates the consideration 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.



b) How are the stand-alone prices of the components determined when allocating the total consideration to the components?

If available, they should be based on of the price the lessor would charge an entity for that component separately. If an observable stand-alone price is not readily available, the lessee estimates the stand-alone price, maximizing the use of observable information.

**Examples of Separating Components of a Contract** (Adapted from IFRS 16.IE4 Example 12)

**Example 1:**

Western Canadian Extracting Corporation (“Western”) leases a wheel loader, a truck and an excavator from Heavy Equipment Leasing & Rentals Ltd. (“HELRL”) to be used in Western’s mineral extraction operations. The contract requires Western to maintain each piece of equipment for the duration of the lease term. The total consideration in the contract is \$500,000, payable in annual instalments of \$100,000. The consideration includes the cost of maintenance services for each item of equipment. Western accounts for equipment leases separately from maintenance services (i.e., non-lease components).

**Assessment:** As such, Western considers the following IFRS 16 criteria to determine if the equipment leases are separate lease components:

- a) Does Western benefit from use of each piece of equipment on its own or together with other resources that are readily available to the Western?  
*Yes – Western can use each piece of equipment on its own or with other resources in its operations. One piece of equipment is not dependent on the other equipment being leased under this contract (i.e., Western could lease or purchase alternative pieces of equipment to use in its operations).*
- b) Each piece of equipment is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.  
*Yes – each piece of equipment is not dependent on another piece of equipment (i.e., can use each separately from each other to derive benefit).*

Western concludes that the lease of each piece of equipment are indeed separate lease components.

As a result, there are three lease components and three non-lease components for the maintenance services in the contract. Per IFRS 16.13-14, the consideration in the contract will need to be allocated to the three lease components and the non-lease component.

Other leasing companies provide maintenance services for a similar wheel loader, truck and excavator. Therefore, observable market inputs exist for the prices of maintenance services for all pieces of leased equipment. Based on the available information, Western determines that the maintenance of the wheel loader, truck and excavator of \$35,000, \$10,000 and \$50,000, respectively (Total \$95,000). Western is also able to determine observable stand-alone prices for the leases of the wheel loader, the truck and the excavator of \$125,000, \$55,000 and \$225,000, respectively.

As a result of the analysis performed, Western would allocate the \$500,000 consideration in the contract to the lease and non-lease components as follows:

	Wheel Loader	Truck	Excavator	Total*
<b>Lease</b>	\$125,000	\$55,000	\$225,000	<b>\$405,000</b>
<b>Non-lease</b>				<b>95,000</b>
<b>Total fixed consideration</b>				<b>\$500,000</b>

**Example of Separating Components of a Contract** (Continued from previous page)

**Example 2:**

How would the consideration be allocated if it was \$600,000 (not \$500,000)?

Component	Stand-alone price	% of total	Allocation*
Wheel loader	\$125,000	25%	\$150,000
Truck	55,000	11%	66,000
Excavator	225,000	45%	270,000
Maintenance (non-lease)	95,000	19%	114,000
<b>Total</b>	<b>\$500,000</b>	<b>100%</b>	<b>\$600,000</b>

**Assessment:** The consideration would be allocated proportionately to each component of the contract as illustrated in the table above.

\* Alternatively, the practical expedient allowed by IFRS 16.15, whereby the lease components are not separated and are accounted for as a single lease, could be applied by Western. However, the non-lease component would then be included “on-balance sheet” which may or may not be a favourable outcome for Western (i.e., the leased assets would be \$500,000 or \$600,000, respectively).

**Portfolio Application**

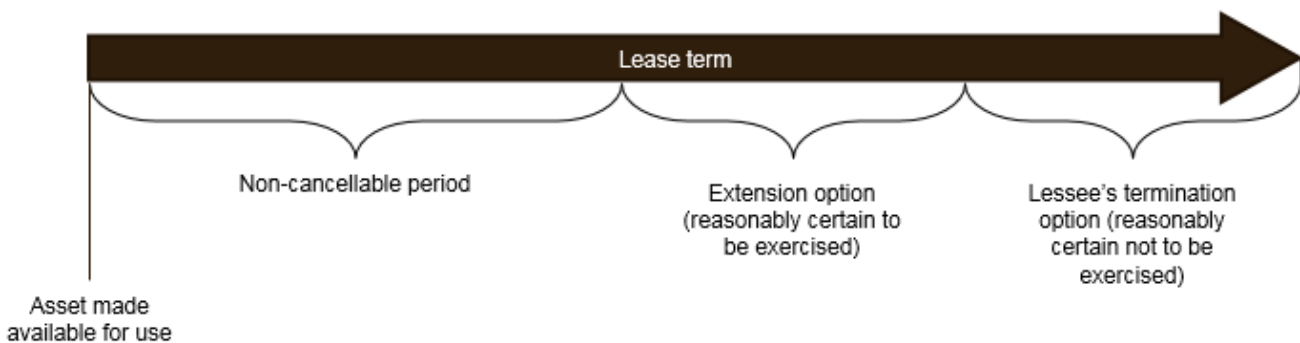
IFRS 16.B1 provides a practical expedient that allows an entity to apply this standard to a portfolio of leases with similar characteristics (leases of similar assets in similar economic environments with the same end date). That is, the requirements of this standard can be applied to a portfolio of leases instead of individual leases.

**Lease Term**

The standard defines lease term as 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 after an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

The lease would start on the date on which a lessor makes an underlying asset available for use by a lessee, including any rent free periods.



When the entity assesses the non-cancellable period of a lease, the entity should determine the period for which the contract is enforceable. A lease is no longer enforceable when both the lessee and the lessor can exercise its right to terminate the lease without permission and by paying an insignificant penalty.

a) *What if only the lessee has the right to terminate a lease?*

The entity considers the option to terminate the lease when determining the lease term. The entity may include the period covered by the right to terminate depending on the facts and circumstances present (i.e., it has a significant economic incentive or not to continue the lease during that period).

b) *What if only the lessor has the right to terminate a lease?*

The period covered by the lessor's option to terminate the lease is included in the non-cancellable period of the lease. In other words, it is not necessary to consider whether the lessor will exercise its option.

The determination of the lease term should not be overlooked as the estimate of the lease term is a key input in calculating the lease liability.

### **Lease Options to Extend or Terminate**

As noted above, appropriate consideration of how likely a lessee is to exercise its right to extend or terminate a lease is crucial in determining the correct lease term.

The analysis should consider all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option, or vice versa. This includes considering any expected changes in facts and circumstances from the start of the lease until the exercise date of the option.

A lessee is more likely to exercise an extension option or not exercise a termination option the shorter the non-cancellable period is. This is due to the higher cost associated with obtaining a replacement asset for the shorter non-cancellable period.

In addition, a lessee is likely to exercise an extension option or not exercise a termination option when the extension or termination option is combined with one or more other contractual features (e.g. a residual value guarantee) where the lessee guarantees the lessor a return that is substantially the same regardless of whether the option is exercised.

The following sample questions will assist the entity in their assessment:

- Are terms and conditions favourable or unfavourable to the lessee for the optional periods compared to market rates (amount of fixed, variable and/or contingent payments in optional periods; any penalties; etc.)?
- Will the lessee need to make significant leasehold improvements to the underlying asset over the lease term?
- Are there significant costs related to the termination of the lease? (e.g. negotiation, relocation, identifying another underlying asset suitable for the lessee's needs, integrating a new asset into the lessee's operations, or termination penalties and similar costs);
- How important is the underlying asset to the lessee's operations? (is it specialized?, what is the availability of suitable alternatives?); and
- Are there conditions that must be met in order for the option to be exercised? If so, what is the likelihood that those conditions will be met?
- Does the lessee have a past practice of exercising extension options or not exercising termination options and the economic reasons relating to past practice is still relevant?

**Example of Lease Term** (Adapted from IFRS 16.IE5 Example 13)

LC Laboratories (“LCL”) is a laboratory services company specializing in environmental chemistry, agricultural analysis, food testing and air quality monitoring. LCL enters into a ten year non-cancellable lease term for three floors of a building to house their laboratory testing operations. At the end of the lease term, LC Laboratories has an option to extend the lease for another five years. Prior to occupying the building, LCL made minor leasehold improvements to modify the space for some lab equipment. Although the building is an important asset in running LCL’s operations, the space is not highly specialized for their purposes as they own key testing equipment that is moveable if needed. Additionally, LCL has not moved locations regularly, however, due to the current downturn in the economy LCL has been able to negotiate favourable lease terms and chose to move its operations to the new leased building.

What is the lease term for the building lease?

**Assessment:** At the end of the ten-year term LCL’s management takes into consideration the following facts:

- They believe that leasehold improvements were not major changes to the building;
- The building is not highly specialized for their needs and they could move locations to other alternatives if needed; and
- Their history indicates that they do not move regularly, however, current economic conditions allowed them to negotiate favourable lease terms.

Based on the facts, LCL’s management determines the lease term is to be ten years. Although they do not historically move frequently, they cannot determine that in ten years that they may need a different location as a result of a growth in the business. Additionally, the other factors point to the conclusion that if LCL was required to move after the initial ten-year term, it would not be a financial burden to do so.

**Reassessment of Lease Term**

A lease term may change because of a change in the likelihood that a lessee will exercise their extension or termination option. Therefore, a lessee must reassess whether it is reasonably certain to exercise or not exercise an extension or termination option upon the occurrence of either 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 vice versa (e.g. significant leasehold improvements, modifications, or customizations to the underlying asset that were not initially expected when the lease commenced or business decisions such as the disposal of a business unit).

If the lease term subsequently changes as a result of this reassessment, the lessee is required to remeasure the lease liability. The lessee will use a revised discount rate at the date of reassessment.

Lessors on the other hand are not required to reassess the lease term after the lease commences.

The lease term must also be adjusted for changes in the non-cancellable period of a lease. Examples include:

- Depending on whether a particular extension/termination option was previously included in the determination of the lease term or not, the lessee exercising or not exercising of that extension or termination option
- 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
  - Prohibits the lessee from exercising an option previously included in the entity’s determination of the lease term.

**Example of a Reassessment of the Lease Term** (Adapted from IFRS16.IE5 Example 13)

Let's assume in the sixth year of the lease, LCL (from the previous example) acquires a new subsidiary ("SUB"). SUB has been leasing another building. The lease entered into by SUB contains a termination option that is exercisable by SUB. Following the acquisition, LCL needs a space to accommodate the increased workforce. To minimise costs, LCL:

- Enters into a separate eight-year lease of two additional floors in LCL's existing leased building that will be available for use at the end of Year 7; and
- Terminates early the lease entered into by SUB effective from the beginning of Year 8.

**Assessment:** Acquiring SUB and relocating its staff to LCL's existing leased building is a significant event within LCL's control and it impacts LCL's determination of whether it will exercise the extension option not previously included in its assessment of the lease term. That is, relocating SUB's staff creates an economic incentive for LCL to extend its original lease at the end of the non-cancellable period of ten years.

Therefore, at the end of Year 6, LCL 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 SUB. As such the lease term would now be considered to end at the end of Year 15 (at the end of Year 7, the new 8 year lease begins = 7 years + 8 year lease = 15 years).

**Lessee Accounting**

**Recognition and Measurement**

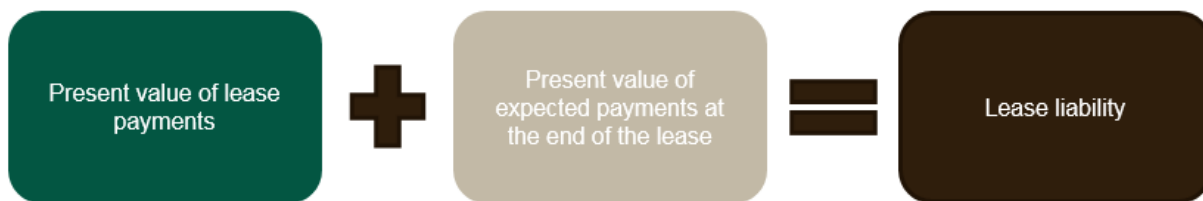
A right-of-use asset and a lease liability is recognized on the commencement date of all leases unless they meet the recognition exemptions (lease term less than 12 months; or underlying asset is of low value). The measurement of these will now be discussed in more detail.

**Initial Measurement**

*Lease Liability*

On lease commencement, the lessee recognizes and measures a lease liability.

Lease liability = present value of future lease payments discounted at the interest rate implicit in the lease.



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

Per IFRS 16.26, if the discount rate implicit in the lease is not readily determinable, the lessee may use its incremental borrowing rate.

A lessee will likely use the incremental borrowing rate since they would not know the lessor's initial direct costs or would have limited information on how the lessor determined the expected residual value of the underlying asset at the end of the lease.

The lessee's incremental borrowing rate is the 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.

IFRS 16.27 lists the following payments will be included in the lease liability:

- a) Fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- b) Variable lease payments that depend on an index or a rate (e.g. payments linked to an inflation index or a benchmark interest rate, such as the Bank of Canada's prime rate, or payments that vary to reflect changes in market rental rates);
- c) Amounts expected to be payable by the lessee under residual value guarantees;
- d) The exercise price of a purchase option that the lessee is reasonably certain to exercise; and
- e) Payments of penalties for terminating the lease, if the lease term reflects early termination.

Note that variable payments are only included in the lease liability if based on an index or a rate. Therefore, payments based solely on a percentage of use or output (e.g. revenue from sale of goods produced of the leased asset) will typically not be included in the leased liability. However, in some cases a portion of variable payments may also be in-substance fixed payments, for example if the contract includes minimum payments. These concepts are demonstrated in the examples below.

#### Example of Variable Lease Payments Tied to an Index or Rate *(Adapted from IFRS 16.IE6 Example 14)*

Using LC Laboratories ("LC") from the previous example, let's assume the annual lease payments are \$120,000 (\$10,000/month). The contract specifies that lease payments will increase every year on the basis of the increase in the Consumer Price Index ("CPI"). The Consumer Price Index at the commencement date is 100.

**Assessment:** The initial measurement of the lease liability would be based on the CPI at the commencement date of the lease and takes into account the annual \$120,000 lease payments over the term of the lease. At the end of Year 1, the CPI increased 105. Therefore, at the end of Year 1, the lease liability would be recalculated by adjusting for the CPI in future lease payments of \$126,000 ( $\$120,000 \times 105 / 100$ ).

#### a) *What are in-substance fixed payments?*

In-substance fixed payments are payments that may be variable but, in substance, are unavoidable. The following are examples of these types of payments:

- Payments structured as variable lease payments, but there is no genuine variability in those payments (i.e., the variable clauses have no real economic substance).
- There is more than one set of payments that a lessee could make, but only one of those sets of payments is realistic.
- 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 (i.e., there is a minimum).



**Example of In-substance Lease Payments**

HD Environmental Services (“HD”) provides expertise in planned remediation, land and water based emergency response, waste transportation and disposal. HD has a fleet of vacuum trucks as part of its waste transport and disposal operations. During the year, HD entered into a new lease contract for a vacuum truck. The lease payments are based on the number of engine hours used per month. The contract states that the minimum payment is based on 150 hours/month. HD expects to operate the vacuum truck between 200-250 hours per month.

Does the contract contain any in-substance fixed payments?

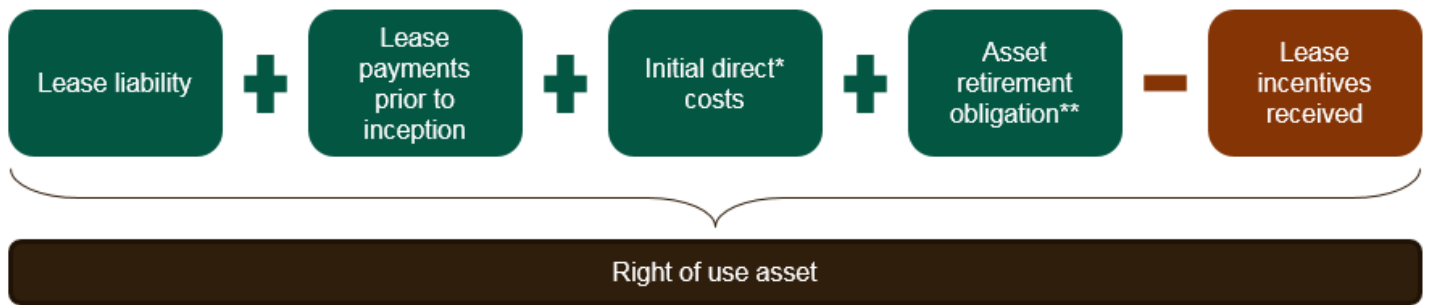
**Assessment:** The contract contains in-substance fixed payments based on the minimum 150 hours/month which are included in the initial measurement of the lease liability as HD is reasonably certain that the minimum hour threshold will always be met. The additional lease payments, which are calculated on the excess hours worked per month are variable payments that do not depend on an index or a rate. Therefore, the additional lease payments are not included in the initial measurement of the lease liability.

b) How are variable payments treated that are not included in the lease liability (i.e., those not based on a rate or index and not in-substance fixed lease payments)?

They are recognized in the period in which the event or condition that triggers their payment occurs unless, they are included in profit or loss or the carrying amount of another asset, if applicable.

*Right-of-Use Asset*

On the commencement date, the lessee recognizes and measures the right-of-use asset at cost. Cost is comprised of the following:



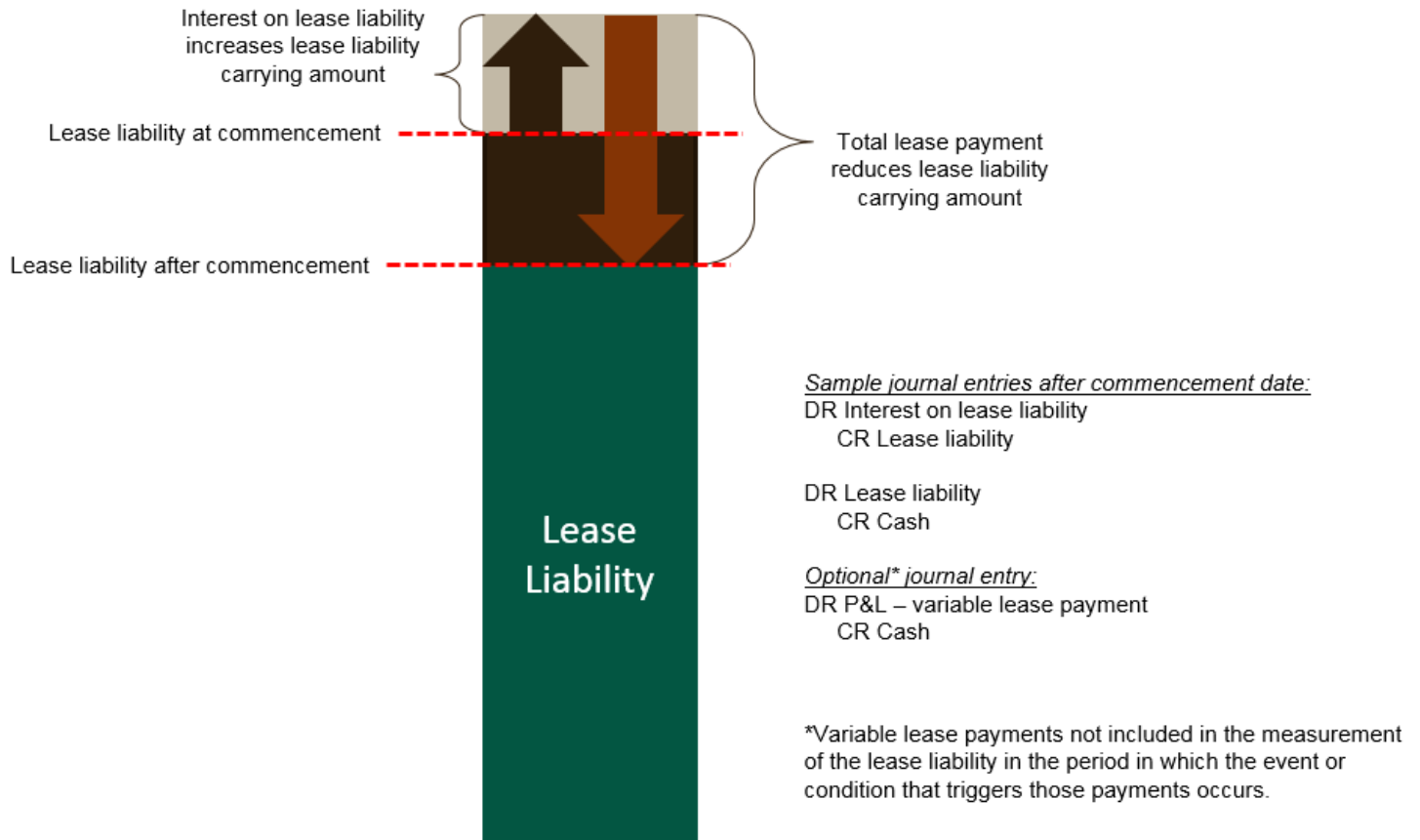
\* The definition of initial direct costs is consistent with the definition of incremental costs of obtaining a contract contained in IFRS 15. These are costs incurred to obtain a lease that would not have been incurred otherwise. These costs typically consist of commissions, legal fees (e.g. costs of originating the lease contract), administrative fees with negotiating the terms and conditions of the lease contract. General overhead or costs associated with obtaining offers for leases are typically not direct costs.

\*\*The asset retirement obligation includes an estimate of costs to the lessee for:

- Dismantling and removing the underlying asset;
- Restoring the site where the underlying asset is located; or
- Restoring the underlying asset to a condition specified by the terms and conditions of the lease (unless those costs are incurred to produce inventories).

**Subsequent Measurement of Lease Liability**

The lease liability is subsequently measured similar to financial liabilities in the scope of IAS 39 by using the effective interest method so that the carrying amount of the lease liability is measured on an amortized cost basis and the interest expense is allocated over the lease term.



Additionally, after the commencement date the lease liability would be remeasured for any lease modifications (refer to the *Reassessment of the Lease Liability Due to Lease Modifications* section of this guide below) or to reflect any changes to lease payments (e.g. in-substance fixed payments as discussed in the *Initial Measurement* section of this guide).

IFRS 16 does not allow a lessee to measure lease liabilities at fair value after initial measurement.

**Reassessment of the Lease Liability Due to Changes in the Lease Payments**

A remeasurement of the lease liability is adjusted against the right-of-use asset. In the event that the carrying amount of the asset is already zero, the adjustment for the remeasurement is recognized in profit or loss.

The lease liability is remeasured using the revised lease payments and either an unchanged or a revised discount rate depending on the situation as illustrated the following table:

Change in:	Use a Revised Discount Rate?
The amounts expected to be payable under a residual value guarantee	No - discount revised lease payments (including the purchase option) over the term using the existing discount rate unless the change in lease payments relate to a change in floating rate.
The future lease payments resulting from a change in an index or rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review	
The lease term	Yes – discount revised lease payments (including the purchase option) over the term using the new discount rate
The assessment of whether a purchase option would be exercised	

The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term, if readily determined. Otherwise, the lessee's incremental borrowing rate at the date of reassessment is used.

**Reassessment of the Lease Liability Due to Lease Modifications**

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

Modification	Accounted for as Separate Lease?	Impact
<ul style="list-style-type: none"> <li>Increased scope of lease (additional underlying assets); and</li> <li>Consideration for the lease increases by an amount equivalent to the stand-alone price for the scope increase and any adjustments to that stand-alone price to reflect the circumstances.</li> </ul>	Yes – account for as a separate lease	Account for separate lease at the stand-alone price increase
Decreased scope of the lease	No – not a separate lease	<ul style="list-style-type: none"> <li>Remeasure the lease liability using a revised discount rate.</li> <li>Decrease the right-of-use asset to reflect the partial or full termination of the lease.</li> <li>Recognize a corresponding gain or loss.</li> </ul>
Other modifications	No – not a separate lease	<ul style="list-style-type: none"> <li>Remeasure the lease liability using a revised discount rate.</li> <li>Make a corresponding adjustment to the right-of-use asset</li> </ul>

**Subsequent Measurement of the Right-of-Use Asset**

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

Depending on the type of the right-of-use asset, it is subsequently either measured at cost or a revalued/fair value amount as illustrated in the following table:

Type of Right-of-use Asset	Subsequent Measurement
Class of property, plant and equipment to which the entity applies the revaluation model in IAS 16 <i>Property, Plant and Equipment</i> .	May elect to apply the revaluation model to all of the right-of-use assets in that class of assets. Otherwise, use cost.
Investment property in accordance with IAS 40 <i>Investment Property</i> if the lessee applies the fair value model to its investment property.	Apply the IAS 40 fair value model
Other	Cost (i.e., the right-of-use asset is measured at cost less any less any accumulated depreciation and any accumulated impairment losses).

If the lease liability is revised for a reassessment or lease modification as discussed in the previous section of this guide, the cost of the right-of-use asset is adjusted accordingly.

The period which the lessee depreciates the right-of-use asset over is based on:

Situation	Depreciation Period
The contract transfers ownership of the asset to the lessee at the end of the lease term	From the commencement date to the end of the asset's useful life
Lessee with exercise purchase option	
Ownership does not transfer and the lessee will not exercise a purchase option	From the commencement date to the earlier of: <ul style="list-style-type: none"> <li>• The end of the useful life of the asset; or</li> <li>• The end of the lease term.</li> </ul>

IAS 36 *Impairment of Assets* is used to identify and measure impairment of the right-of-use asset.

**Examples of Lessee Measurement of Right-of-use Assets and Lease Liabilities with a Change in Lease Term**

*(Adapted from IFRS 16.IE5 Example 13)*

**Example 1:**

Continuing with LC Laboratories ("LCL") from examples 6 and 7. Assuming LCL entered into a ten-years lease for three floors of a building. The lease has an option to extend for an additional five years. Annual lease payments are due at the beginning of the year and during the first ten years are \$50,000 and increase to \$55,000 during the optional extension period. LCL pays initial direct costs of \$20,000 (consisting of \$5,000 commission to a real estate agent and \$15,000 paid to a former tenant occupying the leased space). The property management company (lessor), agrees to reimburse LCL the \$5,000 real estate commission as an incentive.

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. LCL's incremental borrowing rate is 5% per annum.

How would the right-of-use asset and the lease liability be initially measured?

**Examples of Lessee Measurement of Right-of-use Assets and Lease Liabilities with a Change in Lease Term**
*(Continued from previous page)*

**Assessment:** At the commencement date of the lease, LCL is responsible for making the first lease payment for the year of \$50,000, pays \$20,000 for initial direct costs and receives a lease incentive of \$5,000. Therefore, LCL measures the lease liability at the present value of the remaining nine payments of \$50,000, discounted at the interest rate of 5% per annum, which is \$355,391 ( $PV = PMT \times [(1 - (1 + i)^{-n}) \div i] = 50,000 \times [(1 - (1.05^{-9}) \div 0.05]$ )

Therefore, LCL would initially record the following entries to reflect the effect of the building lease.

DR Right-of-use (ROU) asset	\$405,391	
CR Lease liability		\$355,391
CR Cash (lease payment for first year)		50,000
DR ROU asset	\$20,000	
CR Cash (initial direct costs)		\$20,000
DR Cash (lease incentive)	\$5,000	
CR ROU asset		\$5,000

**Example 2:**

In the example under the *Reassessment of Lease Term* section of this guide, LCL acquired a new subsidiary (“SUB”) in the sixth year of the lease. SUB was previously leasing space in another building which LCL terminated through a termination clause and proceeded to enter into a separate lease for an additional two floors in LCL’s leased building to accommodate the increased workforce. The new separate lease is for eight years that will be available for use at the end of Year 7 and SUB’s old lease will terminate from the beginning of Year 8.

In that example, LCL reassessed the lease term as LCL as 15 years because LCL has an economic incentive to exercise its extension option.

Assume LCL’s incremental borrowing rate at the end of Year 6 changed to 6% per annum and LCL depreciates the ROU asset on a straight-line basis.

**1. What is the subsequent measurement of the ROU asset and lease liability for years 1 – 6?**

**Assessment:** The following amortization table details change in the lease liability and ROU asset over years 1 – 6:

Year	Lease Liability				ROU Asset			
	(A) Beginning Balance	(B) Lease Payment	(C) (A) – (B)	(C) × 5% Interest Expense	Ending Balance	Beginning Balance	Depreciation Charge	Ending Balance
1	\$355,391	-	\$355,391	\$17,770	\$373,161	\$420,391	(\$42,039)	\$378,352
2	373,161	(50,000)	323,161	16,158	339,319	378,352	(42,039)	336,313
3	339,319	(50,000)	298,319	14,466	303,785	336,313	(42,039)	294,274
4	303,785	(50,000)	253,785	12,689	266,474	294,274	(42,039)	252,235
5	266,474	(50,000)	216,474	10,823	227,297	252,235	(42,039)	210,196
6	227,297	(50,000)	177,297	8,865	186,162	210,196	(42,039)	168,157

The lease liability begins with a balance of \$355,391 as determined in Example 1 above. Using the incremental borrowing rate of 5% interest expense is calculated for the year based on the liability balance less the annual lease payment made in the beginning of the year. By the end of year 6 (prior to accounting for the change in the lease term – analysis to follow), the lease liability is \$186,162.

**Examples of Lessee Measurement of Right-of-use Assets and Lease Liabilities with a Change in Lease Term**
*(Continued from previous page)*

The ROU asset is depreciated on a straight line basis based on the original ten-year lease term, therefore an annual depreciation charge of \$42,039 (ROU asset = \$405,391 present value of lease payments plus \$20,000 initial direct costs less \$5,000 lease incentive = \$420,391 ÷ 10 years = \$42,039 depreciation charge) is recorded in years 1 – 6. By the end of year 6, the ROU asset is carried at \$168,157.

**2. What is the impact of the change in lease term on the ROU asset and lease liability for years 7 – 15 of the lease?**

**Assessment:** LCL remeasures the lease liability for years 7 – 15 based on the revised discount rate of 6%. The revised lease liability is based on the present value of the remaining four payments of \$50,000 followed by the additional five payments of \$55,000. The revised present value of the lease payments is \$378,174. Calculated as \$50,000 payable immediately plus the present value of the future 3 payments of \$50,000 and 5 payments of \$55,000.

Therefore, LCL will need to increase the lease liability from \$186,162 (previous carrying amount at end of year 6 per amortization table above) to \$378,174 which is a difference of \$192,012. LCL will record the following adjustment to the lease liability and ROU asset:

	DR ROU asset	\$192,012	
	CR Lease liability		\$192,012

As a result, the ROU asset's opening balance for year 7 is \$360,169 (closing balance of 168,157 from the amortization table above plus the \$192,012 adjustment).

The impact of the change in the lease to the lease liability and ROU asset for years 7 – 15 are reflected in the following amortization table:

Year	Lease Liability				ROU Asset			
	(A) Beginning Balance	(B) Lease Payment	(C) (A) – (B)	(C) × 6% Interest Expense	Ending Balance	Beginning Balance	Depreciation Charge	Ending Balance
7	<b>\$378,174</b>	(\$50,000)	\$328,174	\$19,690	<b>\$347,864</b>	<b>\$360,169</b>	(\$40,019)	<b>\$320,150</b>
8	<b>347,864</b>	(50,000)	297,864	17,872	<b>315,736</b>	<b>320,150</b>	(40,019)	<b>280,131</b>
9	<b>315,736</b>	(50,000)	265,736	15,944	<b>281,680</b>	<b>280,131</b>	(40,019)	<b>240,112</b>
10	<b>281,680</b>	(50,000)	231,680	13,901	<b>245,581</b>	<b>240,112</b>	(40,019)	<b>200,093</b>
11	<b>245,581</b>	(55,000)	190,581	11,435	<b>202,016</b>	<b>200,093</b>	(40,019)	<b>160,074</b>
12	<b>202,016</b>	(55,000)	147,016	8,821	<b>155,837</b>	<b>160,074</b>	(40,019)	<b>120,055</b>
13	<b>155,837</b>	(55,000)	100,837	6,050	<b>106,887</b>	<b>120,055</b>	(40,019)	<b>80,036</b>
14	<b>106,887</b>	(55,000)	51,887	3,113	<b>55,000</b>	<b>80,036</b>	(40,018)	<b>40,018</b>
15	<b>55,000</b>	(55,000)	-	-	-	<b>40,018</b>	(40,018)	-

Similar to years 1-6, the lease liability is adjusted for the lease payments and interest expense accordingly, however, the interest expense changes to 6% corresponding with the change interest rate.

In addition, the ROU asset depreciation charge is also adjusted to reflect the straight-line change in years to the 9 remaining years of the lease which results in an annual depreciation charge of \$40,019 (ROU asset balance \$360,169 ÷ 9 years).



**Presentation****Statement of Financial Position**

A lessee presents the following:

- Right-of-use assets separately from other assets. If the right-of-use asset is not presented separately in the statement of financial position, the lessee:
  - Includes right-of-use assets within the same line within which the corresponding underlying assets would be included if they were owned; and
  - Discloses which lines in the statement of financial position include those right-of-use assets.

This requirement does not apply to right-of-use assets that meet the definition of investment property, these should be presented in the statement of financial position as investment property.

- Lease liabilities separately from other liabilities. If the lease liability is not presented separately in the statement of financial position, the lessee discloses which line items include those liabilities.

**Statement of Profit or Loss and Other Comprehensive Income**

- Interest expense on the lease liability is separated from the depreciation on the right-of-use asset.

**Statement of Cash Flows**

- Operating activities:
  - Short-term lease payments;
  - Payments for low-value leases; and
  - Variable lease payments not included in the measurement of the lease liability.
- Financing activities:
  - Cash payments for the principal portion of the lease liability.
- Cash payments for the interest portion of the lease liability are applied using the requirements in IAS 7 for interest paid (i.e., disclosed separately and classified in a consistent manner from period to period as either operating, investing or financing activities).

## Disclosure

Lessees disclose information in the notes as a basis for users of financial statements to assess the effect that leases have on the lessee. Therefore, a lessee discloses the following amounts for the reporting period:

### Disclosures Involving the Statement of Financial Position

- Additions to right-of-use assets;
- The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset; and
- A maturity analysis of lease liabilities in accordance with IFRS 7.39 and B11 *Financial Instruments: Disclosures*. This disclosure is separate from the maturity analyses of other financial liabilities.

### Disclosures Involving the Statement of Profit or Loss and Other Comprehensive Income

- Depreciation charge for right-of-use assets by class of underlying asset;
- Interest expense on lease liabilities;
- Expenses relating to short-term leases and low-value assets where the recognition exemption (refer to the *Recognition Exemptions* section of this guide) has been applied. This expense excludes expenses relating to those leases with a lease term less than one month;
- Expenses relating to variable lease payments not included in lease liabilities;
- Income from subleasing right-of-use assets; and
- Gains or losses arising from sale and leaseback transactions

### Disclosures Involving the Statement of Cash Flows

- Total cash outflow for leases

### Other Disclosure Considerations

- For other disclosure considerations please refer to IFRS 16.51-.60; and
- For further guidance regarding disclosure of additional information, please refer to the application guidance contained in IFRS 16.B48-B52.

## Lessor Accounting

The accounting requirements for lessors under IFRS 16 remains similar to the requirements contained in IAS 17. The following sections will discuss the requirements contained in IFRS 16.

### Classification of Leases

A lessor classifies each lease as either operating lease or a finance lease based on the substance of the transaction rather than the form of the contract.

Finance Lease	Operating Lease
<p>A finance lease transfers substantially all the risks<sup>4</sup> and rewards<sup>5</sup> incidental to ownership of an underlying asset.</p> <p>Per IFRS 16.63, examples of when a lease would typically be classified as a finance lease (either individually or in combination):</p> <ul style="list-style-type: none"> <li>▪ Ownership of the underlying asset is transferred to the lessee at the end of the lease term;</li> <li>▪ The existence of a purchase option for the lessee of the underlying asset at a price that is significantly lower than the fair value of the asset at the option date (at lease inception, it is reasonably certain that the option will be exercised);</li> <li>▪ The lease term is for the major part of the economic life of the underlying asset even if title is not transferred;</li> <li>▪ At lease inception, the present value of the lease payments amounts to at least substantially all of the fair value of the asset; and</li> <li>▪ Only the lessee can use the asset due to its highly specialized nature (i.e., major modifications would be required for another party to use the asset).</li> </ul> <p>Indicators that may also individually or in combination cause finance lease classification:</p> <ul style="list-style-type: none"> <li>▪ Lessee has the ability to cancel the lease;</li> <li>▪ 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</li> <li>▪ Lessee has the ability to extend the lease for a secondary period at a rental rate substantially lower than market rates.</li> </ul>	<p>An operating lease <u>does not</u> meet the definition of a finance lease (i.e., it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset).</p> <p>Per IFRS 16.62, the examples and indicators for a finance lease (in the corresponding column) are not always conclusive. A lease would be classified as operating where other features make it clear that the lease of an underlying asset does not transfer substantially all the risks and rewards of ownership. Features that would lead to an operating lease classification include:</p> <ul style="list-style-type: none"> <li>▪ Transfer of ownership of the underlying asset at the end of the lease for variable consideration equal to its fair value; or</li> <li>▪ Where the lease contains variable lease payments which the lessor does not transfer substantially all such risks and rewards of ownership.</li> </ul>

Classification of a lease as finance or operating is determined at the inception date and only reassessed when there is a lease modification. That is, changes in estimates or in circumstances do not qualify as a lease modification and would not be eligible for changing a lease classification.

The standard includes additional application guidance on the lessor’s lease classification for reference in IFRS 16.B53-B57.

<sup>4</sup> Risks include the possibility of losses from idle capacity or obsolete technology and changes in return due to changing economic conditions.

<sup>5</sup> Rewards can be the profitable operation of the asset over its economic life and a gain in value or realization of a residual value.

**Finance Leases**

*Initial Measurement*

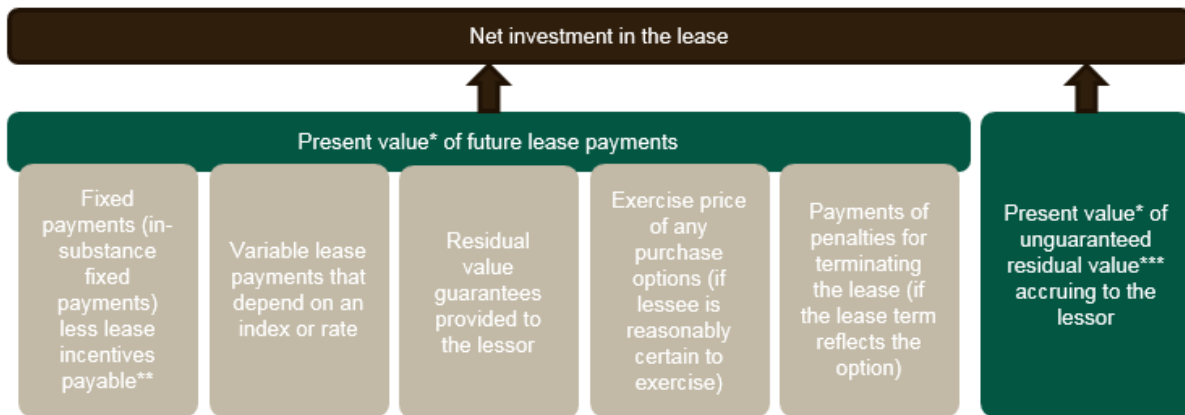
The lessor recognizes assets held under a finance lease in its statement of financial position by:

- Derecognizing the underlying asset;
- Recognizing a financial lease receivable at an amount equal to the net investment in the lease;

Net investment in the lease = the gross investment<sup>6</sup> in the lease discounted at the interest rate implicit in the lease.

The lessor uses the interest rate implicit in the lease. The rate is defined in such a way that initial direct costs are included automatically in the net investment in the lease, therefore, there is no need to add them separately.

The net finance lease receivable, or net investment in the lease, consists of the following:



*\*The rate implicit in the lease is used to calculate present value of the future lease payments and the unguaranteed residual value.*

*\*\*Lease incentives are payments made by a lessor to a lessee relating to the right to use an underlying asset. They can also be in the form of a lessor reimbursing or assuming costs on a lessee's behalf.*

*\*\*\*The unguaranteed residual value is the estimated value of the leased asset to be returned to the lessor at the end of the lease, less a residual value guarantee (if any). If a lease transfers ownership of the leased asset to the lessee at the end of the lease, there is no unguaranteed residual value.*

Manufacturer or dealer lessors

Since 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. Therefore, at the commencement date of a lease, manufacturer or dealer lessors recognize the following for each of its finance leases:



<sup>6</sup> The gross investment in the lease = lease payments receivable by a lessor plus any unguaranteed residual value accruing to the lessor.

- Revenue – the lesser of:
  - Fair value of the underlying asset; or
  - The present value of the lease payments accruing to the lessor (discounted using market rates)
- Cost of sales based on:
  - Cost, or carrying amount if different, of the underlying asset less the present value of the unguaranteed residual value
- Selling profit or loss (i.e., revenue less cost of sales) regardless of whether the lessor transfers the underlying asset as described in IFRS 15.

**Example of Accounting for a Lease by a Manufacturer/Dealer Lessor**

Copiers Inc. (“Copiers”) enters into a lease of photocopying equipment with a local law firm. Copiers is a manufacturer of photocopying equipment that sells and leases its photocopiers. The contract between Copiers and the law firm is for a 5-year period with no renewal/termination option and annual payments of \$1,500 made at the beginning of each year. The fair value of the equipment is \$7,500. The current carrying value of the equipment is \$6,500. The estimated unguaranteed residual value of the equipment at the end of the lease term is \$500. The rate implicit in the lease is 3.04%. How would Copiers measure and record this lease?

**Assessment:** Copiers would first determine the total net investment in the lease as the present value of the lease payments and the unguaranteed residual value.

The present value of the lease payments discounted at 3.04% and amounts to \$7,070 as follows:

$$\begin{aligned}
 \text{PV of an annuity due} &= \text{PMT} \times [(1 - (1 \div (1 + i)^n)) \div i] \times (1 + i) \\
 &= \$1,500 \times [(1 - (1 \div (1.0304)^5)) \div 0.0304] \times (1.0304) \\
 &= \$7,070
 \end{aligned}$$

The present value of the unguaranteed residual value discounted at 3.04% is \$430 ( $500 \div 1.0304^5$ )

Copiers’ net investment in the lease is \$7,500 (the sum of the lease receivable (\$7,070) and the unguaranteed residual asset (\$430)).

Copiers calculates selling profit or loss as the difference between:

- The present value of the lease payments discounted at market rates (because it is lower than the fair value of \$7,500); and
- The carrying amount of the underlying asset net of any unguaranteed residual value.

The calculation is as follows:

Present value of the lease payments discounted at market rates	\$7,070
Carrying value of leased asset (\$6,500) net of unguaranteed residual asset (\$430)	<u>6,070</u>
Selling profit	<u>\$1,000</u>

Copiers would record revenue at lease commencement equal to the lease receivable amount (\$7,070). The cost of sale would be recorded as the difference between the carrying value of the leased asset (\$6,500) and the discounted value of the unguaranteed residual value (\$430).

Therefore, Copiers would record the following journal entry on the lease commencement date:

Dr. Net investment in the lease	\$7,500	
Dr. Cost of goods sold	6,070	
Cr. Property, plant and equipment (leased asset)		\$6,500
Cr. Revenue		7,070

*Subsequent Measurement*

Finance income is recognized over the lease term in a systematic and rational basis by applying a constant periodic rate of return to the lessor's net investment in the lease.

The lease payments received in the period are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

*a) What about derecognition and impairment?*

The derecognition and impairment requirements in IFRS 9 applies to the net investment in the lease. The lessor should regularly review estimated unguaranteed residual values used to determine the gross investment in the lease. Per IFRS 16.77, if the estimated unguaranteed residual value decreases, the income allocation over the lease term is revised and any reduction in respect of amounts accrued is recognized immediately.

*b) What happens if a leased asset is classified as an asset held for sale (or is included in a disposal group classified as held for sale)?*

The lessor shall apply IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and account for the asset in accordance with that standard.

**Example of Accounting for a Finance Lease**

TRU Rentals ("TRU") enters into a five-years non-cancellable lease with Hi-Octane Petroleum ("HP") at the beginning of the period for the lease of a holding tank to be used at HP's new gas station. The tank's fair value is \$100,000 with annual payments of \$21,000 in advance. A's unguaranteed residual value of the tank at the end of the five years is \$10,000. The rate implicit in the lease is 6.62%. What is the accounting impact to TRU (the lessor) for this lease at the end of the first period?

**Assessment:** TRU is required to recognize assets under a finance lease in the statement of financial position as a receivable at an amount equal to the net investment in the lease. The payments made by HP are treated as repayments of principal and finance income. The effect of the lease payments received are illustrated below:

Year	Receivable at Start of Period A	Lease Payment Received B	Receivable before Interest A-B	Finance Income (@ 6.62%)	Receivable at End of Period
1	\$100,000	\$21,000	\$79,000	\$5,231	\$84,231
2	84,231	21,000	63,231	4,187	67,418
3	67,418	21,000	46,418	3,074	49,492
4	49,492	21,000	28,492	1,887	30,379
5	30,379	21,000	9,379	621	10,000

TRU would record the following entries in the first year of the lease:

To initially record the finance lease receivable

DR Finance lease receivable	\$100,000	
CR Property, plant and equipment		\$100,000



**Example of Accounting for a Finance Lease** (Continued from previous page)

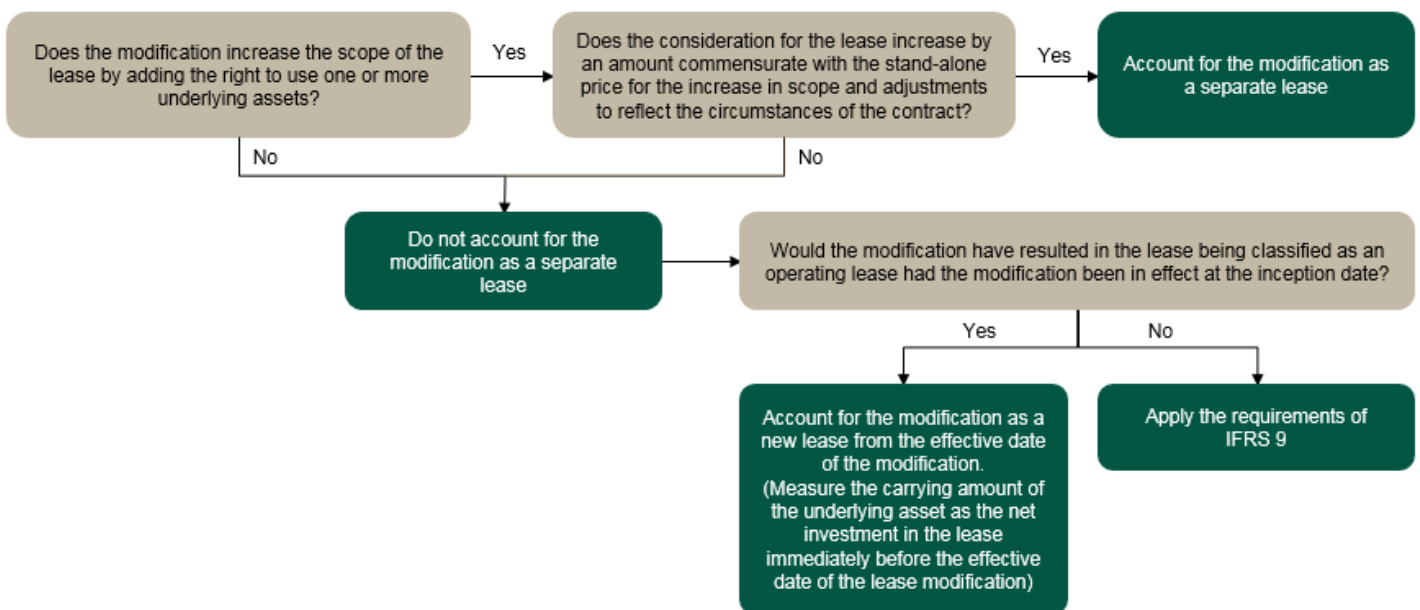
To recognize finance lease income and adjust the receivable at year end

DR Cash	\$21,000	
CR Finance lease receivable*		\$15,769
CR Finance lease income		5,231

\*The change in the finance lease receivable of \$15,769 is the change between the beginning of the period to the end of the period (\$100,000 – 84,231).

Lease modifications

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



The requirements of IFRS 9 referenced in the diagram above relate to IFRS 9.5.4.3. It states that when the contractual cash flows are modified and the modification does not result in derecognition of the financial asset, the entity recalculates the gross carrying amount of the financial asset and recognizes a gain or loss in profit or loss. The gross carrying amount is recalculated as the present value of the modified contractual cash flows that are discounted at the original effective interest rate.

**Operating Leases**

An operating lease is a lease that does not transfer substantially all the risks and rewards of ownership of an underlying asset to a lessee. Since it is neither a sale nor financing of an asset the lessor keeps the underlying asset on its statement of financial position and continues to depreciate the asset. It also recognizes no selling profit.

With respect to the underlying asset on the statement of financial position, any initial direct costs incurred by the lessor in obtaining the operating lease would be added to the asset's carrying value. These costs are then expensed over the lease term on the same basis as the lease income.

Lease income is recognized on a straight-line basis or another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

The entity expenses costs, such as depreciation, as it earns the associated lease income. Depreciation is calculated consistently with IAS 16 and IAS 38 and the lessor’s normal depreciation policy for similar assets.

A lessor applies IAS 36 to assess and measurement impairment for the leased asset.

Lease modifications

Modifications to operating leases are accounted for as new leases from the effective date of the modification. Any prepaid or accrued lease payments relating to the original lease is treated as part of the lease payments for the new lease.

**Disclosure**

Lessors disclose information in the notes as a basis for users of financial statements to assess the effect that leases have on the lessor. Therefore, a lessor discloses the following amounts for the reporting period:

Finance Lease	Operating Lease
<ul style="list-style-type: none"> <li>▪ Selling profit or loss</li> <li>▪ Finance income on the net investment in the lease</li> <li>▪ Income relating to variable lease payments not included in the measurement of the net investment in the lease</li> <li>▪ Qualitative and quantitative information to explain significant changes in the carrying amount of the net investment in its finance leases</li> <li>▪ A maturity analysis of the lease payments receivable (the undiscounted amounts on an annual basis for the first five years and a total of the amounts for the remaining years). The undiscounted lease payments should be reconciled to the net investment in the lease (it should identify the unearned finance income relating to the lease payments receivable and any discounted unguaranteed residual value)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lease income</li> <li>▪ Income from variable lease payments that do not depend on an index or rate are disclosed separately</li> <li>▪ A maturity analysis of lease payments (the undiscounted amounts on an annual basis for the first five years and a total of the amounts for the remaining years)</li> <li>▪ If applicable the entity shall apply the disclosure requirements of:                             <ul style="list-style-type: none"> <li>• IAS 16 - disaggregate assets in those subject to operating leases and assets not subject to operating leases;</li> <li>• IAS 36;</li> <li>• IAS 38;</li> <li>• IAS 40; and</li> <li>• IAS 41.</li> </ul> </li> </ul>

In addition to the disclosures discussed above, the entity needs to consider if the lease information disclosed provides the users of the financial statements with enough information to assess the impact of leases on the entity. IFRS 16.92 discusses the additional information, which may include, but is not limited to, information that helps users of financial statements to assess:

- The nature of the lessor’s leasing activities;
- How the risk associated with any rights retained in underlying assets is managed. Lessors disclose their risk management policy for the rights it retains in underlying assets (i.e., buy-back agreements, residual value guarantees or variable lease payments for excess use).

## Sublease Classification

A sublease is defined as a transaction where 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.



The requirements of IFRS 16 applies to right-of-use assets in a sublease. That is, the intermediate lessor accounts for both the head lease and the sublease as two separate contracts.

The classification of a sublease by the intermediate lessor as a finance or an operating lease is in reference to the right-of-use asset in the head lease and not the underlying asset.

The intermediate lessor uses the interest rate implicit in the lease to measure the net investment in the lease, if readily determined. Otherwise, it uses the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease).

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

### Example of Sublease *(Adapted from IFRS 16.IE8 Examples 20 and 21)*

**Example 1:**

Power Cell Ltd. (intermediate lessor), leases office space (head lease) from a property manager (the head lessor) in downtown Vancouver for a 5 year period. Due to a change in management, Power Cell has decided to relocate its headquarters to Toronto at the beginning of Year 3. Power Cell has agreed to a sublease with a new company for the remaining three years of the lease term.

**Assessment:** Power Cell classifies the sublease by reference to the right-of-use asset arising from the head lease. Power Cell classifies the sublease as a finance lease.

When Power Cell enters into the sublease, it:

- Derecognizes the right-of-use asset relating to the head lease that it transfers to the sublessee and recognizes the net investment in the sublease;
- Recognizes the differences between the carrying value of the right-of-use asset and the net investment in the sublease in profit or loss; and
- Retains the lease liability relating the head lease (which represents the payments still owed to the head lessor).

During the three year term of the sublease, Power Cell recognizes:

- Finance income on the sublease; and
- Interest expense on the head lease.

**Example 2:**

Continuing with the same fact pattern in the example above, Power Cell under this example classifies the sublease as an **operating lease**.

**Assessment:** When Power Cell enters into the sublease, Power Cell 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, Power Cell:

- Recognizes depreciation of the right-of-use asset and interest on the lease liability; and
- Recognizes lease income from the sublease.

## Sale and Leaseback Transactions

A sale and leaseback transaction occurs when one entity (seller-lessee) transfers an asset to another entity (buyer-lessor) and then leases the same asset back.

The accounting treatment of sale and leaseback transactions depends on whether the transfer of the asset is a sale or not. The entity makes this assessment using the requirements of IFRS 15.31 - 38 relating to when a performance obligation is satisfied (e.g. transfer of legal title, a present right to payment, transferred physical possession and significant risks and rewards of ownership).

### Transfer of Asset is a Sale

Accounting Treatment if Transfer of Asset is a Sale in Accordance with IFRS 15																									
Seller-lessee	Buyer-lessor																								
<ul style="list-style-type: none"> <li>▪ Measure the right-of-use asset from the leaseback at the proportion of the previous carrying amount (i.e., the cost) of the asset that relates to the right-of-use retained by the seller-lessee. This is calculated as: carrying amount x fair value of asset ÷ lease liability.</li> <li>▪ Recognize a financial liability for the leased asset following the lessee accounting model.</li> <li>▪ Recognize only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor. This is calculated as (fair value of asset – carrying amount) x (fair value of the asset – lease liability) ÷ fair value of the asset</li> <li>▪ The following journal entries would be recorded to recognize the sale-leaseback transaction from the seller-lessee’s perspective using an asset classified as Property plant and equipment (PP&amp;E) was sold and is being leased back:</li> </ul> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">DR Cash</td> <td style="width: 20%; text-align: right;">\$XXX</td> <td style="width: 20%;"></td> </tr> <tr> <td>DR right-of-use asset</td> <td style="text-align: right;">XXX</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">CR PP&amp;E</td> <td></td> <td style="text-align: right;">\$XXX</td> </tr> <tr> <td style="padding-left: 20px;">CR Financial liability</td> <td></td> <td style="text-align: right;">XXX</td> </tr> <tr> <td style="padding-left: 20px;">CR Gain</td> <td></td> <td style="text-align: right;">XXX</td> </tr> </table>	DR Cash	\$XXX		DR right-of-use asset	XXX		CR PP&E		\$XXX	CR Financial liability		XXX	CR Gain		XXX	<ul style="list-style-type: none"> <li>▪ Account for the purchase of the asset applying applicable standards (e.g. IAS 16 for property, plant and equipment).</li> <li>▪ Account for the lease applying the lessor accounting model in this standard.</li> <li>▪ The following journal entries would be recorded to recognize the sale-leaseback transaction from the buyer-lessor’s perspective:</li> </ul> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 60%;">DR PP&amp;E</td> <td style="width: 20%; text-align: right;">\$XXX</td> <td style="width: 20%;"></td> </tr> <tr> <td>DR Financial asset</td> <td style="text-align: right;">XXX</td> <td></td> </tr> <tr> <td style="padding-left: 20px;">CR Cash</td> <td></td> <td style="text-align: right;">\$XXX</td> </tr> </table>	DR PP&E	\$XXX		DR Financial asset	XXX		CR Cash		\$XXX
DR Cash	\$XXX																								
DR right-of-use asset	XXX																								
CR PP&E		\$XXX																							
CR Financial liability		XXX																							
CR Gain		XXX																							
DR PP&E	\$XXX																								
DR Financial asset	XXX																								
CR Cash		\$XXX																							

In instances where the sale of an asset is not at fair value or if the payments for the lease are not at market rates, the following adjustments are made to measure the sale proceeds at fair value:

- Below-market terms are accounted for as a prepayment of lease payments; and
- Above-market terms are accounted for as additional financing provided by the buyer-lessor to the seller-lessee.

**Example of Sale and Leaseback Transaction** (Adapted from IFRS 16.IE11 Example 24)

Central Real Estate Company (“Central”) sells a building to Lakeside Property Management (“Lakeside”) for cash of \$2,000,000. Immediately before the transaction, the building is carried at a cost of \$1,000,000. At the same time, Central (seller-lessee) enters into a contract with Lakeside (buyer-lessor) for the right to use the building for 18 years, with annual payments of \$120,000 payable at the end of each year. The terms and conditions of the contract meet the requirements for a sale in IFRS 15.

**Assessment:** The fair value of the building at the date of sale is \$1,800,000. Because the consideration for the sale of the building is not at fair value, Central and Lakeside make adjustments to measure the sale proceeds at fair value. The amount of the excess sale price of \$200,000 (\$2,000,000 sale price – \$1,800,000 fair value) is recognized as additional financing provided by Lakeside to Central. The interest rate implicit in the lease is 4.5% per annum.

The present value of the annual payments is \$1,459,200 (\$120,000 payments for 18 years, discounted at 4.5%):

- \$200,000 relates to the additional financing; and
- \$1,259,200 relates to the lease

At the commencement date, Central accounts for the transaction as follows.

Cash	\$2,000,000		
ROU asset	699,555		
	Building	\$1,000,000	
	Financial liability	1,459,200	
	Gain on rights transferred	240,355	

- The ROU asset is measured as a proportion of the previous carrying amount, which is \$699,555 ( $\$1,000,000 \times \$1,259,200 \div \$1,800,000$ ).
- Central only recognizes the amount of the gain that relates to the rights transferred to Lakeside, which is \$240,355 ( $\$800,000 \times (\$1,800,000 - \$1,259,200) \div \$1,800,000$ ).

At the commencement date, Lakeside accounts for the transaction as follows.

Building	\$1,800,000	
Financial asset*	200,000	
Cash		\$2,000,000

\*The financial asset is calculated as \$200,000 (18 payments of 16,447, discounted at 4.5% per annum).

After commencement date, Lakeside accounts for the 18 annual \$120,000 lease payments as follows:

- \$103,553 is allocated as the lease payment; and
- \$16,447 allocated to the \$200,000 financial asset and as interest revenue.

**Example of Sale and Leaseback Transaction** *(Continued from previous page)*

To illustrate the allocation of the \$16,447 over the term of the lease, the following amortization table is presented:

Year	Opening Balance A	Interest Revenue @ 4.5% B	Annual Payment C	Change in Financial Asset D = B-C	Closing Balance A-D
1	\$200,000	\$8,999	\$16,447	(\$7,448)	\$192,552
2	192,552	8,664	16,447	(7,783)	184,770
...	...	...	...	...	...
17	30,800	1,386	16,447	(15,061)	15,739
18	15,739	708	16,447	(15,739)	-

**Transfer of Asset is Not a Sale**
**Accounting Treatment if Transfer of Asset is not a Sale in Accordance with IFRS 15**

Seller-lessee	Buyer-lessor
<ul style="list-style-type: none"> <li>▪ Continue to recognize the transferred asset; and</li> <li>▪ Recognize a financial liability equal to the transfer proceeds and account for in accordance with IFRS 9.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Do not recognize the transferred asset; and</li> <li>▪ Recognize a financial asset equal to the transfer proceeds which is accounted for in accordance with IFRS 9.</li> </ul>

a) *What is the impact to an entity on sale and leaseback transactions under IAS 17 and IFRS 16?*

Under IAS 17, an entity could sell its owned assets and then lease those same assets back as off-balance sheet leases. The entity's statement of financial position would report a smaller asset base and less financial debt.

Under IFRS 16, the entity reports the rights to use the assets that it sold and the resulting financial commitments due.

As a result, IFRS 16 reduces the incentive for entities to enter into such transactions by requiring the recognition of assets and liabilities arising from the leaseback, and restricting the amount of any gain recognised on sale of an asset.

**Transition**
**Effective Date**

This standard is effective for annual reporting periods beginning on or after January 1, 2019. Earlier application is permitted for those entities that adopt IFRS 15 before this standard is effective.

## Application of New Definition of a Lease on Transition

On initial application an entity, whether it is a lessee or lessor, has two options available to it:

- 1) Apply the new definition of a lease in this standard to all contracts (i.e., reassess all previous decisions about which existing contracts do or do not contain leases); or
- 2) Apply a practical expedient<sup>7</sup> available in the standard whereby the new definition of a lease is only applied to those contracts previously identified as leases under IAS 17 and IFRIC 4. That is, contracts that were not previously identified as containing a lease would not need to be reassessed. Contracts entered into or changed on or after the date of initial application are required to apply the requirements of this standard.

## Impact of Transition to Lessees

A lessee has a choice of whether to apply the standard to its leases:

- a) Retrospectively to each prior reporting period presented (“Full retrospective application”); or
- b) Retrospectively with a cumulative effect of initial application recognized at the date of initial application as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate). The comparative information under this option is not restated. (“Modified retrospective application”)

When modified retrospective application is selected by the entity, the standard contains specific transition requirements and practical expedients depending on whether the lease was previously classified as operating or finance lease.

The IFRS Discussion Group has considered the transition options related to the adoption of IFRS 16 and has issued the results of those discussions in the document referenced in the Resources Section.

## Leases Previously Classified as Operating Leases

For leases previously classified as operating leases, a lessee that elected the modified retrospective application should apply the requirements of IFRS 16 as follows on the date of initial application:

**Recognize a lease liability** → measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate.

**Recognize a right-of-use asset\*** → measured at either (accounting policy choice):

- Carrying amount as if IFRS 16 was applied (discount at incremental borrowing rate); or
- An amount equal to the lease liability adjusted for prepaid or accrued lease payments in the statement of financial position directly before the date of initial application.







*\* The right-of-use asset should be evaluated for impairment on the date of initial application using IAS 36, unless the practical expedient “Impairment review on date of initial application” as discussed in the practical expedient table on page 41 is applied.*

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<sup>7</sup> If the practical expedient is applied, the entity discloses that fact and applies it to all of its contracts.



As indicated above, the lessee is permitted to choose on a lease-by-lease basis, how to measure the right-of-use asset. The following table illustrates the potential impact of each option on the lessee:

Recognize a Right-of-use Asset by:	Implementation Costs	Value of Leased Assets	Operating Expenses
Carrying amount as if IFRS 16 was applied			
An amount equal to the lease liability			

Key considerations when determining which option to select for leases previously classified as operating leases:

- It is expected that measuring the asset based on the lease liability will reduce implementation costs because a company would not need to capture historical information (i.e., lease start dates; historical payment schedules; etc.).
- Lease assets are expected to be initially measured at a higher amount applying the lease liability method than if measured as if IFRS 16 had always been applied.
- The increased value of the lease asset under the lease liability method would result in increased operating expenses (i.e., higher depreciation) for the remainder of the lease term.

Therefore, an entity will need to assess the options available based on a cost/benefit approach (i.e., do the costs outweigh the benefit of achieving a 'correct' post-transition income statement).

No transition adjustments are required for leases:

- Meeting the low value recognition exemption. Those leases should be accounted for by applying this standard from the date of initial application.
- Previously accounted for as investment property using the fair value model in IAS 40. The right-of-use asset and the lease liability are accounted for by applying IAS 40 and this standard from the date of initial application.

Note: a lessee will measure the right-of-use asset that will be accounted for as investment property by applying the fair value model in IAS 40 from the date of initial application.

The following practical expedients may also be applied<sup>8</sup>:

Practical Expedient	Details
<b>Single discount rate for portfolio of leases</b>	Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
<b>Impairment review on date of initial application</b>	Rely on its assessment of whether leases are onerous in accordance with IAS 37 <i>Provisions, contingent liabilities and contingent assets</i> immediately before the date of initial application as an alternative to performing an impairment review. If so, lessee adjusts 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. It could be costly for a lessee to perform an impairment review of each of its right-of-use assets on transition. In addition, any onerous lease liability identified under IAS 37 would likely result in the right-of-use asset being impaired. This practical expedient will provide a cost savings without any significant impact on reported information for the lessee.
<b>Leases were term ends within 12 months of date of initial application</b>	An entity can choose to apply the short-term lease exemption to these leases. Specifically, the lessee should: <ul style="list-style-type: none"> <li>▪ Disclose the cost associated with those leases within short-term lease expense in the annual reporting period that includes the date of initial application.</li> <li>▪ Exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.</li> </ul>
<b>Hindsight</b>	Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

### ***Leases Previously Classified as a Finance Lease***

For leases previously classified as finance leases, a lessee that elected the modified retrospective application should, on the date of initial application recognize a lease liability and right-of-use asset measured at the previous carrying amount of the finance lease liability and asset, respectively.

### **Impact of Transition to Lessors**

A lessor is not required to make any adjustments on transition, except for sale and leaseback transactions and subleases. The lessor applies this standard to leases on date of initial application.

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<sup>8</sup> These practical expedients can be applied on a lease-by-lease basis for those leases previously classified as operating leases.

**Sale and Leaseback Transactions**

Sale and leaseback transactions entered into before the date of initial application are not reassessed to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale. The seller-lessee's treatment on the date of initial application depends on the previous assessment as follows:

**Previously accounted as a sale and operating lease:**

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

**Previously accounted as a sale and finance lease:**

- Account for leaseback in the same way it accounts for any other finance lease that exists at the initial date of application; and
- Recognize any gain on sale over the lease term.

**Subleases**

IFRS 16 requires an intermediate lessor to evaluate the classification of a sublease with reference to the right-of-use asset of the head lease, not the underlying asset. Therefore, many subleases previously classified as operating leases under IAS 17 will be classified as finance leases under IFRS 16.

Accordingly, an intermediate lessor should:

- Reassess subleases that were previously classified as operating leases 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. The intermediate lessor performs this assessment on the remaining contractual terms and conditions of the head lease and sublease.
- For those subleases that were previously classified as operating leases but are considered finance leases when applying IFRS 16, the sublease should be accounted for as a new finance lease entered into at the date of initial application.

## Key Definitions

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**Commencement date of the lease:** The date on which a lessor makes an underlying asset available for use by a lessee.

**Contract:** An agreement between two or more parties that creates enforceable (matter of law) rights and obligations.

**Economic life:** Either the period over which an asset is expected to be economically usable by one or more users or the number of production or similar units expected to be obtained from an asset by one or more users.

**Fair value:** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

**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:** 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.

**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 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.

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

**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.

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

**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.

**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.

## Resources

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**Financial Reporting & Assurance Standards Canada:** IFRS 16 *Leases* completed project page – click [here](#)

**IFRS Discussion Group – IFRS 16 Transition:** Considering the implications of adoption, including the practical expedients available (refer to the meeting held on 2016-11-29) – click [here](#)

**International Accounting Standards Board:** IFRS 16 *Leases* implementation project page – click [here](#)



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