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APPENDIX A – Illustrative Disclosure Example

APPENDIX B – Definitions
1. INTRODUCTION

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

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

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

Those requirements are summarised as:

Lessees

Almost all leases are recognised in the statement of financial position as a ‘right-of-use’ asset and a lease liability. There are narrow exceptions to this recognition principle for leases where the underlying asset is of low value and for short term leases (i.e. those with a lease term of 12 months or less). The asset is subsequently accounted for in accordance with the cost or revaluation model in IAS 16 Property, Plant and Equipment (IAS 16) or as investment property under IAS 40 Investment Property (IAS 40). The liability and right-of-use asset are unwound over the term of the lease giving rise to an interest expense and depreciation charge, respectively.

Lessors

As noted above the guidance relating to lessors remains substantially unchanged from IAS 17. Lessors continue to account for leases as either operating or finance leases depending on whether the lease transfers substantially all the risks and rewards incidental to ownership of the underlying asset to the lessee.

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

Effective date

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

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

IFRS 16 began as a joint project between the International Accounting Standards Board (IASB) and its US counterpart, the Financial Accounting Standards Board (FASB). However, the Boards did not agree on some points and, ultimately, the FASB’s standard differs from the IASB’s in that the FASB’s standard retains distinct categories of leases for lessees with different accounting requirements. However, both IFRS and US GAAP require leases previously classified as operating leases to be capitalised and in a number of key respects, the two accounting standards are converged.
2. SCOPE

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

(a) Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
(b) Leases of biological assets within the scope of IAS 41 Agriculture held by a lessee;
(c) Service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements;
(d) Licences of intellectual property granted by a lessor within the scope of IFRS 15; and
(e) Rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets (IAS 38) for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

2.1. Recognition Exemptions

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

(a) Short-term leases; and
(b) Leases for which the underlying asset is of low value ('low value leases').

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

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

Short-term leases are defined as ‘leases that, at the commencement date, have a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease.’

BDO comment

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

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

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

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

Leases of Low Value Assets

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

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

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

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

BDO comment

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

The assessment of low value should be applied consistently, regardless of the lessee's size and nature. This is illustrated in the following two examples.
Example 1 – Low Value Lease Assessment

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

Assessment

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

Example 2 – Low Value Lease Assessment

A lessee in the pharmaceutical manufacturing and distribution industry has the following leases:
(a) Leases of real estate (both office buildings and warehouses);
(b) Leases of manufacturing equipment;
(c) Leases of company cars, both for sales personnel and senior management and of varying quality, specification and value;
(d) Leases of trucks and vans used for delivery purposes, of varying size and value;
(e) Leases of IT equipment for use by individual employees (such as laptop computers, desktop computers, hand held computer devices, desktop printers and mobile phones);
(f) Leases of servers, including many individual modules that increase the storage capacity of those servers. The modules have been added to the mainframe servers over time as the lessee has needed to increase the storage capacity of the servers;
(g) Leases of office equipment:
   (i) Office furniture (such as chairs, desks and office partitions);
   (ii) Water dispensers; and
   (iii) High-capacity multifunction photocopier devices.

Assessment

The lessee determines that the following leases qualify as leases of low-value assets on the basis that the underlying assets, when new, are (or were) individually of low value:
(a) Leases of IT equipment for use by individual employees; and
(b) Leases of office furniture and water dispensers.

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

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

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

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

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

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

Separation of Lease Components

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

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

Combining Contracts

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

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

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

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

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

However, as a practical expedient to treating the unit of account as the lease of a single asset, an entity may apply IFRS 16 to a portfolio of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the standard to the portfolio would not differ materially from applying the standard to the individual lease contracts within the portfolio. If it accounts for the leases on a portfolio basis, an entity is then able to make estimates and assumptions that reflect the size and composition of the portfolio. Therefore, if an entity leases 1,000 vehicles under 1,000 separate contracts (i.e. each contract is for a single vehicle) it may be possible to consider the portfolio of leases as a single right to use 1,000 vehicles, rather than 1,000 rights to use a single vehicle. It will depend on how similar the features of each contract are (such as the specification of the vehicles) and the extent to which they were entered into at or around the same time.

BDO comment

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

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

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

- **Is there an identified asset that the customer has the right to use?**
  - **Section 3.2.**
  - If **YES** move to next step. If **NO** the contract does not contain a lease; apply other applicable IFRSs.

- **Does the lessee obtain substantially all the economic benefits?**
  - **Section 3.3.**
  - If **YES** move to next step. If **NO** the contract does not contain a lease; apply other applicable IFRSs.

- **Does the lessee have the right to direct use of the asset?**
  - **Section 3.4.**
  - If **YES** the contract contains a lease. If **NO** the contract does not contain a lease; apply other applicable IFRSs.
3.2. Identified Asset

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

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

Substitution Rights

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

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

**BDO comment**

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

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

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

**BDO comment**

*That the standard requires lessees to conclude substitution rights are non-substantive where it is unclear means that in situations of doubt lessees should assume that the contract contains a lease. Consequently, notwithstanding the existence of the substitution rights, if an asset is identified in the contract (by being explicitly or implicitly specified), further analysis of the contract is needed to see if the other two conditions of the definition of a lease are met (see Sections 3.3. and 3.4. below).*
Example 3 – Lease of Rail Cars

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

Assessment

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

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

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

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

Portions of Assets

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

Example 4a – Fibre Optic Cable

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

Assessment

The contract does not contain a lease as the capacity specified is not physically distinct and it does not represent substantially all of the underlying asset as the capacity is only 20% of the total capacity of the cable. If the contract specified an amount of capacity equivalent to, say, 14 fibre strands of the total cable, the contract would contain a lease because this represents substantially all (approximately 94%) of the cable’s capacity.
Example 4b – Fibre Optic Cable (specific strands)

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

**Assessment**

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

**BDO comment**

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

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

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

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

Example 5 – Obtaining Economic Benefits with Outputs Flowing to Supplier

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

Assessment

It is the customer’s control and use of the property which generates all of the sales revenue. The fact that a portion of the cash flows generated from use of the property are passed to the lessor is not relevant. The lessee has a right to 100% of the sales revenue generated from the store (i.e. all of the economic benefits generated by the store), albeit that it has negotiated a contract which results in rent being determined by reference to that gross sales revenue.
In assessing whether a customer has a right to substantially all the economic benefits from the use of an identified asset, the assessment should be made based on the asset’s use within the defined scope of the contract. For example:

- If a contract limits the use of a vehicle to only a particular geographic area, an entity assesses only the economic benefits from use of the motor vehicle within that territory. It does not consider what economic benefits could be obtained had there not been any geographical restriction in the contract.

- If a contract specifies a machine can only be utilised during specific times of the day, an entity assesses only the economic benefits from use of the machinery during that time of the day. It does not consider what economic benefits could be obtained from using the machine 24 hours a day.

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

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

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

**Assessment**

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

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

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

Who directs how and for what purpose the asset is used throughout the period of use?

- Supplier
- Pre-determined due to nature of asset
- Customer
- Contract does not contain a lease
- See Section 3.4.1. for further analysis
- Contract contains a lease

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

Examples of decision-making rights that may grant a customer the right to change how and for what purpose an asset is used (depending on the circumstances), include rights to change:
- The type of output that is produced by the asset (e.g. what type of food certain food processing equipment produces);
- When the output is produced (e.g. the regular operating hours for equipment);
- Where the output is produced (e.g. the physical location of machinery or destinations and routes for transport equipment); and
- Whether the output is produced, and the quantity of the output (e.g. to decide whether to produce energy from a power plant and how much energy to produce).

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

**BDO comment**

*The guidance on determining who has the right to direct the use of the asset focuses on control. This is consistent with the IASB’s focus on control being a primary element in determining whether transactions qualify for recognition in other recently issued standards, such as IFRS 10 Consolidated Financial Statements and IFRS 15. However, it is slightly different from the current focus in IAS 17 on which party has the risks and rewards of the leased asset.*
Example 7 – Customer Directs Use

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

Assessment

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

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

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

For an asset where the relevant decisions are pre-determined, the contract contains a lease if:
(a) The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
(b) The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

BDO comment

Assets that may fall into this category include those that are:
– Technologically advanced such that they are designed for highly specific purposes;
– Costly to modify or repurpose for other uses; and/or
– Whose use is restricted based on regulation or law.

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

Example 8 – Pre-determined Functionality

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

Assessment

In assessing the ‘right to direct use of asset’ criterion, the functionality of the facility is predetermined based on its design, and those predeterminations were made by the customer. Therefore, the customer has the right to direct its use.
4. DETERMINING THE LEASE TERM

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

(a) The non-cancellable period of the lease (Section 4.1.);
(b) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option (Section 4.2.); and
(c) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option (Section 4.2.).

4.1. Non-cancellable Period

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

During the non-cancellable period only extension and termination options held by the lessee are considered when determining the lease term. If only a lessor has termination rights, the non-cancellable period of the lease includes the period of time covered by these lessor termination options.

BDO comment

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

Options to extend or terminate a lease contract are common in many types of leases. For leases where only the lessee has a termination option the analysis is entirely about the duration the lessee will choose. However, if both the lessee and the lessor have termination options IFRS 16 Paragraph B34 is considered. Paragraph B34 states that a lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty. To assess if there is an insignificant penalty the analysis needs to include both what is explicitly in the contract as well as other kinds of economic penalties that may not be included in the contract. Termination clauses must have economic substance to be considered.

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

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

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

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

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

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

A lessee’s past practice with leases, particularly leases of similar assets, should also be considered in determining the likelihood of options being exercised. The reason for exercising such options may not be apparent from any single criterion, but may relate to synergies and a weighting of several reasons that must be considered in aggregate. Therefore two lessees may determine different lease terms on identical lease contracts because the facts and circumstances under which they operate may mean that one lessee concludes it is reasonably certain to exercise one or more options, whereas the other might conclude it is not reasonably certain any of them will be exercised.
Example 9 – Assessment of Lease Term (only lessee has termination option)

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

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

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

**Assessment**

Paragraph B34 does not apply, since only the lessee can terminate the lease. The customer lacks a direct, contract-specific economic incentive to extend the lease given that lease payments are at a market rate throughout the period of the lease. However, all relevant facts and circumstances that create an economic incentive for the customer to exercise, or not exercise, options must be considered. This, therefore, includes entity-specific factors such as the costs the customer would incur to obtain a suitable replacement asset, the importance of the asset to the customer’s operations, and the availability of suitable replacement assets. As the customer operates in a remote location, which inherently increases the cost of not extending a lease for a key piece of equipment needed in its business due to installation and transportation costs of obtaining a replacement, it concludes that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be 7 years.
In the second scenario, in which both the lessee and lessor have termination options, IFRS 16 Paragraph B34 is relevant.

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

Assume similar facts to the prior example except both the lessee and the lessor have a termination option at the end of Year 5 with a zero termination payment.

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

The lease has a 5 year term, with an option to extend the lease for an additional 2 years. Either party can terminate the lease at the end of the 5 year term with zero termination payment. The monthly rental payments escalate at an industry accepted rate based on inflation plus a margin. This escalation also applies to the additional 2 year period if the lessee exercises its extension option.

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

Assessment

Paragraph B34 does apply, since both the lessee and lessor have a termination option. Therefore, the second requirement of Paragraph B34 is addressed to determine if there is no more than an insignificant penalty.

The contract specifies there is no monetary penalty, however, this is only one kind of penalty that could arise. There needs to be no penalty of any type in order for the termination clause to have economic substance and the lease term to be capped at 5 years. There could be other kinds of economic penalties in addition to those explicitly in the contract. In this instance, due to the remote location and likely difficulty obtaining a new tenant along with the specialised nature of the leasehold improvements, the lessor would have an economic penalty. In addition, as noted in the prior example the lessee would also have economic penalties. Therefore, the penalty is determined to be more than insignificant and the contract is enforceable.

The term of the lease is then determined based on the lessee factors similar to the prior example with the conclusion that it is reasonably certain that the extension option will be exercised, and therefore, the lease term is estimated on commencement of the lease to be 7 years.
4.3. Revisions to the Lease Term

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

Reassessment of Original Estimate

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

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

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

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

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

Remeasurements due to Modifications to the Lease Contract

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

At the commencement date of a lease, i.e. the date on which the lessor makes an underlying asset available for use by a lessee, the lease liability and right-of-use asset comprise:

- Fixed Payments from commencement date
- Certain Variable Payments
- Residual Value Guarantee
- Exercise Price of Purchase Options
- Termination penalties
- *Discounted payments (see Section 5.2. – Discount Rate on Initial Recognition)

Lease Liability

- Initial Direct Costs
- Costs of removal and restoring
- Payments made at or prior to commencement
- Lease incentives received

Right-of-Use Asset
5.1. Lease Liability – Initial Recognition

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

Fixed Payments

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

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

Example 11 – In-Substance Fixed Payments

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

Scenario #1 – Low minimum payments

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

Analysis – The lease contract technically specifies variable payments in that rental payments can be either CU 100 or CU 50,000. However, it is not realistically possible that the lessee will have less than CU 1,000 in sales per annum given its history with past retail locations. In this case, there is no true variability in the lease payments as only one outcome is realistically probable to occur. The lessee would include the lease payments of CU 50,000 per annum in its initial measurement of the lease contract.
Example 11 – In-Substance Fixed Payments (continued)

Scenario #2 – Payments entirely based around sales

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

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

BDO comment

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

Scenario #3 – Consumables contract attached to a lease

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

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

Analysis – The contract does not contain a minimum order for consumables that the lessee must place. Consequently, as with Scenario #2, because the variable payments are linked to the future use of the medical equipment (payments for the equipment are included in the price of the consumables), they are excluded from the definition of lease payments and no lease liability is recognised. If the contract contained a minimum order quantity, this would give rise to the need to record a lease liability.
**Variable Payments**

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

The treatment of variable lease payments is summarised as:

<table>
<thead>
<tr>
<th>Category</th>
<th>Treatment</th>
</tr>
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</table>
| Variable payments that depend on an index or a rate | - Include in the initial measurement of the lease using the index or rate as at the commencement date.  
- Remeasure lease in the period the rate or index changes (see Section 5.6.). |
| In-substance fixed payments                   | - Include in the initial measurement of the lease.  
- Remeasure the lease in the period in-substance fixed payments are changed or are resolved (see Section 5.6.). |
| Other variable payments                       | - Do not include in the initial measurement of the lease.  
- Recognise in profit or loss (or in the carrying value of another asset as required by another Standard) when the event or condition that triggers the payments occur. |
Example 12 – Variable Lease Payments that Depend on an Index or Rate

Year One – Beginning of Lease

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

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

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

Assessment

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

| Dr         | Right-of-use asset | CU 405,391 |
| Cr         | Lease liability    | CU 355,391 |
| Cr         | Cash               | CU 50,000  |

(lease payment for the first year)

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

BDO comment

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

However, as and when passing rent changes as a result of lease payments being linked to a rate or index, leased assets and liabilities have to be remeasured. Long-term real estate leases often contain lease escalations linked to indexes such as the consumer price index, inflation rates posted by government agencies or periodic uplifts to market rent. Section 5.6. below covers such remeasurements in more detail.
Example 13 – Variable Lease Payments not included in the Initial Measurement of the Lease

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

Assessment

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

<table>
<thead>
<tr>
<th>Dr</th>
<th>Right-of-use asset</th>
<th>CU 405,391</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Lease liability</td>
<td>CU 355,391</td>
</tr>
<tr>
<td>Cr</td>
<td>Cash</td>
<td>CU 50,000</td>
</tr>
</tbody>
</table>

Residual Value Guarantees

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

Purchase and Termination Options

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

BDO comment

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

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

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

**Embedded Derivatives in Leases**

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

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**Example 14 – Embedded derivatives in Leases**

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

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

**Assessment**

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

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

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

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

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

An entity’s weighted-average cost of capital (‘WACC’) is generally not appropriate to use as a proxy for the incremental borrowing rate because it is not generally representative of the rate an entity would pay on borrowings. WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings.

**BDO comment**

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

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

Therefore, it is likely that many lessees will use their incremental borrowing rate for a wide variety of leases.
Example 15 – Negative Implicit Interest Rates

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

Assessment

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

IFRS 16 defines the ‘interest rate implicit in the lease’ as:

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

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

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

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

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

Initial Direct Costs

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

BDO comment

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

Removal and Restoration Costs

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

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

BDO comment

Leases of property often require the lessee to restore the leased asset to a specified state upon the termination of the lease. For example:

- A manufacturing lessee may install significant amounts of equipment and customised leasehold improvements in a factory it leases, with these items being required to be removed at the end of the lease term; or
- A lessee may make changes to the internal configuration of a leased property but have a contractual obligation to return the property to the lessor at the end of the lease in its original state.

A requirement to return a property to its original state is sometimes referred to in contracts as leasehold dilapidations.
Example 16 – Initial Recognition of a Lease

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

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

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

**Assessment**

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

<table>
<thead>
<tr>
<th>To record the initial value of the lease asset and liability:</th>
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</thead>
<tbody>
<tr>
<td>Dr Right-of-use asset</td>
</tr>
<tr>
<td>Cr Lease liability</td>
</tr>
<tr>
<td>Cr Cash</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>To record the initial direct costs:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Right-of-use asset</td>
</tr>
<tr>
<td>Cr Cash</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>To record lease incentive relating to the lease:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Cash</td>
</tr>
<tr>
<td>Cr Right-of-use asset</td>
</tr>
</tbody>
</table>
5.4. Lease Liability – Subsequent Measurement

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

**BDO comment**

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

- The production of inventory utilising leased equipment;
- The construction of property, plant and equipment where leased assets are a component of the construction; and
- The development of intangible assets where leased assets are a component of the directly identifiable costs to obtain or develop those intangible assets.
5.5. Right-of-Use Asset – Subsequent Measurement

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

- **Cost Model (IAS 16)**
- **Revaluation Model (IAS 16)**
- **Fair Value Model Investment Property (IAS 40)**

*BDO comment*

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

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

Under the cost model, an entity measures a right-of-use asset at:
- Cost measured in accordance with Section 5.3. above;
- Less accumulated amortisation and accumulated impairment losses (recognised in accordance with IAS 36);
- Adjusted for remeasurements (see Sections 5.6. and 5.7.).

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

Revaluation Model

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

BDO comment

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

Fair Value Model

If an entity applies the fair value model in IAS 40, the same model must also be applied to right-of-use assets that meet the definition of investment property.

BDO comment

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

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

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

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

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

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

Note that prior period figures are not adjusted, with all of these remeasurements being accounted for prospectively.
Example 17 – Remeasurement of a Lease due to Reassessment of an Option

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

Assessment

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

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

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

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

BDO comment

Judgement must be applied to assess whether the extension of lease terms between existing parties are treated as new leases or the modification of the original lease. For example, consider a lease that does not include any renewal option. During the lease term, the parties enter into a new lease for the same identified asset that commences when the original lease ends. Facts and circumstances would need to be considered to determine the substance of the new arrangement and whether it constitutes a modification (which would require re-measurement of the existing lease) or a new lease (which would not require remeasurement of the existing lease, but would instead result in the recognition of a new lease from the start of the subsequent period).

Modifications – Separate Leases

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

– The modification increases the scope of the lease by adding the right to use one or more underlying assets; and
– The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

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

Example 18 – Lease Modification that is a Separate Lease

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

Assessment

Lessee accounts for the modification as a separate lease, i.e. separately from the original 10-year lease, the accounting for which is unaffected by the lease modification. This is because the modification grants Lessee an additional right to use an underlying asset, and the increase in consideration for the new right is commensurate with its stand-alone price. In this example, the additional right-of-use asset is the extra 3,000 square metres of office space for three and a half years. Accordingly, at the commencement date of the new lease (at the end of the second quarter of Year 6), Lessee recognises a right-of-use asset and a lease liability relating to the lease of the additional 3,000 square metres of office space for three and a half years. Lessee does not make any adjustments to the right-of-use asset or lease liability relating to the original lease of 2,000 square metres of office space which continue to be accounted for as if there had been no modification.
The legal form of a lease agreement may be modified to add additional assets (e.g. additional floors of an office building). In cases where the additional right-of-use assets are added to the contract at a price commensurate with their standalone price, the modification is in substance a new lease contract and the modification is accounted for as a separate lease under IFRS 16.

Modifications – Not Separate Leases

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

- Decrease right-of-use asset and lease liability by their relative amounts compared to the original lease taking the difference to P&L
- Remeasure lease liability using revised discount rate* with off-set to right-of-use (ROU) asset

Decrease in scope

- Decrease right-of-use asset and lease liability by same amount
- No P&L impact

All other lease modifications

- Remeasure lease liability using revised discount rate*
- Remeasure right-of-use asset by same amount
- No P&L impact

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

If a lease modification results in the lessee obtaining additional rights to use one or more underlying assets, but not at an amount that is commensurate with the standalone price for the increase in scope, the liability is remeasured by discounting all of the future lease payments as revised in the modified contract at the lessee’s prevailing incremental borrowing rate (assuming the rate inherent in the lease is not readily determinable). It does not use the discount rate that applied to the pre-modified lease payments. The remeasurement of the lease liability is adjusted against the carrying value of the right-of-use asset such that no gain or loss arises as a result of the modification. The same accounting is applied if the term of the original lease is extended without adding any additional rights to use any more underlying assets.
Example 19 – Lease Modification that Increases Scope

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

**Assessment**

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

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

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

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

Adjustment required = newly remeasured liability - previous carrying value of liability

= CU 597,130 - CU 346,511

= CU 250,619

Entry required as a result of the modification:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Right-of-use asset</th>
<th>CU 250,619</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr</td>
<td>Lease liability</td>
<td>CU 250,619</td>
</tr>
</tbody>
</table>

**BDO comment**

IFRS 16 does not address how the adjustment to right-of-use assets should be recorded; that is, whether the adjustment should be made to the cost of the asset, the accumulated amortisation, or on a pro-rata basis.

However, Paragraph 35 of IAS 16 provides guidance on remeasurements related to the revaluation model of subsequent measurement. It provides a choice between:

(a) Adjusting the gross carrying amount in a manner consistent with the revaluation, for example by adjusting gross cost and accumulated depreciation by the same proportion as the overall change in net book value; or

(b) Eliminating accumulated depreciation against the cost of the asset until it equals the revalued amount, with any excess upward revaluation added to the gross carrying amount.

Either of the above approaches would therefore appear to be appropriate when accounting for lease modifications. The approach adopted by a lessee should be treated as an accounting policy choice and be disclosed in its financial statements.
If the modification results in a decrease in scope (e.g. by reducing the lease term or reducing the amount of asset(s) that are being leased) the accounting is more complex. Although the resulting liability is measured in the same way as above by discounting the lease payments in the modified contract at the lessee’s prevailing borrowing rate, this adjustment is undertaken in two steps:

- **Step 1**: the carrying amount of the right-of-use asset at the date of modification is reduced to reflect the partial or full termination on the lease, with the lease liability being reduced by the same proportion. The difference between the carrying amount of the right-of-use asset and lease liability derecognised gives rise to a gain or loss.

- **Step 2**: the carrying amount of the liability resulting from Step 1 is adjusted again to ensure its carrying amount equals the future lease payments in the modified contract discounted at the prevailing incremental borrowing rate. This second adjustment to the lease liability is accounted for by making a corresponding adjustment to the right-of-use asset. No gain or loss is recognised in this step.

**Example 20 – Lease Modification that Decreases Scope**

Entity B has a 10-year lease on 5,000 square metres of office space with annual payments of CU 50,000 payable at the end of each year. The rate used to discount the payments due is Entity B’s incremental borrowing rate of 6% as the implicit rate is not readily determinable. At the beginning of Year 6, Entity B and the lessor agree to reduce the lease to 2,500 square metres and reduce the remaining payments to CU 30,000 a year. At the beginning of Year 7, Entity A’s incremental borrowing rate is 5%.

**Assessment**

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

The lease liability immediately prior to the modification is CU 210,618 and the right-of-use asset is CU 184,002. The scope of the decrease in the right-of-use asset is 50%, as the leased space has decreased from 5,000 square metres to 2,500.

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

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

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>Right-of-use asset</td>
<td>CU 105,309 (CU 210,618 original x 50%)</td>
</tr>
<tr>
<td>Cr</td>
<td>Cr</td>
<td>CU 92,001 (CU 184,002 original x 50%)</td>
</tr>
<tr>
<td>Gain</td>
<td></td>
<td>CU 13,308 (remainder)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>Lease liability</td>
<td>CU 24,575 ( corresponds to liability adjustment)</td>
</tr>
<tr>
<td>Cr</td>
<td></td>
<td>CU 24,575 (CU 210,618 - CU 105,309 + CU 24,575 = CU 129,884)</td>
</tr>
</tbody>
</table>
BDO comment

There are two consequences arising from the required accounting for lease modifications that reduce the scope of the lease that may seem counterintuitive:

– Firstly, a lease modification will often result in a gain. This is because at any point in time a lease liability will generally be greater than the leased asset as higher interest charges in the earlier years of the lease result in the lease liability being reduced at a lower rate than the straight-line depreciation charge that is typically applied to the right-of-use asset. As the adjustment in Step 1 results in the pre-modification carrying amounts of the right-of-use asset and lease liability being reduced by the same proportion, generally more of the lease liability will be derecognised than the right-of-use asset. This may not be the case if the right-of-use asset is not being depreciated on a straight-line basis or the majority of lease payments prior to modification were paid in advance and the reduction in scope was not resulting in a refund of those advance payments;

– Secondly, the gain will be the same irrespective of the amount by which future lease payments are being modified. This is because it is Step 2 which ensures the carrying amount of the liability reflects the present value of future lease payments, which is only adjusted against the right-of-use asset. No gain or loss arises from Step 2.

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

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

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

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

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

IFRS 16.47(a)(i) states that if an entity wishes to group right-of-use assets with other assets, they must be grouped ‘within the same line item as that within which the corresponding underlying assets would be presented if they were owned’.

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

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

**BDO comment**

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

The timing of overall expenses being recognised in profit and loss will also change. See the example below for the effect on an entity for a typical real estate lease.
Example 21 – Illustration of Effect on Profit and Loss for Leases Previously Classified as Operating

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

<table>
<thead>
<tr>
<th></th>
<th>IAS 17</th>
<th></th>
<th></th>
<th>IFRS 16</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amortisation</td>
<td>Interest</td>
<td>Operating Cost</td>
<td>Net income</td>
<td>Amortisation</td>
<td>Interest</td>
</tr>
<tr>
<td>Year 1</td>
<td>-</td>
<td>-</td>
<td>75,000</td>
<td>25,000</td>
<td>64,942</td>
<td>16,235</td>
</tr>
<tr>
<td>Year 2</td>
<td>-</td>
<td>-</td>
<td>75,000</td>
<td>25,000</td>
<td>64,942</td>
<td>13,297</td>
</tr>
<tr>
<td>Year 3</td>
<td>-</td>
<td>-</td>
<td>75,000</td>
<td>25,000</td>
<td>64,942</td>
<td>10,212</td>
</tr>
<tr>
<td>Year 4</td>
<td>-</td>
<td>-</td>
<td>75,000</td>
<td>25,000</td>
<td>64,942</td>
<td>6,972</td>
</tr>
<tr>
<td>Year 5</td>
<td>-</td>
<td>-</td>
<td>75,000</td>
<td>25,000</td>
<td>64,942</td>
<td>3,571</td>
</tr>
<tr>
<td>Total</td>
<td>-</td>
<td>-</td>
<td>375,000</td>
<td>125,000</td>
<td>324,711</td>
<td>50,289</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>IAS 17</th>
<th></th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>25,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Year 2</td>
<td>25,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Year 3</td>
<td>25,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Year 4</td>
<td>25,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Year 5</td>
<td>25,000</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>125,000</td>
<td>500,000</td>
<td></td>
</tr>
</tbody>
</table>
BDO comment

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

Entities may need to revisit covenant and regulatory calculations, and financial statement users’ methods of analysing results may need to be updated.
7. DISCLOSURE

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

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

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

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

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

<table>
<thead>
<tr>
<th>Qualitative Disclosure Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>- A summary of the nature of the entity’s leasing activities;</td>
</tr>
<tr>
<td>- Potential cash outflows the entity is exposed to that are not included in the lease liability, including:</td>
</tr>
<tr>
<td>- Variable lease payments;</td>
</tr>
<tr>
<td>- Extension options and termination options;</td>
</tr>
<tr>
<td>- Residual value guarantees; and</td>
</tr>
<tr>
<td>- Leases not yet commenced to which the lessee is committed.</td>
</tr>
<tr>
<td>- Restrictions or covenants imposed by leases; and</td>
</tr>
<tr>
<td>- Information about sale-and-leaseback transactions.</td>
</tr>
</tbody>
</table>
BDO comment – Disclosure Initiative

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

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

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

**BDO comment**

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

The areas that may affect lessors are those where IFRS 16 expands guidance or provides guidance on issues not previously addressed in IAS 17, such as:

- The new definition of a lease (see Section 3);
- Clarification that variable payments that depend on an index or a rate are factored in to the definition of lease payments, and so could impact the assessment as to whether the present value of the lease payments amounts to substantially all of the fair value of the underlying asset for the purposes of classifying a lease as a finance lease or operating lease;
- Revised sale-and-leaseback guidance (see Section 9);
- Separation of lease and non-lease components in a contract (see below);
- Sub-lease guidance (see below);
- Guidance on lease modifications (see below); and
- Enhanced disclosure requirements (see below).

8.1. Separation of Lease and non-Lease Components

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

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

Example 22 – Sub-Lease Assessment

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

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

Assessment

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

BDO comment

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

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

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

When a head lease is short-term and the intermediate lessor takes advantage of the related practical expedient not to recognise short-term leases in its statement of financial position in its capacity as a lessee, the intermediate lessor must classify the sub-lease as an operating lease.
In summary, the accounting treatment required for a sub-lease depends on its classification by the intermediate lessor as follows:

<table>
<thead>
<tr>
<th>Classification</th>
<th>Treatment</th>
</tr>
</thead>
</table>
| **Finance leases** | - Derecognise the right-of-use asset (1) and recognise instead a lease receivable equal to the net investment in the sub-lease (2);  
- Recognise the difference between (1) and (2) as a gain or loss in the income statement;  
- Retain the previously recognised lease liability in capacity as lessee and recognise interest expense thereon; and  
- Recognise interest income on the lease receivable in capacity as finance lessor. |
| **Operating leases** | - Retain the right-of-use asset in capacity as lessee and continue to recognise depreciation thereon;  
- Retain the lease liability in capacity as lessee and continue to recognise interest expense thereon; and  
- Recognise lease income from the sub-lease in capacity as operating lessor. |
8.3. Lease Modifications

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

8.3.1. Finance Leases

Modifications – Separate Leases

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

– The modification increases the scope of the lease by adding the right to use one or more underlying assets; and
– The consideration for the lease increases by an amount commensurate with the standalone price for the increase in scope.

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

Modifications – Not Separate Leases

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

Applying the modified contract from inception, the lease would have been classified as an operating lease

– Account for the lease modification as a new lease from the effective date of the modification; and
– Measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.

All other lease modifications

– Apply the requirements of IFRS 9 Financial Instruments.

The remeasurements above occur on the effective date of the lease modification on a prospective basis.
8.3.2. Operating Leases

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

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

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

Disclosure requirements for lessors are summarised as follows:

### Quantitative Disclosure Requirements

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

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

### Qualitative Disclosure Requirements

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

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

– Buy-back agreements;
– Residual value guarantees;
– Variable lease payments for excess use; and
– Any other risk management strategies.
9. SALE-AND-LEASEBACK TRANSACTIONS

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

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

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

<table>
<thead>
<tr>
<th>Lessee (seller)</th>
<th>Lessor (buyer)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transfer to buyer-lessor qualifies as a sale</strong></td>
<td></td>
</tr>
<tr>
<td>– Derecognise asset and apply lessee accounting requirements.</td>
<td>– Apply lessor accounting requirements to asset purchased.</td>
</tr>
<tr>
<td>– Measure right-of-use asset as the retained portion of the previous carrying value.</td>
<td></td>
</tr>
<tr>
<td>– Recognise gain/loss on the rights transferred to the lessor.</td>
<td></td>
</tr>
</tbody>
</table>

| **Transfer to buyer-lessor does not qualify as a sale** | | |
| – Continue recognition of asset. | – Asset purchased is not recognised. |
| – Amounts received are recognised as a financial liability under IFRS 9 *Financial Instruments*. | – Amounts paid are recognised as a financial asset under IFRS 9 *Financial Instruments*. |

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

If it is determined that the fair value of the asset is less than or greater than the contractual sales price, then the difference is accounted for by the lessee as additional borrowing or a prepayment, respectively. Similarly, the lessor accounts for the difference as rents receivable or deferred rental income, respectively, (if the leaseback is classified as an operating lease) or an adjustment to the finance lease receivable (if the leaseback is classified as a finance lease).
In some cases, it may be easier to compare the contractual leaseback rentals to market rentals rather than the contractual sales price to the fair value of the leased asset, in which case the standard also permits this approach when determining whether both sides of the SALT transaction are on-market.

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

**Example 23 – Sale-and-leaseback transaction where transfer is a sale (lessee)**

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

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

The discount rate is 4.5% per annum determined by reference to the seller-lessee’s incremental borrowing rate as the rate inherent in the lease is not readily determinable. The present value of the annual leaseback payments (18 payments of CU 120,000, 4.5% discount per annum) is CU 1,459,200.
Example 23 – Sale-and-leaseback transaction where transfer is a sale (lessee) (continued)

Assessment

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

\[
\begin{align*}
\text{Dr} & \quad \text{Cash} \quad \quad \quad \quad \quad \quad \text{CU} \ 2,000,000^1 \\
\text{Dr} & \quad \text{Right-of-use asset} \quad \quad \quad \text{CU} \ 699,555^2 \\
\text{Cr} & \quad \text{PPE (the property sold)} \quad \quad \quad \text{CU} \ 1,000,000^3 \\
\text{Cr} & \quad \text{Lease liability} \quad \quad \quad \text{CU} \ 1,459,200^4 \\
\text{Cr} & \quad \text{Gain on rights transferred} \quad \quad \text{CU} \ 240,355^5
\end{align*}
\]

1 Total cash received from the buyer-lessor.
2 The retained right-of-use of the asset sold is measured by reference to the previous carrying value of the property. The fair value of the property is CU 1,800,000, whilst the fair value of the leaseback rental is CU 1,259,000 (i.e. CU 200,000 less than the repayments that the lessee is required to make). Therefore, the cost of the property for which control has not passed to the buyer-lessor = CU 1,000,000 x CU 1,259,000/CU 1,800,000 = CU 699,355.
3 The previous carrying value of the property is derecognised.
4 Present value of future lease payments of CU 1,459,200 (CU 120,000 per year for 18 years, 4.5% annual discount). This includes the difference between the consideration received and the fair value of the property of CU 200,000 (CU 2,000,000 – CU 1,800,000). In other words, had proceeds on sale been on-market at CU 1,800,000, then the present value of the leaseback payments would only have been CU 1,259,000. The proceeds above market on the sale side of the transaction are therefore treated as additional financing.
5 The gain on sale is the balancing entry in the transaction, but can be reconciled as follows:

\[
\text{Gain} = \frac{\text{Proceeds attributable to the portion of the asset for which control is transferred}}{\text{Carrying value of the portion of the asset for which control is transferred}}
\]

\[
\text{Proceeds attributable to the portion of the asset being disposed:} \\
\quad = \text{Total proceeds less total amount of financing received} \\
\quad = \text{CU 2,000,000} - \text{CU 1,459,200} \\
\quad = \text{CU 540,800}
\]

\[
\text{Carrying value of the portion of the asset being sold:} \\
\quad = \text{Carrying value less right-of-use asset retained} \\
\quad = \text{CU 1,000,000} - \text{CU 699,555} \\
\quad = \text{CU 300,445}
\]

Therefore gain on disposal:

\[
\text{= CU 540,800} - \text{CU 300,445} \\
\text{= CU 240,355}
\]
**BDO comment**

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

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

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

BDO comment

IFRS 16 was issued in January 2016, allowing a 3 year period of time for implementation. The amount of time between a standard being issued and its effective date can be viewed as a measure of several factors, including its:

- Relative complexity;
- Overall effects on reported financial position, financial performance and cash flows;
- Importance to key financial statement users such as lenders, investors and regulators; and
- Cost of implementation and impact on systems and processes.

3 years is a significant period of time, which indicates that the IASB anticipates some entities will have to dedicate significant resources to implement IFRS 16. Given that IFRS 9 and IFRS 15 are effective for periods beginning on or after 1 January 2018, the comparatively long period afforded to implement IFRS 16 may also relate to the potentially significant amount of work required to implement IFRSs 9 and 15.

However, notwithstanding this potentially heavy workload, because of the interaction between IFRS 15 and IFRS 16 in accounting for sale-and-leaseback transactions and to avoid two significant changes in accounting in successive years, some entities might consider adopting IFRS 16 a year early.
10.1. Retrospective Application Options – Lessees

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

### Full Retrospective Approach

This approach results in an entity applying IFRS 16 to all periods presented as if it had always been applied.

Application of the full retrospective approach requires presentation of a third statement of financial position in accordance with IAS 1 *Presentation of Financial Statements*. Further, there is only limited transitional relief related to applying the definition of a lease as (discussed in Section 10.3.). This may lead entities to follow the modified retrospective approach instead as it provides for significantly more transitional relief and also does not require presentation of a third statement of financial position.

### Modified Retrospective Approach

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

The modified retrospective approach is summarised as follows:

- **Operating Leases**

- **Finance Leases**

  - **Lease liability**
    - Equal to remaining lease payments using incremental borrowing rate at the date of initial application to discount

  - **ROU asset**
    - (1) equal to the lease liability adjusted for prepaid or accrued lease payments immediately before the date of initial application; or (2) as if IFRS 16 had always been applied but using the incremental borrowing rate at the date of initial application

  - **Lease liability**
    - Use previous carrying value of finance lease liability

  - **ROU asset**
    - Use previous carrying value of finance lease asset

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

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

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

**Other Disclosures – Modified Retrospective Approach**

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

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

**BDO comment**

Reconciling current and comparative year balance sheets

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

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

- Discounting: the lease commitment note would have been discounted; and
- In-substance fixed payments: the lease commitment note may have considered only minimum lease payments.

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

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

1. Apply a single discount rate to a portfolio of leases with reasonably similar characteristics.
2. Rely on its assessment of whether a lease is onerous by applying IAS 37 immediately before the date of initial application.
3. Not recognise leases whose term ends within 12 months of the date of initial application (use short-term lease accounting).
4. Exclude initial direct costs from the measurement of ROU assets at the date of initial application.
5. Use hindsight, such as in determining the lease term if the contract contains options to extend or terminate the lease.

**BDO comment**

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

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

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

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

**IFRS 16**
- Reassess all leases using criteria in IFRS 16 as to whether they meet the definition of a lease within IFRS 16.

**Previous Standards**
- Apply IFRS 16 measurement guidance to contracts identified as leases under previous standards;
- Do not apply IFRS 16 measurement guidance to contracts deemed to not meet the definition of a lease under previous standards;
- Follow IFRS 16 guidance on the definition of a lease subsequent to the date of initial application.
10.4. Transition – Lessors

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

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

The implications of this assessment are summarised as follows:

- **Sublease (IAS 17)**
  - Operating Lease (IAS 17)
    - Assessed as operating under IFRS 16: continue to account for lease as operating lease
  - Finance Lease (IAS 17)
    - Assessed as finance under IFRS 16: account for lease as new finance lease as of the date of initial application
    - Continue to account for lease as finance lease
10.5. Transition – Sale-and-Leaseback Transactions (SALTs)

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

<table>
<thead>
<tr>
<th>SALT (IAS 17)</th>
<th>Previous assessment of lease under IAS 17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Lease (IAS 17)</td>
<td>Account for lease in the same way as other operating leases that exist at the date of initial application, but adjust the ROU asset for any deferred gain/loss related to off-market terms.</td>
</tr>
<tr>
<td>Finance Lease (IAS 17)</td>
<td>Account for lease in the same way as other finance leases that exist at the date of initial application and continue to amortise any gain on sale over the lease term.</td>
</tr>
</tbody>
</table>

**BDO comment**

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

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

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

10.7. Illustration of Transition Approaches

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

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

Example 24

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

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

The above facts are applied to each of the 3 approaches explained further in Sections 10.7.1., 10.7.2. and 10.7.3. below.
10.7.1. Illustration of Transition – Full Retrospective Approach

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

- **Step #1** – Calculate the lease liability as at the commencement date (1 January 2016).
- **Step #2** – Calculate the right-of-use asset as at the commencement date (1 January 2016).
- **Step #3** – Roll the lease liability forward to 1 January 2018 and 1 January 2019 using the effective interest method.
- **Step #4** – Roll the right-of-use asset forward to 1 January 2018 and 1 January 2019 by amortising the asset.

**Step #1 – Lease Liability as at 1 January 2016**

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

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

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

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

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

(5) The lease does not include any termination options.
Step #2 – Right-of-use asset as at 1 January 2016

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

1. The lease liability component is equal to the value calculated in Step #1.
2. Under the full retrospective approach, initial direct costs must be capitalised into the right-of-use asset. The practical expedient to exclude initial direct costs from the measurement of right-of-use assets is only available to entities applying the modified retrospective approach.
3. The lease does not contain any costs of removal or costs to restore.
4. The initial payment on the first day of the lease is capitalised into the right-of-use asset.
5. The lessee has not received any lease incentives.

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

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

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Opening balance(A)</th>
<th>Payment (B)</th>
<th>Interest (C)</th>
<th>Closing balance(D)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 2016</td>
<td>CU 9,773</td>
<td>-</td>
<td>CU 684</td>
<td>CU 10,457</td>
</tr>
<tr>
<td>31 December 2017</td>
<td>CU 10,457</td>
<td>CU 1,500</td>
<td>CU 627</td>
<td>CU 9,584</td>
</tr>
<tr>
<td>31 December 2018</td>
<td>CU 9,584</td>
<td>CU 1,500</td>
<td>CU 566</td>
<td>CU 8,650</td>
</tr>
</tbody>
</table>
Step #4 – Right-of-use asset as at 1 January 2018 and 1 January 2019

The lessee has chosen to use the cost model under IAS 16 to amortise the right-of-use asset. Since the lease does not transfer ownership of the underlying asset to the lessee by the end of the lease term, Entity A depreciates the asset over the shorter of the lease term and the asset’s useful economic life. Entity A has assessed that the useful economic life of the underlying asset exceeds the lease term, so the amortisation of the right-of-use asset will begin on the lease commencement date and be charged evenly over the lease term, as this best represents the consumption of the economic benefits of the asset. The annual amortisation charge is therefore 1/10th of CU 11,773, i.e. CU 1,173.

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

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Opening balance</th>
<th>Amortisation charge</th>
<th>Closing balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 2016</td>
<td>CU 11,773</td>
<td>CU 1,173</td>
<td>CU 10,596</td>
</tr>
<tr>
<td>31 December 2017</td>
<td>CU 10,596</td>
<td>CU 1,173</td>
<td>CU 9,419</td>
</tr>
<tr>
<td>31 December 2018</td>
<td>CU 9,419</td>
<td>CU 1,173</td>
<td>CU 8,242</td>
</tr>
</tbody>
</table>

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

Summary

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

<table>
<thead>
<tr>
<th></th>
<th>31 December 2018</th>
<th>1 January 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 8,242</td>
<td>CU 9,419</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 8,650</td>
<td>CU 9,584</td>
</tr>
<tr>
<td>Adjustment to equity</td>
<td>(CU 408)</td>
<td>(CU 165)</td>
</tr>
</tbody>
</table>

In its financial statements for the year ended 31 December 2019, Entity A would also present the 31 December 2017 figures in a third statement of financial position as required by IAS 1 *Presentation of Financial Statements*, and the 31 December 2018 figures as its comparative figures.
10.7.2. Illustration of Transition – Modified Retrospective Approach #1

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

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

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

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

Step #1 – Lease Liability as at 1 January 2019

\[
\text{Fixed Payments} \quad + \quad \text{Certain Variable Payments} \quad + \quad \text{Residual Value Guarantee} \quad + \quad \text{Exercise Price of Purchase Options} \quad + \quad \text{Termination penalties} = \quad \text{Lease Liability}
\]

\[
\text{CU 9,114} \quad (1) \quad + \quad \text{Nil} \quad (2) \quad + \quad \text{Nil} \quad (3) \quad + \quad \text{Nil} \quad (4) \quad + \quad \text{Nil} \quad (5) = \quad \text{CU 9,114}
\]

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

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

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

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

(5) The lease does not include any termination options.
Step #2 – Right-of-use asset as at 1 January 2019

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

ROU Asset (1) (CU 9,114) = Lease Liability (CU 9,114)

Summary

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

<table>
<thead>
<tr>
<th></th>
<th>1 January 2019</th>
<th>31 December 2018</th>
<th>1 January 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 9,114</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 9,114</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

This version of the modified retrospective approach is simplest in that it essentially requires a single calculation in most instances for the outstanding lease liability on 1 January 2019. As can be seen from the above table, the comparative period is not restated, so comparability between periods will be reduced. Additionally, the right-of-use asset is recorded at an amount higher than it would if the full retrospective approach (see Section 10.7.1. above) or the second version of the modified retrospective approach (see Section 10.7.3. below) were used. This will result in higher amortisation charges in subsequent periods and less comparability with new leases entered into subsequent to the date of initial application.
10.7.3. Illustration of Transition – Modified Retrospective Approach #2

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

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

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

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

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

- Step #3 – Calculate the lease liability as at the date of initial application (1 January 2019).

- Step #4 – Roll the right-of-use asset forward to 1 January 2019 by amortising the asset.
Step #1: Lease Liability as at 1 January 2016

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

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

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

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

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

(5) The lease does not include any termination options.
Step #2 – Right-of-use asset as at 1 January 2016

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

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

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

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

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

Step #3 – Lease Liability as at 1 January 2019

The lease liability under both versions of the modified retrospective approach is identical, therefore the calculation is identical to Step #1 described in Section 10.7.2., meaning the amount to recognise on the date of initial application is CU 9,114.
**Step #4 – Right-of-use asset as at 1 January 2019**

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

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

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Opening balance</th>
<th>Amortisation charge</th>
<th>Closing balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 December 2016</td>
<td>CU 12,162</td>
<td>CU 1,216</td>
<td>CU 10,946</td>
</tr>
<tr>
<td>31 December 2017</td>
<td>CU 10,946</td>
<td>CU 1,216</td>
<td>CU 9,730</td>
</tr>
<tr>
<td>31 December 2018</td>
<td>CU 9,730</td>
<td>CU 1,216</td>
<td>CU 8,514</td>
</tr>
</tbody>
</table>

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

**Summary**

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

<table>
<thead>
<tr>
<th></th>
<th>1 January 2019</th>
<th>31 December 2018</th>
<th>1 January 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>CU 8,514</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Lease liability</td>
<td>CU 9,114</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Adjustment to equity</td>
<td>(CU 600)</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Date</th>
<th>Full Retrospective</th>
<th>Modified #1 (ROU = Lease Liability)</th>
<th>Modified #2 (ROU restated retrospectively)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROU Asset – 31 December 2017</td>
<td>CU 9,419</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Lease Liability – 31 December 2017</td>
<td>CU 9,584</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>ROU Asset – 31 December 2018</td>
<td>CU 8,242</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Lease Liability – 31 December 2018</td>
<td>CU 8,650</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>ROU Asset – 1 January 2019</td>
<td>CU 8,242</td>
<td>CU 9,114</td>
<td>CU 8,514</td>
</tr>
<tr>
<td>Lease Liability – 1 January 2019</td>
<td>CU 8,650</td>
<td>CU 9,114</td>
<td>CU 9,114</td>
</tr>
</tbody>
</table>

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

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

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

*BDO comment*

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

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

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

<table>
<thead>
<tr>
<th>Standard</th>
<th>Effect of Amendments</th>
</tr>
</thead>
</table>
| IFRS 1 *First-time Adoption of IFRS* | – The option to use fair value as deemed cost in an entity's opening statement of financial position upon adopting IFRS has been extended to right-of-use assets.  
– If an entity elects not to apply IFRS 3 retrospectively to past business combinations upon adopting IFRS, it still must recognise the acquiree's lease contracts based on the requirements of IFRS 16.  
– An entity may elect to follow several simplifications for initial measurement:  
  – Measure the lease liability as the present value of remaining lease payments discounted using the lessee's incremental borrowing rate at the date of transition;  
  – Measure the right-of-use asset at either:  
    (1) The amount that would have been recognised had IFRS 16 applied on commencement of the lease except that it is discounted using the lessee's incremental borrowing rate at the date of transition; or  
    (2) An amount equal to the lease liability.  
– A right-of-use asset for a lease that meets the definition of investment property and is measured using the fair value model would be measured at fair value on adoption of IFRS.  
– A lessee may also use several other simplifications on a lease-by-lease basis:  
  – Use a single discount rate for a reasonably similar portfolio of leases;  
  – Elect not to measure leases that terminate within 12 months of the date of transition to IFRS;  
  – Elect not to measure leases where the underlying asset is of low-value;  
  – Exclude initial direct costs from the measurement of right-of-use assets;  
  – Elect to use hindsight (e.g. in determining the lease term if options exist). |
<p>| IFRS 3 <em>Business Combinations</em> | – Clarifies that an acquirer recognises and measures an acquiree's lease liabilities and right-of-use assets using the principles in IFRS 16, and not at fair value. |
| IFRS 7 <em>Financial Instruments: Disclosures</em> | – Extends the exemption from disclosure of fair values of financial instruments to lease liabilities. |</p>
<table>
<thead>
<tr>
<th>Standard</th>
<th>Effect of Amendments</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 9 Financial Instruments</td>
<td>- Permits lessors to measure finance lease receivables using lifetime expected credit losses instead of the three-staged approach otherwise required by IFRS 9 for impairment of financial assets.</td>
</tr>
<tr>
<td>IFRS 13 Fair Value Measurement</td>
<td>- Extends the scope exemption for the measurement and disclosure requirements to leasing transactions within the scope of IFRS 16.</td>
</tr>
<tr>
<td>IAS 21 The Effects of Changes in Foreign Exchange Rates</td>
<td>- Clarifies that lease liabilities are monetary liabilities and right-of-use assets are non-monetary assets.</td>
</tr>
<tr>
<td>IAS 40 Investment Property</td>
<td>- Significant editorial amendments to reflect that leased right-of-use assets may meet the definition of investment property.</td>
</tr>
</tbody>
</table>
## APPENDIX A
### ILLUSTRATIVE DISCLOSURE EXAMPLE

<table>
<thead>
<tr>
<th>Reference</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 1:117(b)</td>
<td>Disclose accounting policies that are relevant to understanding the financial statements (i.e. those for material items).</td>
</tr>
<tr>
<td>IFRS 16:60</td>
<td>If a lessee accounts for short-term leases or leases of low-value assets applying Paragraph 6 of IFRS 16 (i.e. by not recognising a lease liability and corresponding right-of-use asset), disclose that fact.</td>
</tr>
</tbody>
</table>
IFRS 16 Leases is effective for periods beginning on or after 1 January 2019. This appendix provides example illustrative disclosures that A Layout (International) Group might have provided had it adopted IFRS 16 two years earlier than required on a fully retrospective basis. For entities using the modified retrospective method on adoption of IFRS 16 (i.e. not restating comparatives), then the disclosure requirements of IAS 17 Leases apply to those comparatives. However, IFRS 16 also includes disclosure requirements in the year of adoption when the modified retrospective method is used, an example of which is also at the end of this appendix.

Accounting Policy

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

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

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

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

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

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

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

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

When The Group revises its estimate of the term of any lease (because, for example, it re-assesses the probability of a lessee extension or termination option being exercised), it adjusts the carrying amount of the lease liability to reflect the payments to make over the revised term, which are discounted at the same discount rate that applied on lease commencement. The carrying value of lease liabilities is similarly revised when the variable element of future lease payments dependent on a rate or index is revised. In both cases an equivalent adjustment is made to the carrying value of the right-of-use asset, with the revised carrying amount being amortised over the remaining (revised) lease term.
<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFRS 16:52</td>
<td>Disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.</td>
</tr>
</tbody>
</table>
| IAS 16:59 | Disclose qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in Paragraph 51 (as described in Paragraph B48). This additional information may include, but is not limited to, information that helps users of financial statements to assess:  
(a) The nature of the lessee's leasing activities;  
(b) Future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:  
(i) Variable lease payments (as described in Paragraph B49);  
(ii) Extension options and termination options;  
(iii) Residual value guarantees;  
(iv) Leases not yet commenced to which the lessee is committed;  
(c) Restrictions or covenants imposed by leases; and  
(d) Sale-and-leaseback transactions. |
| IAS 16:B48 | For the purposes of IFRS 16:59:  
(a) Only disclose information that is expected to be relevant to users of financial statements. This is likely to be the case if it helps those users to understand:  
(i) The flexibility provided by leases. Leases may provide flexibility if, for example, a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions;  
(ii) Restrictions imposed by leases. Leases may impose restrictions, for example, by requiring the lessee to maintain particular financial ratios;  
(iii) Sensitivity of reported information to key variables. Reported information may be sensitive to, for example, future variable lease payments;  
(iv) Exposure to other risks arising from leases;  
(v) Deviations from industry practice. Such deviations may include, for example, unusual or unique lease terms and conditions that affect a lessee's lease portfolio;  
(b) Whether information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements. |
| IFRS 16:B49 | Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in Paragraph 51 could include information that helps users of financial statements to assess, for example:  
(a) The lessee's reasons for using variable lease payments and the prevalence of those payments;  
(b) The relative magnitude of variable lease payments to fixed payments;  
(c) Key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and  
(d) Other operational and financial effects of variable lease payments. |
When The Group renegotiates the contractual terms of a lease with the lessor, the accounting depends on the nature of the modification:

- If the renegotiation results in one or more additional assets being leased for an amount commensurate with the standalone price for the additional rights-of-use obtained, the modification is accounted for as a separate lease in accordance with the above policy;

- In all other cases where the renegotiated increases the scope of the lease (whether that is an extension to the lease term, or one or more additional assets being leased), the lease liability is remeasured using the discount rate applicable on the modification date, with the right-of-use asset being adjusted by the same amount;

- If the renegotiation results in a decrease in the scope of the lease, both the carrying amount of the lease liability and right-of-use asset are reduced by the same proportion to reflect the partial or full termination of the lease with any difference recognised in profit or loss. The lease liability is then further adjusted to ensure its carrying amount reflects the amount of the renegotiated payments over the renegotiated term, with the modified lease payments discounted at the rate applicable on the modification date. The right-of-use asset is adjusted by the same amount.

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

**Nature of leasing activities (in the capacity as lessee)**

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

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

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

<table>
<thead>
<tr>
<th>31 December 2017</th>
<th>Lease Contracts</th>
<th>Fixed payments</th>
<th>Variable payments</th>
<th>Sensitivity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>%</td>
<td>%</td>
<td>CU'000</td>
</tr>
<tr>
<td>Property leases with payments linked to inflation</td>
<td>3</td>
<td>-</td>
<td>25%</td>
<td>±495</td>
</tr>
<tr>
<td>Property leases with periodic uplifts to market rentals</td>
<td>6</td>
<td>-</td>
<td>40%</td>
<td>±791</td>
</tr>
<tr>
<td>Property leases with fixed payments</td>
<td>2</td>
<td>15%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Leases of plant and equipment</td>
<td>46</td>
<td>17%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Vehicle leases</td>
<td>3</td>
<td>3%</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>60</strong></td>
<td><strong>35%</strong></td>
<td><strong>65%</strong></td>
<td><strong>±1,286</strong></td>
</tr>
</tbody>
</table>
Entities that apply the modified retrospective approach for adopting IFRS 16 (i.e. do not restate comparatives retrospectively) are not required to provide comparatives on an IFRS 16 basis in the period of adoption. Instead, comparative disclosures would be made in accordance with IAS 18 and IAS 10 as appropriate.

### IFRS 16:B50

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

(a) The lessee’s reasons for using extension options or termination options and the prevalence of those options;
(b) The relative magnitude of optional lease payments to lease payments;
(c) The prevalence of the exercise of options that were not included in the measurement of lease liabilities; and
(d) Other operational and financial effects of those options.

### IFRS 16:B51

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

(a) The lessee’s reasons for providing residual value guarantees and the prevalence of those guarantees;
(b) The magnitude of a lessee’s exposure to residual value risk;
(c) The nature of underlying assets for which those guarantees are provided; and
(d) Other operational and financial effects of those guarantees.

### IFRS 16:B52

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

(a) The lessee’s reasons for sale-and-leaseback transactions and the prevalence of those transactions;
(b) Key terms and conditions of individual sale-and-leaseback transactions;
(c) Payments not included in the measurement of lease liabilities; and
(d) The cash flow effect of sale-and-leaseback transactions in the reporting period.

*BDO Comment*  
*A Layout (International) Group has not entered into any sale-and-leaseback transactions and so addition information required by IFRS 16:52 has not been given.*
The Group sometimes negotiates break clauses in its property leases. On a case-by-case basis, The Group will consider whether the absence of a break clause would expose The Group to excessive risk. Typically factors considered in deciding to negotiate a break clause include:

- The length of the lease term;
- The economic stability of the environment in which the property is located; and
- Whether the location represents a new area of operations for The Group.

At both 31 December 2017 and 2016 the carrying amounts of lease liabilities are not reduced by the amount of payments that would be avoided from exercising break clauses because on both dates it was considered reasonably certain that The Group would not exercise its right to exercise any right to break the lease. Of the total lease payments of CU 7,327,000 (2016 – CU 6,878,000) is potentially avoidable were The Group to exercise break clauses at the earliest opportunity.

One of the contracts that The Group has with a distributor conveys to The Group the right to use certain vehicles for the contractual term. The Group agreed to the inclusion of a residual value guarantee in favour of the supplier. This because the pricing of the contract does not result in The Group having to pay full fair value of the vehicles, but as those vehicles are under The Group’s control The Group is able to use the vehicles to such an extent that they would have little value to the supplier at the end of the lease term. The alternative would have been to restrict the mileage use of the vehicles over the lease term, but The Group did not wish to be operationally restricted on its ability to use the vehicles. The amount of the residual value guarantee, which has been included in the carrying value of lease liabilities, is CU 1,475,000 (2016 – CU 1,475,000).

<table>
<thead>
<tr>
<th>Lease Contracts</th>
<th>Fixed payments</th>
<th>Variable payments</th>
<th>Sensitivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>%</td>
<td>%</td>
<td>CU’000</td>
</tr>
<tr>
<td>Property leases with payments linked to inflation</td>
<td>3</td>
<td>-</td>
<td>25%</td>
</tr>
<tr>
<td>Property leases with payments linked to market rentals</td>
<td>5</td>
<td>-</td>
<td>38%</td>
</tr>
<tr>
<td>Property leases with fixed payments</td>
<td>2</td>
<td>20%</td>
<td>-</td>
</tr>
<tr>
<td>Leases of plant and equipment</td>
<td>42</td>
<td>15%</td>
<td>-</td>
</tr>
<tr>
<td>Vehicle leases</td>
<td>3</td>
<td>2%</td>
<td>-</td>
</tr>
<tr>
<td><strong>55</strong></td>
<td><strong>37%</strong></td>
<td><strong>63%</strong></td>
<td><strong>±926</strong></td>
</tr>
</tbody>
</table>
IFRS 16:52 Disclose information about its leases for which the entity is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross-reference in the single note or separate section about leases.

IFRS 16:53 Disclose the following amounts for the reporting period:
(a) Depreciation charge for right-of-use assets by class of underlying asset;
(b) Interest expense on lease liabilities;
(c) The expense relating to short-term leases accounted for applying Paragraph 6. This expense need not include the expense relating to leases with a lease term of one month or less;
(d) The expense relating to leases of low-value assets accounted for applying Paragraph 6. This expense shall not include the expense relating to short-term leases of low-value assets included in Paragraph 53(c);
(e) The expense relating to variable lease payments not included in the measurement of lease liabilities;
(f) Income from subleasing right-of-use assets;
(g) Total cash outflow for leases;
(h) Additions to right-of-use assets;
(i) Gains or losses arising from sale-and-leaseback transactions; and
(j) The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

IFRS 16:54 Provide the disclosures specified in Paragraph 53 in a tabular format, unless another format is more appropriate. The amounts disclosed shall include costs that a lessee has included in the carrying amount of another asset during the reporting period.

BDO Comment A Layout (international) Group has disclosed amounts in compliance with IFRS 16:53 (a), (b), (g), (h) and (j) in a reconciliation of both right-of-use assets and lease liabilities rather than as standalone amounts in a table. This is considered more appropriate as it facilitates a clearer picture of what has given rise to changes in the carrying amounts of these items as well as enables ease of cross reference to other parts of the financial statements. For example, the amounts in the reconciliation for right-of-use assets would equal the amount included on the face of the statement of financial position (if that presentation approach is chosen under IFRS 16), and the interest expense on lease liabilities would tie into that component of total finance cost included in Note 9. Providing the disclosures in the form of a reconciliation results in voluntary disclosures being given for the effect of lease modifications, adjustments from revising variable lease payments linked to an index or rate, and foreign exchange movements on the carrying amounts for both right-of-use assets and lease liabilities.

IFRS 16:56 If right-of-use assets meet the definition of investment property, apply the disclosure requirements in IAS 40. In that case, a lessee is not required to provide the disclosures in Paragraph 53(a), (f), (h) or (j) for those right-of-use assets.
### Right-of-Use Assets

<table>
<thead>
<tr>
<th></th>
<th>Land and buildings</th>
<th>Plant, machinery and motor vehicles</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU’000</td>
<td>CU’000</td>
<td>CU’000</td>
</tr>
<tr>
<td><strong>At 1 January 2017</strong></td>
<td>24,395</td>
<td>5,200</td>
<td>29,595</td>
</tr>
<tr>
<td>Additions</td>
<td>3,279</td>
<td>1,246</td>
<td>4,525</td>
</tr>
<tr>
<td>Amortisation</td>
<td>(1,626)</td>
<td>(1,200)</td>
<td>(2,826)</td>
</tr>
<tr>
<td>Modification to lease terms</td>
<td>1,500</td>
<td>(85)</td>
<td>1,415</td>
</tr>
<tr>
<td>Variable lease payment adjustment</td>
<td>3,772</td>
<td>-</td>
<td>3,772</td>
</tr>
<tr>
<td>Foreign exchange Movements</td>
<td>328</td>
<td>75</td>
<td>403</td>
</tr>
<tr>
<td><strong>At 31 December 2017</strong></td>
<td><strong>31,648</strong></td>
<td><strong>5,236</strong></td>
<td><strong>36,884</strong></td>
</tr>
</tbody>
</table>

|                      | CU’000             | CU’000                              | CU’000|
| **At 1 January 2016**| 26,340            | 5,670                               | 32,010|
| Additions            | -                 | 650                                 | 650   |
| Amortisation         | (2,196)           | (1,085)                             | (3,281)|
| Variable lease payment adjustment | 411            | -                                   | 411   |
| Foreign exchange Movements | (160)        | (35)                                | (195) |
| **At 31 December 2016** | **24,395** | **5,200**                          | **29,595** |

### Lease liabilities

<table>
<thead>
<tr>
<th></th>
<th>Land and buildings</th>
<th>Plant, machinery and motor vehicles</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU’000</td>
<td>CU’000</td>
<td>CU’000</td>
</tr>
<tr>
<td><strong>At 1 January 2017</strong></td>
<td>28,700</td>
<td>6,500</td>
<td>35,200</td>
</tr>
<tr>
<td>Additions</td>
<td>3,349</td>
<td>1,246</td>
<td>4,595</td>
</tr>
<tr>
<td>Interest expense</td>
<td>2,010</td>
<td>390</td>
<td>2,400</td>
</tr>
<tr>
<td>Effect of modification to lease terms</td>
<td>1,500</td>
<td>(101)</td>
<td>1,399</td>
</tr>
<tr>
<td>Variable lease payment adjustment</td>
<td>3,772</td>
<td>-</td>
<td>3,772</td>
</tr>
<tr>
<td>Lease payments</td>
<td>(3,500)</td>
<td>(850)</td>
<td>(4,350)</td>
</tr>
<tr>
<td>Foreign exchange movements</td>
<td>287</td>
<td>85</td>
<td>372</td>
</tr>
<tr>
<td><strong>At 31 December 2017</strong></td>
<td><strong>36,118</strong></td>
<td><strong>7,270</strong></td>
<td><strong>43,388</strong></td>
</tr>
</tbody>
</table>

|                      | CU’000             | CU’000                              | CU’000|
| **At 1 January 2016**| 29,890            | 6,065                               | 35,955|
| Additions            | -                 | 650                                 | 650   |
| Interest expense     | 1,794             | 650                                 | 2,444 |
| Variable lease payment adjustment | 411            | -                                   | 411   |
| Lease payments       | (3,200)           | (825)                               | (4,025)|
| Foreign exchange movements | (195)       | (40)                                | (235) |
| **At 31 December 2016** | **28,700** | **6,500**                          | **35,200** |
**BDO Comment**  
A Layout (international) Group has disclosed amounts in compliance with IFRS 16:53 (c), (d), (e), (f) and (i) in a table as required by Paragraph 54. Income from sub-leases is already disclosed in Note 5 and, in accordance with IFRS 16:53, the disclosure is not duplicated here. A Layout (International) Group has not entered into any sale-and-leaseback transactions in the current or prior period.

**IFRS 16:55**  
Disclose the amount of its lease commitments for short-term leases accounted for applying Paragraph 6 if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed applying Paragraph 53(c) relates.

**IFRS 16:57**  
If a lessee measures right-of-use assets at revalued amounts applying IAS 16, disclose the information required by Paragraph 77 of IAS 16 for those right-of-use assets.

**BDO Comment**  
A Layout does not measure right-of-use assets at revalued amounts and hence these disclosures are not applicable.

**IFRS 16:58**  
Disclose a maturity analysis of lease liabilities applying Paragraphs 39 and B11 of IFRS 7 Financial Instruments: Disclosures separately from the maturity analyses of other financial liabilities.

**BDO Comment**  
The same format has been used for disclosing the maturity of other liabilities in Note 3 as the disclosure might more appropriately be included within the same table in Note 3 rather than separately within the separate lease note.
<table>
<thead>
<tr>
<th>Description</th>
<th>2017 CU'000</th>
<th>2016 CU'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term lease expense</td>
<td>1,313</td>
<td>1,200</td>
</tr>
<tr>
<td>Low value lease expense</td>
<td>600</td>
<td>850</td>
</tr>
<tr>
<td>Expense relating to variable lease payments not included in the measurement of lease liabilities</td>
<td>65</td>
<td>24</td>
</tr>
<tr>
<td>Aggregate undiscounted commitments for short-term leases</td>
<td>410</td>
<td>865</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>At 31 December 2017</th>
<th>Up to 3 months CU'000</th>
<th>Between 3 and 12 months CU'000</th>
<th>Between 1 and 2 year(s) CU'000</th>
<th>Between 2 and 5 years CU'000</th>
<th>Over 5 years CU'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liabilities</td>
<td>1,428</td>
<td>4,285</td>
<td>4,031</td>
<td>12,092</td>
<td>30,041</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>At 31 December 2016</th>
<th>Up to 3 months CU'000</th>
<th>Between 3 and 12 months CU'000</th>
<th>Between 1 and 2 year(s) CU'000</th>
<th>Between 2 and 5 years CU'000</th>
<th>Over 5 years CU'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liabilities</td>
<td>1,139</td>
<td>3,416</td>
<td>3,266</td>
<td>9,797</td>
<td>24,000</td>
</tr>
</tbody>
</table>
Disclosures applicable only to entities not applying IFRS 16 on a fully retrospective basis

IFRS 16:C13  If a lessee elects to apply this Standard using the modified retrospective approach, disclose:  
(a) The weighted average lessee’s incremental borrowing rate applied to lease liabilities recognised in  
the statement of financial position at the date of initial application; and  
(b) An explanation of any difference between:  
   (i) Operating lease commitments disclosed applying IAS 17 at the end of the annual reporting  
       period immediately preceding the date of initial application, discounted using the incremental  
       borrowing rate at the date of initial application; and  
   (ii) Lease liabilities recognised in the statement of financial position at the date of initial application.

BDO Comment  A Layout (International) Group has chosen to provide this explanation by presenting a numerical reconciliation.

IFRS 16:C14  If a lessee uses one or more of the specified practical expedients in Paragraph C10, it shall disclose that fact.
Disclosures applicable only to entities not applying IFRS 16 on a fully retrospective basis

The weighted average incremental borrowing rate applied to lease liabilities on 1 January 2017 was 6.24%.

The aggregate lease liability recognised in the statement of financial position at 1 January 2017 and The Group’s operating lease commitment at 31 December 2016 can be reconciled as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>CU’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating lease commitment at 31 December 2016</td>
<td>40,000</td>
</tr>
<tr>
<td>Effect of discounting those lease commitments at an annual rate of 6.24%</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Effect of estimating for the purposes of IFRS 16 that lease break clauses will not be exercised (i.e. present value of lease payments to be made after the break date)</td>
<td>7,400</td>
</tr>
<tr>
<td>Effect of electing to account for short-term and low value leases off balance sheet</td>
<td>(200)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>35,200</strong></td>
</tr>
</tbody>
</table>

In applying the modified retrospective approach, The Group has taken advantage of the following practical expedients [delete as appropriate]:

- A single discount rate has been applied to portfolios of leases with reasonably similar characteristics;
- Impairment losses on right-of-use assets as at 1 January 2017 have been measured by reference to the amount of any onerous lease provision recognised on 31 December 2016;
- Leases with a remaining term of twelve months or less from the date of application have been accounted for as short-term leases (i.e. not recognised on balance sheet) even though the initial term of the leases from lease commencement date may have been more than twelve months;
- Initial direct costs have not been included in the measurement of the right-of-use asset as at the date of initial application.

[Note: This relief is only relevant if the modified retrospective approach is applied by measuring the right-of-use asset by reference to the amount of lease payments from lease commencement date. It is not relevant if the entity applies the modified retrospective approach by reference to the measurement of the lease liability recognised on the date of initial application.]

- For the purposes of measuring the right-of-use asset hindsight has been used. Therefore, it has been measured based on prevailing estimates at the date of initial application and not retrospectively by making estimates and judgements (such as the term of leases) based on circumstances on or after the lease commencement date.

[Note: This relief is only relevant if the modified retrospective approach is applied by measuring the right-of-use asset by reference to the amount of lease payments from lease commencement date. It is not relevant if the entity applies the modified retrospective approach by reference to the measurement of the lease liability recognised on the date of initial application.]
Please note that the disclosures required by IFRS 13 must be tailored:

- Item-by-item;
- Technique-by-technique;
- Entity-by-entity.

The adjacent disclosures are purely for illustrative purposes only.
The following table sets out the valuation techniques used in the determination of fair values within Level 3 including the key unobservable inputs used and the relationship between unobservable inputs to fair value [IFRS 13.93(d)(h)(i)(ii)].

<table>
<thead>
<tr>
<th>Item and valuation approach</th>
<th>Key unobservable inputs</th>
<th>Relationship between unobservable inputs to fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unlisted equity securities</strong>&lt;br&gt;Fair value is determined by discounted cash flow.</td>
<td>– Weighted average cost of capital (X% to X%; weighted average X%)&lt;br&gt;– Long term revenue growth rate (X% to X%; weighted average X%)&lt;br&gt;– Long-term pre-tax operating margin (X% to X%; weighted average X%)&lt;br&gt;– Discount for lack of marketability (X% to X%; weighted average X%)&lt;br&gt;– Control premium (X% to X%; weighted average X%)</td>
<td>Increased long term revenue growth rate and long-term pre-tax operating margin by X% and lower weighted average cost of capital (-X%) would increase FV by $XX; lower long term revenue growth rate and long-term pre-tax operating margin (-X%) and higher weighted average cost of capital (X%) would decrease FV by SX.</td>
</tr>
<tr>
<td><strong>Investment property</strong>&lt;br&gt;Fair value is determined by applying the income approach based on the estimated rental value of the property. Discount rates, terminal yields, expected vacancy rates and rental growth rates are estimated by an external valuer or management based on comparable transactions and industry data.</td>
<td>– Discount rate (X% to X%; weighted average X%)&lt;br&gt;– Terminal yield (X% to X%; weighted average X%)&lt;br&gt;– Expected vacancy rate (X% to X%; weighted average X%)&lt;br&gt;– Rental growth rate (X% to X%; weighted average X%)</td>
<td>The higher the discount rate, terminal yield and expected vacancy rate the lower the fair value.&lt;br&gt;The higher the rental growth rate, the higher the fair value.</td>
</tr>
<tr>
<td><strong>Buildings</strong>&lt;br&gt;Fair value is determined by applying the income approach based on the estimated rental value of the property. Discount rates, terminal yields, expected vacancy rates and rental growth rates are estimated by an external valuer or management based on comparable transactions and industry data.</td>
<td>– Discount rate (X% to X%; weighted average X%)&lt;br&gt;– Terminal yield (X% to X%; weighted average X%)&lt;br&gt;– Expected vacancy rate (X% to X%; weighted average X%)&lt;br&gt;– Rental growth rate (X% to X%; weighted average X%)</td>
<td>The higher the discount rate, terminal yield and expected vacancy rate the lower the fair value.&lt;br&gt;The higher the rental growth rate, the higher the fair value.</td>
</tr>
</tbody>
</table>
BDO Comment

Please note that the disclosures required by IFRS 13 must be tailored:

- Item-by-item;
- Technique-by-technique;
- Entity-by-entity.

The adjacent disclosures are purely for illustrative purposes only.
The following table sets out the valuation technique used in determination of fair values within Level 2 including the key inputs used [IFRS 13.93(d)].

<table>
<thead>
<tr>
<th>Item</th>
<th>Valuation approach and inputs used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derivatives at FVTPL</td>
<td>The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.</td>
</tr>
<tr>
<td></td>
<td>The fair value of forward exchange contracts is determined based on the forward exchange rates as at reporting date.</td>
</tr>
<tr>
<td>Land</td>
<td>The fair values of land are derived using the sale comparison approach. Sale prices of comparable land in similar location are adjusted for differences in key attributes such as land size. The valuation model is based on price per square metre.</td>
</tr>
<tr>
<td>Land held for sale</td>
<td>The fair values of land are derived using the sale comparison approach. Sale prices of comparable land in similar location are adjusted for differences in key attributes such as land size. The valuation model is based on price per square metre.</td>
</tr>
</tbody>
</table>

The following table sets out the assets and liabilities for which fair values are disclosed in the notes.

<table>
<thead>
<tr>
<th>Item</th>
<th>Fair value</th>
<th>Valuation technique</th>
<th>Valuation technique</th>
<th>Significant unobservable inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables and payables</td>
<td>XX</td>
<td>Current</td>
<td>The carrying amount of short term (less than twelve months) trade receivable and payables approximates its fair values.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Non-current</td>
<td>The carrying amount of non-current trade receivables at floating interest rates approximates fair value. Fair values of non-current receivables are based on cash flows discounted using an estimated current lending rate of X% and loans to related parties and key management personnel X%.</td>
<td></td>
</tr>
<tr>
<td>Non-current borrowings</td>
<td>XX</td>
<td>Current</td>
<td>Discount rate X% for other receivables. Discount rate of X% for related parties and key management personnel.</td>
<td></td>
</tr>
</tbody>
</table>

The fair value of non-current borrowings in Note X, is estimated by discounting the future contractual cash flows at the current market interest rates.
## APPENDIX B – DEFINITIONS

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commencement date of the lease</strong>&lt;br&gt;(commencement date)</td>
<td>The date on which a <strong>lessor</strong> makes an <strong>underlying asset</strong> available for use by a <strong>lessee</strong>.</td>
</tr>
<tr>
<td><strong>Contract</strong></td>
<td>An agreement between two or more parties that creates enforceable rights and obligations.</td>
</tr>
<tr>
<td><strong>Economic life</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Effective date of the modification</strong></td>
<td>The date when both parties agree to a <strong>lease modification</strong>.</td>
</tr>
<tr>
<td><strong>Fair value</strong></td>
<td>For the purpose of applying the <strong>lessor</strong> accounting requirements in this Standard, the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.</td>
</tr>
<tr>
<td><strong>Finance lease</strong></td>
<td>A <strong>lease</strong> that transfers substantially all the risks and rewards incidental to ownership of an <strong>underlying asset</strong>.</td>
</tr>
<tr>
<td><strong>Fixed payments</strong></td>
<td>Payments made by a <strong>lessee</strong> to a <strong>lessor</strong> for the right to use an <strong>underlying asset</strong> during the <strong>lease term</strong>, excluding <strong>variable lease payments</strong>.</td>
</tr>
<tr>
<td><strong>Gross investment in the lease</strong></td>
<td>The sum of:&lt;br&gt;(a) The <strong>lease payments</strong> receivable by a <strong>lessor</strong> under a <strong>finance lease</strong>; and&lt;br&gt;(b) Any <strong>unguaranteed residual value</strong> accruing to the lessor.</td>
</tr>
<tr>
<td><strong>Inception date of the lease</strong>&lt;br&gt;(inception date)</td>
<td>The earlier of the date of a <strong>lease</strong> agreement and the date of commitment by the parties to the principal terms and conditions of the lease.</td>
</tr>
<tr>
<td><strong>Initial direct costs</strong></td>
<td>Incremental costs of obtaining a <strong>lease</strong> that would not have been incurred if the lease had not been obtained, except for such costs incurred by a manufacturer or dealer <strong>lessor</strong> in connection with a <strong>finance lease</strong>.</td>
</tr>
<tr>
<td><strong>Interest rate implicit in the lease</strong></td>
<td>The rate of interest that causes the present value of:&lt;br&gt;(a) The <strong>lease payments</strong>; and&lt;br&gt;(b) The <strong>unguaranteed residual value</strong> to equal the sum of:&lt;br&gt; (i) The <strong>fair value</strong> of the <strong>underlying asset</strong>; and&lt;br&gt; (ii) Any <strong>initial direct costs</strong> of the lessor.</td>
</tr>
<tr>
<td><strong>Lease</strong></td>
<td>A contract, or part of a contract, that conveys the right to use an asset (the <strong>underlying asset</strong>) for a period of time in exchange for consideration.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
</tr>
<tr>
<td>------</td>
<td>------------</td>
</tr>
<tr>
<td><strong>Lease incentives</strong></td>
<td>Payments made by a <em>lessor</em> to a <em>lessee</em> associated with a <em>lease</em>, or the reimbursement or assumption by a lessor of costs of a lessee.</td>
</tr>
<tr>
<td><strong>Lease modification</strong></td>
<td>A change in the scope of a <em>lease</em>, or the consideration for a lease, that was not part of the original terms and conditions of the lease (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual lease term).</td>
</tr>
</tbody>
</table>
| **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. |
<p>| <strong>Lessee</strong> | An entity that obtains the right to use an underlying asset for a period of time in exchange for consideration. |
| <strong>Lessee's incremental borrowing rate</strong> | The rate of interest that a <em>lessee</em> 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. |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessor</td>
<td>An entity that provides the right to use an underlying asset for a period of time in exchange for consideration.</td>
</tr>
<tr>
<td>Net investment in the lease</td>
<td>The gross investment in the lease discounted at the interest rate implicit in the lease.</td>
</tr>
<tr>
<td>Operating lease</td>
<td>A lease that does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset.</td>
</tr>
<tr>
<td>Optional lease payments</td>
<td>Payments to be made by a lessee to a lessor for the right to use an underlying asset during periods covered by an option to extend or terminate a lease that are not included in the lease term.</td>
</tr>
<tr>
<td>Period of use</td>
<td>The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time).</td>
</tr>
<tr>
<td>Residual value guarantee</td>
<td>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.</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>An asset that represents a lessee's right to use an underlying asset for the lease term.</td>
</tr>
<tr>
<td>Short-term lease</td>
<td>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.</td>
</tr>
<tr>
<td>Sublease</td>
<td>A transaction for which an underlying asset is re-leased by a lessee ('intermediate lessor') to a third party, and the lease ('head lease') between the head lessor and lessee remains in effect.</td>
</tr>
<tr>
<td>Underlying asset</td>
<td>An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.</td>
</tr>
</tbody>
</table>
| Unearned finance income                   | The difference between:  
                                           (a) The gross investment in the lease; and  
                                           (b) The net investment in the lease.  |
| Unguaranteed residual value               | That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor. |
| Useful life                               | The period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from an asset by an entity. |
| Variable lease payments | The portion of payments made by a **lessee** to a **lessor** for the right to use an **underlying asset** during the **lease term** that varies because of changes in facts or circumstances occurring after the **commencement date**, other than the passage of time. |
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