



Real estate leases

The landlord perspective

IFRS 16

December 2020

home.kpmg/ifrs



Contents

The landlord perspective	1	6	Lease payments	44
1 At a glance	2	6.1	Overview	44
2 Landlord accounting model	3	6.2	Fixed and in-substance fixed payments	44
2.1 Overview	3	6.3	Variable lease payments	45
2.2 Lease classification	4	6.4	Lease incentives	49
2.3 Operating lease model	6	7 Lease modifications	51	
2.4 Finance lease model	6	7.1	Overview	51
3 Lease definition	8	7.2	Modifications to operating leases – General considerations	53
3.1 Overview	8	7.3	Modifications to operating leases related to COVID-19	54
3.2 Applying the definition to real estate	8	7.4	Changes to operating leases that are not lease modifications	59
3.3 Typical real estate arrangements	11	7.5	Modifications to finance leases	61
4 Separating components of a contract	15	8 Sub-leases	65	
4.1 Overview	15	9 Sale-and-leaseback	67	
4.2 Typical lease components in real estate contracts	16	10 Investment property	72	
4.3 Common area maintenance and other non-lease components	22	Appendices		
4.4 Property taxes and insurance	23	I – IFRS 16 at a glance	75	
4.5 Allocation of consideration	25	II – Comparison with US GAAP	76	
4.6 Allocation of variable consideration	29	III – List of examples	80	
5 Lease term	32	Keeping in touch	82	
5.1 Overview of lease term	32	About this publication	84	
5.2 Non-cancellable period	33			
5.3 The enforceable period	33			
5.4 Reasonably certain threshold	37			
5.5 Renewable and cancellable leases – Application issues	39			
5.6 Changes in the lease term	41			

The landlord perspective

Landlords found much that was familiar in IFRS 16 *Leases*. Indeed, many breathed a sigh of relief when the International Accounting Standards Board (the Board) abandoned plans to overhaul landlord accounting. But some things have changed.

The new guidance on separating lease and maintenance income is clear and prescriptive – and impacts key reporting metrics for common real estate leases.

More complex arrangements such as sale-and-leaseback transactions and sub-leases face more radical accounting changes. Some sale-and-leaseback transactions that landlords previously presented as real estate transactions may now need to be accounted for as pure financings. Sub-leases of real estate are now more likely to be classified as finance leases.

More recently, the impact of the COVID-19 coronavirus pandemic has meant that landlords have been dealing with unprecedented levels of defaults, rent concessions and other lease modifications. IFRS 16's guidance on lease modifications has been vitally important, particularly given the Board's decision not to extend to landlords the practical expedient that it offered to tenants.

This publication covers key areas of IFRS 16 that are particularly relevant to landlords in real estate leases. Each section is illustrated with examples based on real-life terms and conditions.

A companion publication looking at real estate leases from the [tenant's perspective](#) is also available. More in-depth guidance on particularly complex areas of IFRS 16, such as lease modifications, lease term, discount rate and lease components, is available at home.kpmg/ifrs16.

Kimber Bascom
Brian O'Donovan
Marcio Rost

KPMG global IFRS leases leadership team
KPMG International Standards Group

1

At a glance

IFRS 16 preserves the basic landlord accounting model but introduces important changes in key areas.

Landlords continue to use the basic accounting model that applied under the old guidance. This means that landlords continue to classify real estate leases as either:

- **operating leases**, recognising the net consideration for the lease, including lease incentives, as income over the lease term, typically on a straight-line basis; or
- **finance leases**, presenting the right to receive future rentals as a receivable, and recognising interest income on that receivable.

As previously, the long useful life and high residual value of non-specialised real estate mean that many real estate leases will be operating leases. Finance lease accounting may be required in certain circumstances, typically for more structured transactions and/or leases of more specialised real estate.

Many of the changes introduced by IFRS 16 are detailed and subtle – but they can be very important.

- **Components** (see [Chapter 4](#)). The combined effect of IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 is that there is now detailed and prescriptive guidance on separating, measuring and presenting components such as maintenance income.
- **Lease term** (see [Chapter 5](#)). New guidance on lease term could impact the period over which operating lease incentives are recognised in profit or loss, particularly for renewable and cancellable leases.
- **Lease modifications** (see [Chapter 7](#)). IFRS 16 contains specific guidance on accounting for lease modifications, which is relatively simple to apply to a single modification to an operating lease but more challenging to apply to more complex combinations of modifications, or modifications of finance leases.
- **Rent concessions** (see [Chapter 7](#)). There is no practical expedient for landlords in accounting for rent concessions. Instead, they need to assess whether each rent concession is a lease modification.
- **Sub-leases** (see [Chapter 8](#)). New classification guidance means that more sub-leases are finance leases under IFRS 16 than previously, impacting the statement of financial position and the statement of profit or loss and other comprehensive income of intermediate lessors.
- **Sale-and-leaseback** (see [Chapter 9](#)). New guidance on ‘failed sales’ means that some sale-and-leaseback transactions are now accounted for as pure financing transactions by both landlords and tenants.
- **Investment property** (see [Chapter 10](#)). It is now mandatory rather than optional for landlords to apply IAS 40 *Investment Property* to account for leased investment property, requiring landlords to disclose fair value information for all leased investment property.

2

Landlord accounting model

Landlords continue to classify leases as finance or operating leases, and continue to classify many real estate leases as operating leases.

2.1

Overview

The lessor follows a dual accounting approach for lease accounting. The accounting is based on whether significant risks and rewards incidental to ownership of an underlying asset are transferred to the lessee, in which case the lease is classified as a finance lease. This is similar to the previous lease accounting requirements that applied to lessors.



What are the impacts of IFRS 16 on lessors?

Much of the guidance in IFRS 16 on lessor accounting is a 'carry forward' from IAS 17 *Leases* – literally a cut-and-paste. This reflects feedback from financial statement users and other stakeholders that lessor accounting was not 'broken'.

However, there are a number of changes in the details of lessor accounting. For example, lessors apply the new:

- definition of a lease (see [Chapter 3](#));
- guidance on separating components of a contract (see [Chapter 4](#));
- guidance on lease term (see [Chapter 5](#));
- guidance on lease modifications (see [Chapter 7](#));
- guidance on sub-lease (see [Chapter 8](#)); and
- guidance on sale-and-leaseback (see [Chapter 9](#)).

The same definition of 'lease term' applies to both lessees and lessors. IFRS 16 includes guidance on when extension options and termination options are taken into consideration when determining the lease term. Additional guidance has been issued about determining the lease term – an estimate that could significantly impact the overall lease accounting.

In addition, IFRS 16 includes specific guidance on separating the components of a contract and accounting for lease modifications by lessors.

The new guidance may significantly impact the accounting for sub-leases and sale-and-leaseback transactions.

2.2

IFRS 16.62–63

Lease classification

A lessor classifies a lease as either a finance lease or an operating lease, as follows:

- leases that transfer substantially all of the risks and rewards incidental to ownership of the underlying asset are finance leases; and
- all other leases are operating leases.

The lease classification test is essentially unchanged from IAS 17.

Generally, the presence of the following indicators, either individually or in combination, leads to a lease being classified as a finance lease:

- transfer of ownership to the lessee either during or at the end of the lease term;
- existence of a purchase option that is reasonably certain to be exercised;
- the lease term is for a major part of the economic life of the underlying asset;
- the present value of the lease payments amounts to substantially all of the fair value of the underlying asset at inception of the lease; and
- the underlying asset is specialised.

IFRS 16.66

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

IFRS 16.B54

However, if the contract includes terms and conditions to adjust the lease payments for particular changes occurring between the inception date and the commencement date, then, for the purpose of classifying the lease, the effect of any such changes is deemed to have taken place at the inception date.



What is the typical classification of real estate leases?

Typically, landlords classify leases of real estate as operating leases, because the underlying asset – the real estate – generally has a long useful life and significant residual value.

However, a lease of real estate may be classified as a finance lease. This may be the case, for instance, if the lease term is very long or the underlying property is of a specialised nature or for structured transactions. In addition, sub-leases of real estate are now more likely to be classified as finance leases – see [Chapter 8](#).



Are there special rules on the classification of leases of land?

No. The classification of a lease of land is assessed based on the general classification guidance. An important consideration is that land normally has an indefinite economic life. However, the fact that the lease term is normally shorter than the economic life of the land does not necessarily mean that a lease of land is always an operating lease; the other classification requirements are also considered.

IFRS 16.B55, BCZ241–BCZ244

For example, in a 99-year lease of land with fixed lease payments, the significant risks and rewards associated with the land are transferred to the tenant during the lease term, and on lease commencement the present value of the residual value of the land would be negligible. It follows that a long lease term may indicate that a lease of land is a finance lease.

There is no bright-line threshold for the lease term above which a lease of land would always be classified as a finance lease, and assessing classification can require the use of significant judgement in some cases.



Do changes between the inception and commencement dates impact lease classification?

IFRS 16.66–67, 70–71, 81, B54

Yes, in some cases. Generally, the classification of a lease is determined at inception of the lease and is not revised unless the lease agreement is modified. However, the classification is updated for certain changes between inception date and commencement date that are deemed to have taken place at the inception date.

A significant amount of time may pass between the inception date and the commencement date – e.g. when parties commit to leasing an underlying asset that has not yet been built. A lease contract may also include terms and conditions to adjust the lease payments for changes that occur between the inception date and the commencement date – e.g. a change in the lessor's cost of the underlying asset or a change in the lessor's cost of financing the lease.

In such cases, the calculation of the present value of lease payments used in determining the classification of the lease covers all lease payments made from the commencement of the lease term. However, if the lease payments are adjusted for contractual changes such as changes in the construction or acquisition cost of the underlying asset, general price levels or the lessor's costs of financing the lease between the inception and commencement dates, then the effect of these changes is deemed to have taken place at inception for the purpose of classifying the lease.

It appears that the lease payments for classification purposes should also be updated for changes between the inception and commencement dates in:

- the non-cancellable period of the lease;
- lease payments that depend on an index or a rate; and
- variable payments that become in-substance fixed.

We believe that these changes are akin to contractual changes between the inception and commencement dates, and therefore the effect of these changes should be deemed to have taken place at inception for the purpose of classifying the lease. Consequently, a lessor should also update the rate implicit in the lease and its estimate of the unguaranteed residual value for classification purposes for such contractual changes.

However, for measurement purposes it appears that a lessor should update the lease payments, the rate implicit in the lease and the unguaranteed residual value for all changes between inception and commencement date. This is because a lessor measures the net investment in a finance lease, and the amount of operating lease income to be recognised, at the commencement date.

2.3 Operating lease model

The lessor classifies a lease that is not a finance lease as an operating lease. It accounts for an operating lease as follows.

Statement of financial position:

- continue to present the underlying asset; and
- add any initial direct costs incurred in connection with obtaining the lease to the carrying amount of the underlying asset.

Statement of profit or loss:

- recognise lease income over the lease term, typically on a straight-line basis; and
- expense costs associated with the underlying asset (e.g. depreciation).

IFRS 16.81, 83

Generally, a lessor recognises lease income on a straight-line basis from the commencement date over the lease term. However, it may be possible for the lessor to recognise lease income using another systematic basis if that is more representative of the time pattern in which the benefit from the use of the underlying asset is diminished. The initial direct costs are recognised as an expense on the same basis as the lease income over the lease term.

IFRS 16.85, 9.2.1(b)(i)

A lessor applies IAS 36 *Impairment of Assets* to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified. In addition, the lessor applies the impairment and derecognition requirements of IFRS 9 *Financial Instruments* to operating lease receivables.

2.4 Finance lease model

A lessor accounts for a finance lease as follows.

Statement of financial position:

- derecognise the underlying asset; and
- recognise a finance lease receivable at an amount equal to the net investment in the lease.

Statement of profit or loss:

- recognise finance income on the net investment in the lease over the lease term, based on a pattern reflecting a constant rate of return on the net investment;
- recognise any reduction in the estimated unguaranteed residual value; and
- recognise any loss allowance on the finance lease receivable.

IFRS 16.67–69

A lessor initially measures a finance lease receivable at the present value of the future lease payments plus any unguaranteed residual value accruing to the lessor, discounted at the interest rate implicit in the lease. Initial direct costs are included in the measurement of the finance lease receivable, because the interest rate implicit in the lease takes initial direct costs incurred into consideration.

IFRS 16.A

The 'interest rate implicit in the lease' is the discount rate at which:

- the sum of the present value of (i) the lease payments and (ii) the unguaranteed residual value *equals*
- the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

For additional guidance, see our publication [Leases – Discount rates](#).

IFRS 16.77

A lessor applies the derecognition and impairment requirements of IFRS 9 to the net investment in the lease. A lessor regularly reviews estimated unguaranteed residual values used in computing the gross investment in the lease. If there is a reduction in the estimated unguaranteed residual value, then the lessor revises the income allocation over the lease term without changing the discount rate and immediately recognises any reduction in respect of amounts accrued. For a discussion on measuring the expected credit losses on lease receivables, see Chapter 7.8 in the 17th Edition 2020/21 of our publication [Insights into IFRS](#).

3

Lease definition

Identifying a lease of real estate is usually straightforward – but some scenarios will require judgement.

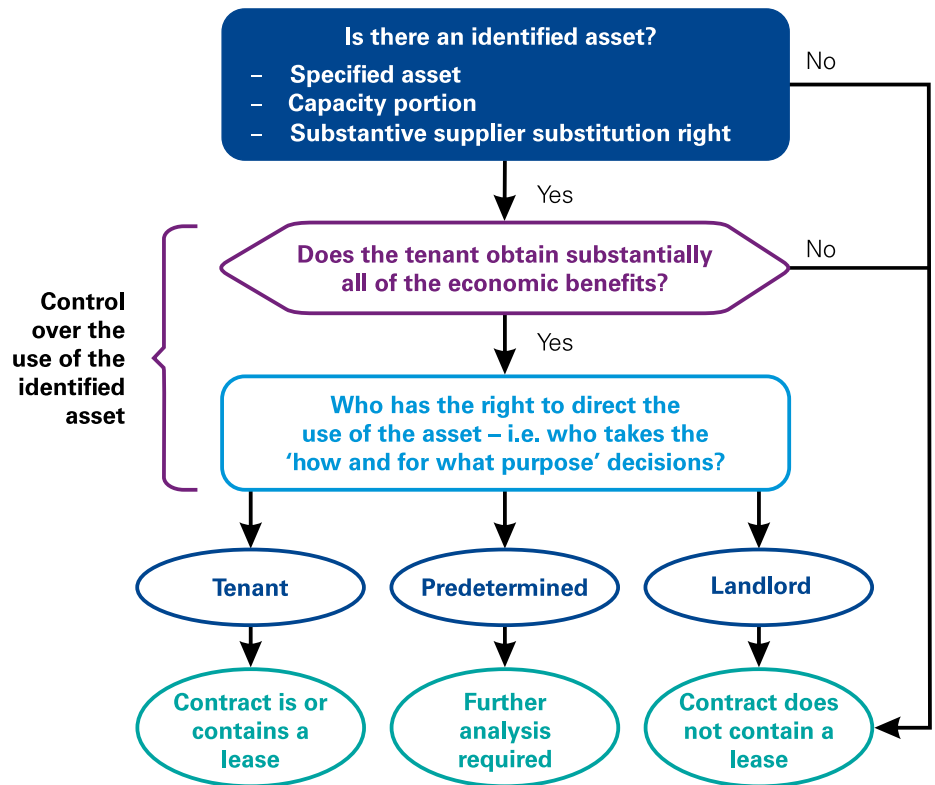
3.1

IFRS 16.A, B9

Overview

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

The key factors to consider when applying the lease definition are as follows.



3.2






Applying the definition to real estate

Types of properties common in real estate leases include:

- land and buildings;
- office space: e.g. a floor of a building;
- retail space;
- specified spots in a car park; and
- residential property.

When applying the lease definition to real estate arrangements, it will usually be clear whether the arrangement meets the lease definition criteria.

Key factors to consider when applying the lease definition are as follows.

	Consideration	Criteria usually met in real estate arrangements?
<i>IFRS 16.B13, BC111</i>	Specified asset	 Yes. Generally, the address or particular component of a property (e.g. numbered floors of a building or units in a shopping mall) is identified in the agreement.
<i>IFRS 16.B20</i>	Capacity portions	 Yes. Generally, a tenant has exclusive use of the leased property, or a defined portion of that property that is physically distinct (e.g. a floor of a building). In practice, this would be specified in the agreement.
<i>IFRS 16.B14–B19, BC112–BC115</i>	Substantive substitution rights	 No. Generally, there are not substantive substitution rights because a tenant physically occupies the leased property and may have invested in leasehold improvements that are not easy to dismantle and reassemble elsewhere.
<i>IFRS 16.B21–B23</i>	Tenant obtains substantially all of the economic benefits?	 Yes, if the tenant has exclusive use of the property. This can include directly using the property or sub-leasing it.
<i>IFRS 16.B24–B30</i>	Tenant has the right to direct the use of the asset?	 Yes. Generally, the tenant has the right to direct the use of the underlying property. For example, the tenant of an office building will usually have control over who they grant access to, the hours of operation and activities performed on the property. Although it is common for property leases to include conditions that define the scope of the tenant's right to use the property (e.g. a requirement to follow a particular operating practice or only to use the property for the agreed purpose), these are usually the landlord's protective rights and do not prevent the tenant from having the right to direct the use of the asset within that scope.

Consideration	Criteria usually met in real estate arrangements?
	However, in some cases the nature of the property may need to be considered.

IFRS 16.A

The ‘period of use’ is the total period of time that an asset is used to fulfil a contract with a lessee (including any non-consecutive periods of time). [Section 5.1](#) deals with determination of the lease term and landlord recognition of operating lease income when the period of use comprises non-consecutive periods.

IFRS 16.B14–B15

Even if an asset is specified in a contract, a lessee does not control the use of an identified asset if the lessor has a substantive right to substitute the asset for an alternative asset throughout the period of use.



Why is lease identification important for landlords?

Lease identification is an important issue for landlords because it impacts presentation and disclosures, and a number of measurement issues.

A landlord continues to be required to assess whether each lease is an operating lease or a finance lease. Although many real estate leases will continue to be classified as operating leases, it is possible that some structured leases will be classified as finance leases – see [Section 2.2](#). In addition, IFRS 16 includes a new approach to the classification of sub-leases, which may result in more sub-leases being classified as finance leases – see [Chapter 8](#).

A landlord is required to present and/or disclose operating lease income separately from other forms of income, including income that it earns by delivering services to tenants. This is discussed at more length in [Chapter 4](#) on components.

In addition, income recognition is governed by IFRS 16 (see [Sections 2.3–2.4](#)) and changes to the lease contract are accounted for in accordance with the specific guidance on lease modifications included in IFRS 16 (see [Chapter 7](#)).



Are there any recognition exemptions for lessors?

No. This is one of the differences between lessee and lessor accounting.

A lessee can elect *not* to apply the lease accounting model to:

- short-term leases: i.e. leases for which the lease term as determined under IFRS 16 is 12 months or less; and
- leases in which the underlying asset is of low value.

However, neither of these exemptions is available to lessors.

IFRS 16.5, BC94



What is the period of use if the landlord provides the right to use the property to the tenant for non-consecutive periods?

An arrangement to use an identified property would meet the definition of a lease if it contains intermittent periods during which the tenant does not have the right to control the use of the asset.

For example, Retailer V sells beachwear (swimwear, beach umbrellas, beach towels etc) and has the exclusive right to use a retail space for six months during spring and summer. The contract runs for 10 years. For the remaining six months of the year, the space is leased to a different retailer, which sells equipment for winter sports.

In this situation, the period of use is 60 months. This is because V can use the space for six months each year over the 10-year contract. The use of the same retail space by a different tenant in the remaining months of the year does not prevent the contract from being a lease (provided that the other aspects of the definition are met).

This means that companies cannot avoid lease accounting by including in the contract term periods during which the customer cannot make the decisions about how and for what purpose the asset is used and/or obtain substantially all of the economic benefits from use of the identified asset.

3.3

Typical real estate arrangements

The following examples show considerations for landlords when evaluating whether common real estate arrangements contain a lease.



Example 1 – Lease of office space

Landlord W leases two floors of an office building to Tenant M.

Under the contract, M has exclusive use of the floors and can fit out the premises as long as it does not make any structural changes to the building and it returns the property to W in its original condition at the end of the lease.

M has full control over who can access the floors, the hours of operation and what business its staff performs on the site (within legal limits).

In this scenario, there is a lease. This is because:

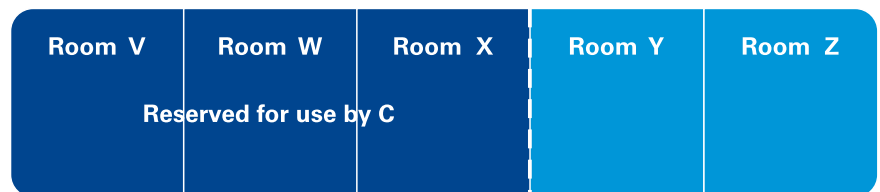
- the floors are explicitly specified in the contract and physically distinct from the rest of the building;
- M obtains all of the economic benefits because it has exclusive use;
- W does not have a substantive substitution right; and
- M directs the use of the office space.



Example 2 – Capacity portion is an identified asset

Supplier S enters into an arrangement with Customer C for the right to store its products in a specified storage warehouse. Within this storage warehouse, Rooms V, W and X are contractually allocated to C for its exclusive use. S has no substitution rights. Rooms V, W and X represent 60% of the warehouse's total storage capacity.

Warehouse



In this scenario, there is an identified asset even though C is using only 60% of the warehouse's total storage capacity. This is because:

- the rooms that comprise the 60% usage are explicitly specified in the contract;
- the rooms are physically distinct from the other storage locations within the warehouse; and
- S has no substitution rights.

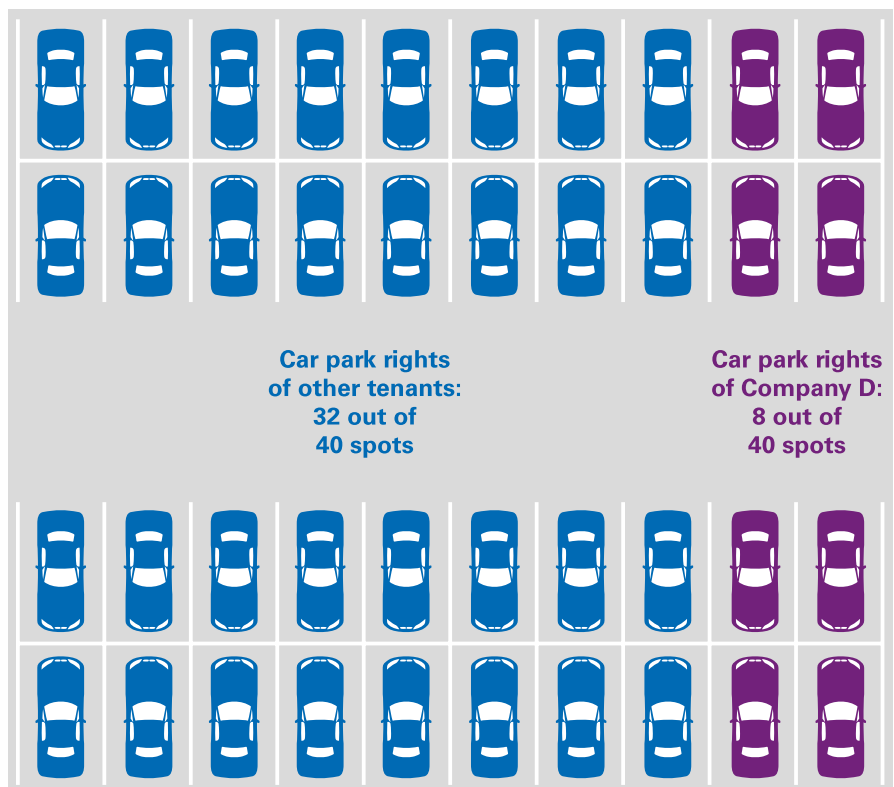
To complete its assessment of whether there is a lease, S then considers whether C has the right to direct the use of Rooms V, W and X, noting that C has the right to obtain substantially all of the economic benefits from their use by virtue of its exclusive use rights.



Example 3 – Capacity portion is not an identified asset

Landlord E leases one floor of an office building to Company D. In addition, D enters into an arrangement with E for the right to use the building's car park, where individual spaces are unmarked and not assigned to specific tenants. As part of the arrangement, D's staff can park a maximum of eight cars, anywhere in the car park, at any given time. The car park has a total of 40 spaces. E has similar arrangements in place with its other tenants in the building for the remaining car spaces.

Building car park



E applies the lease definition separately to the office space and the car park, because the assets are physically distinct and can be used by D independently of each other. E concludes that there is a lease of one floor of the office building.

However, in the case of the car park there is no identified asset. This is because D only has rights to 20% of the car park's capacity and that capacity portion neither is physically distinct from the remainder of the car park nor represents substantially all of the capacity of the car park. Therefore, D does not have the right to substantially all of the benefits of the entire car park.

By contrast, if E provided D with the right to use eight car spaces in the building's car park and the assigned spaces were clearly marked for D's use, then there would be an identified asset. This is because in this situation D has the right to use a portion of the car park that is physically distinct.

To complete its assessment of whether there is a lease, E then considers whether D obtains substantially all of the economic benefits from the use of the eight car spaces, and who has the right to direct their use.

IFRS 16.B16



Example 4 – Substitution right: Retail space

Company P owns a large shopping centre and enters into a contract with Customer M to lease a retail space for five years.

Under the contract, P can require M to relocate to another retail space within the shopping centre. P would need to pay the costs of relocation and provide M with another space of similar quality and size. P would only benefit economically from relocating M if a major new tenant were to move in, taking up a large amount of space at a sufficiently higher rate than the existing tenants.

In this case, P's substitution right is not substantive. Although the circumstance may arise, an assessment of whether a supplier's substitution right is substantive is made at inception of the contract based on the conditions at that time and does not include consideration of future events that are not likely to occur.



See our [Lease definition](#) publication for more guidance on identifying whether a contract contains a lease.

4

Separating components of a contract

Many real estate leases contain multiple lease and non-lease components, which landlords need to identify and account for separately.

4.1

IFRS 16.12, BC135(b)

IFRS 15.110, 114, 16.90

Overview

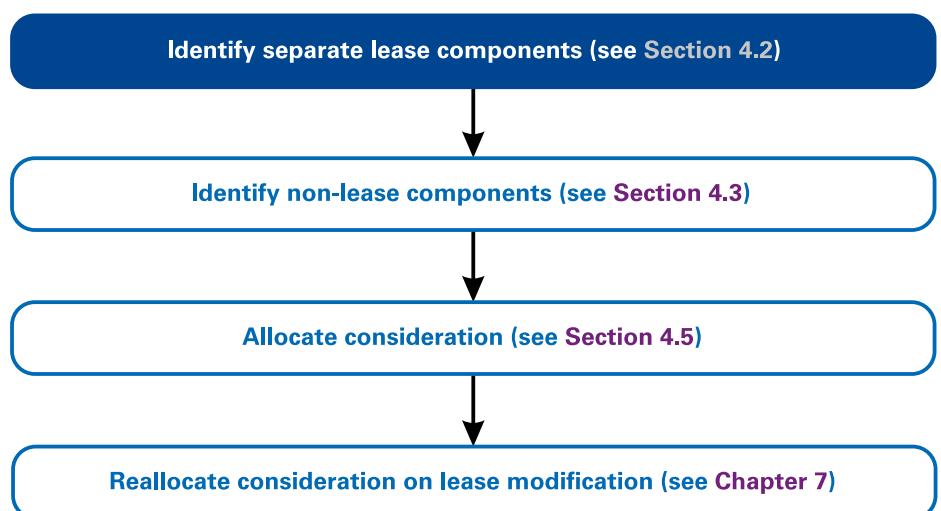
IFRS 16 requires a landlord to separate the lease and non-lease components of a contract.

In practice, real estate contracts may contain:

- one or more lease components: e.g. the right to use land and/or a building; and
- one or more non-lease components: e.g. maintenance, cleaning and provision of utilities.

For lessors, identifying components and allocating consideration will determine the split of lease income vs revenue from contracts with customers. These amounts are often presented and have to be disclosed separately. For example, a real estate company will need to distinguish lease income from revenue for other property-related services – e.g. common area maintenance (CAM).

The key steps in accounting for the components of a contract are as follows.



4.2

Typical lease components in real estate contracts

IFRS 16.B32–B33

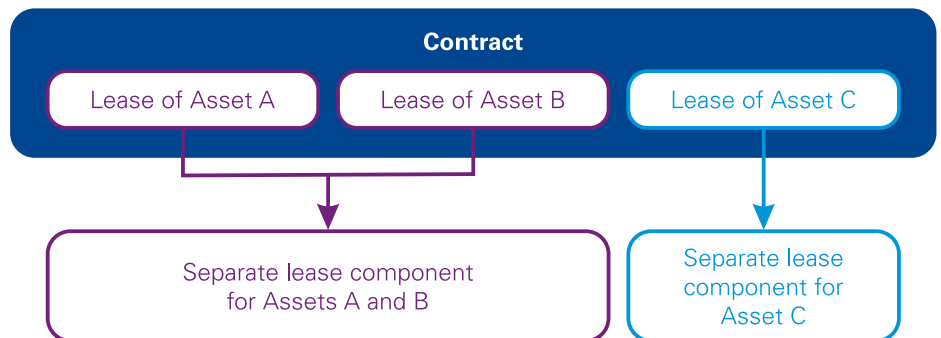
A landlord considers the right to use an asset as a separate lease component if it meets the following criteria:

- the tenant can benefit from using that underlying asset either on its own or together with other resources that are readily available; and
- the asset is neither highly dependent on nor highly inter-related with the other assets in the contract.

For example, there is a single lease component when a heating or air conditioning system is integrated in a building and cannot be removed and used in another building without incurring substantial costs.

However, when an office building is rented fully furnished, the office furniture is a distinct lease component if it is readily available and not integrated in the office building.

A contract with multiple leases may contain one or many separate lease components.



The following examples show common scenarios that landlords may encounter when identifying and accounting for components in a real estate contract.



Example 5 – Multiple lease components: Separation criteria met


IFRS 16.B32

Landlord X enters into a 15-year lease with Tenant T for five floors of a building. The floors are accessed via common lifts and stairs, but each floor has separate access controls. Each floor is equipped with necessary facilities (e.g. washrooms) to allow it to be used separately. T can sub-lease each floor without significant work.

X concludes that the right to use each individual floor is a separate lease component because:

- T can benefit from the use of an individual floor on its own; and
- the use of an individual floor is neither dependent on nor highly inter-related with the use of other floors in the building. T can control access to each individual floor separately. In addition, each floor can be sub-leased without significant work.

IFRS 16.B32


 **Example 6 – Multiple lease components: Land and building: Separation criteria not met**

Landlord Q leases a single-storey industrial building to Tenant T for 20 years. T has exclusive use of the property, which includes a driveway. In addition to the explicit lease of the building, there is an implied lease of the underlying land. Q concludes that there is a single lease component in the contract because:

- T cannot derive any benefit from using the land without the building; and
- the assets (i.e. building, driveway and land under the building) are highly dependent on each other.

However, if the lease contract included an adjacent piece of land that T could use for a number of different purposes (e.g. to redevelop into a garden or a car park), then there might be multiple lease components – one component for the building and underlying land, and another component for the adjacent land. Additional considerations may apply to Q’s assessment of whether to account for the land and building elements separately – see 4.2.1.

IFRS 16.BC134


 **Is identifying lease components under IFRS 16 consistent with identifying a performance obligation under IFRS 15?**

Yes, in broad terms. Identifying separate lease components in a lease contract under IFRS 16 is similar to identifying performance obligations in a revenue contract under IFRS 15.

Under both standards, a company determines whether a customer or a lessee is contracting for a number of separate deliverables or for one deliverable. Therefore, IFRS 16’s requirements on separating lease components are similar to those in IFRS 15 on the identification of performance obligations.

However, IFRS 16 does not simply cross-refer to IFRS 15. Instead, it contains guidance that is similar to, but less extensive than, that in IFRS 15. In addition, IFRS 16 contains additional guidance for lessors on separation of the land and building elements of a lease of real estate (see 4.2.1). In theory, different conclusions could be reached under IFRS 15 and IFRS 16.

IFRS 15.27(a), 28

 **How should a landlord interpret ‘readily available’ when applying the first criterion?**

The first criterion for considering whether a right-of-use asset is a separate lease component is based on the ‘capable of being distinct’ test in IFRS 15. This test is based on the characteristics of the underlying asset itself.

Resources are considered ‘readily available’ when they are sold or leased separately by the lessor or other suppliers, or when the lessee has already obtained them from the lessor or from other transactions or events.

IFRS 16.B32(a)

The fact that the lessor or other companies regularly lease an asset separately indicates that a customer can benefit from the lease of that asset on its own or with other readily available resources.

For a discussion of identifying a performance obligation in a revenue contract, see Section 2.1 of our [IFRS 15 handbook – Revenue](#).



How should a landlord interpret 'highly dependent or highly inter-related' when applying the second criterion?

IFRS 15.27(b), 29(c)

The second criterion for considering whether a right-of-use asset is a separate lease component is based on part of the 'distinct in the context of the contract' test in IFRS 15.

IFRS 16.B32(b)

An asset might be highly dependent on, or highly inter-related with, the other assets if the lessee could not lease the asset without significantly affecting its rights to use other assets in the contract.

IFRS 15 provides an example of when two or more goods or services are 'significantly affected by each other'. It states that this would be the case when the company would not be able to fulfil its promise to the customer by transferring each of the goods or services independently – i.e. the fulfilment of each promise depends on the other.

For a discussion of identifying a performance obligation in IFRS 15, see Section 2.1 of our [IFRS 15 handbook – Revenue](#).

4.2.1

Additional considerations for leases of land and buildings for landlords

IFRS 16.12, B53

The general guidance on identifying separate lease components is the same for lessees and lessors. A lessor then classifies each lease component as a finance or an operating lease, based on the extent to which the lease transfers the risks and rewards incidental to ownership of the underlying assets (this guidance is not relevant to lessees).

IFRS 16.B55, 57

When a lease includes both land and building elements, the lessor assesses the classification of each element separately, unless the value of the land at inception of the lease is deemed immaterial. In this case, the lessor may treat the land and building as a single unit to classify it as either a finance or an operating lease, applying the criteria in IFRS 16.

If separating the land element would have no effect on the lease classification, then the lessor does not need to separate it because the accounting impact would be insignificant. However, if the land and building elements are classified differently – e.g. operating lease for the land and finance lease for the building – then the lessor accounts for the two elements separately.

IFRS 16.B56

When accounting for the land and building separately, the lessor allocates lease payments between the two elements in proportion to the relative fair values of the leasehold interests in the land and building elements at the lease inception date. This is different from the general allocation requirements.

IFRS 16.B56

If the lease payments cannot be allocated reliably between the two elements, then the entire lease is classified as a finance lease, unless both elements are clearly operating leases.

IFRS 16.61–63, B32, B55



Example 7A – Classification of land and building: No separation

Landlord Q leases a single-storey industrial building to Tenant T for five years. T has exclusive use of the property, which includes a driveway. In addition to the explicit lease of the building, there is an implied lease of the underlying land. T and Q conclude that there is only one separate lease component in the contract because:

- T cannot derive any benefit from using the land without the building; and
- the assets (i.e. building, driveway and land under the building) are highly dependent on each other.

However, Q is required to assess the classification of the land and building elements separately. Q concludes that both land and building elements are clearly operating leases. This is because Q does not transfer substantially all of the risks and rewards incidental to ownership of either the land or building. Therefore, separating the land and building elements would have no effect on lease classification and would be insignificant from an accounting perspective. Q classifies the entire lease as an operating lease.

IFRS 16.61–63, B32, B55–B56



Example 7B – Classification of land and building: Separation required

Modifying Example 7A, Landlord Q leases the building to Tenant T for 30 years. The remaining economic life of the building at lease inception is expected to be 30 years. T and Q again conclude that there is only one separate lease component in the contract because:

- T cannot derive any benefit from using the land without the building; and
- the assets (i.e. building, driveway and land under the building) are highly dependent on each other.

However, Q is required to assess the classification of the land and building elements separately. Q concludes that:

- the land element is classified as an operating lease; but
- the building element is classified as a finance lease, because the lease term is for the major part of the economic life of the building.

Therefore, Q accounts for the land and building elements separately. To do this, Q allocates the lease payments between the land and building elements in proportion to the relative fair value of their respective leasehold interests.

IFRS 16.B55, BC58

**Why does IFRS 16 include additional guidance on separating land and building leases for landlords?**

This guidance is brought forward from IAS 17 to minimise changes to landlord accounting. However, it is inconsistent with the general guidance on separating components in a number of respects. For example, it requires separate lease classification of land and building elements even when they would be a single lease component. In addition, it requires lease payments to be allocated based on the relative fair values of the leasehold interests, rather than using the principles in IFRS 15 that landlords are required to apply in other cases.

IFRS 16.BCZ250

**How small does the relative value of the land element need to be in relation to the total value of the lease to avoid separation?**

The test here is whether the value of the land element at inception of the lease is deemed immaterial. There is no bright-line test – e.g. no specific percentage threshold.

Generally, materiality as a concept is applied at the level of the financial statements. However, this test – which is brought forward from IAS 17 – typically considers the significance of the land element in relation to the lease, not the financial statements as a whole.

IFRS 16.B56, BCZ245–BCZ247

**Why does the landlord allocate the lease payments between the land and building components based on the relative fair values of the respective leasehold interests?**

An allocation based on the relative fair values of the land and building elements – rather than based on the relative fair values of the respective leasehold interests in the land and building elements – is not generally appropriate because the land often has an indefinite economic life and is likely to maintain its value beyond the lease term. Therefore, the landlord would not normally need compensation for ‘using up’ the land. In contrast, the future economic benefits of a building are likely to be ‘used up’ to some extent over the lease term (which is reflected via depreciation).

Therefore, when allocating the lease payments between the land and the building elements, it is reasonable to assume that the lease payments relating to the:

- *building element (depreciable asset)* are set at a level that enables the landlord not only to make a return on its initial investment, but also to recover the part of the value of the building ‘used up’ over the lease term; and
- *land element (non-depreciable asset)* (assuming a residual value that equals its value at inception of the lease) are set at a level that enables the landlord to make only a return on the initial investment.

IFRS 16.B32, B55–B57



How does the guidance on classification apply when a lease contract contains both land and building elements that are highly interdependent and highly inter-related?

When a lease contract contains both land and building elements, a landlord considers the specific guidance described above, notwithstanding the fact that the land and building might be highly interdependent and highly inter-related.

As mentioned above, if a lease of a building (or space in a multi-tenant property) includes a land element, then it is accounted for separately by the landlord unless it is deemed to be immaterial or separation would have no effect on the lease classification. Consequently, in such a lease the landlord determines:

- whether the tenant obtains a right to use the land on which the building is located; and if so
- whether the accounting for that right of use is immaterial or the classification for both components would differ.

Determining whether a lease of a building (or space in a multi-tenant property) includes a right to use the underlying land includes determining:

- whether the land represents an identified asset; and if so
- whether the tenant has the right to control its use.

The evaluation will depend on property law in the relevant jurisdiction. However, it will often differ for leases of single-tenant properties and leases of space in multi-tenant properties. Although leases of single-tenant properties will generally include a lease of the underlying land, leases of space in multi-tenant properties often will not.

IFRS 16.B9, B55



Does a landlord of a multi-tenant building separate land and building lease elements?

Generally, no. When a landlord owns a high-rise apartment building and leases apartments to individual tenants, the landlord first needs to determine whether there is a lease of the underlying land. If there is not, then the landlord does not need to evaluate the separation criteria.

In this case, the entire underlying land is an identified asset. Each tenant has only shared use of the land – i.e. no tenant has a right of use over a physically distinct portion of the underlying land.

This is similar to the conclusion under IFRS 15 that in a sale of an apartment in a multi-tenant building, the promise to transfer the apartment and the related land can be a single performance obligation.

In contrast, a lease component may exist for the land if the tenant is leasing substantially all of the building. In this case, the entire underlying land is likely to be a single, identified asset and the tenant may have the right to control its use. If that is the case, then the landlord is required to account for it as a separate lease component unless it is immaterial or both components (i.e. the land and the building leases) would have the same classification.

4.3

Common area maintenance and other non-lease components

IFRS 16.12

A lease contract often includes non-lease components. For example, a lease of a building often includes provision of CAM and similar services. A lessor always accounts for non-lease components separately from the lease components.

IFRS 16.B33

Only activities or costs that transfer a good or service to the lessee are identified as separate non-lease components. Examples of separate non-lease components in real estate contracts include repairs or maintenance, cleaning, landscaping, security services and management services.

IFRS 16.Ex12



Are CAM services a non-lease component?

Yes. It is common in a real estate lease for the landlord to provide CAM services – e.g. cleaning services, common area repairs or maintenance of the building.

It appears that CAM services are generally a separate non-lease component (or components) because they transfer a service to a tenant that is separate from the right to use the underlying asset. Therefore, they are accounted for separately from the lease components, under other applicable standards.



Are CAM services a single non-lease component or do they include multiple non-lease components?

A landlord assesses the goods and services promised in a contract and determines whether the series of goods and services is a single performance obligation based on the guidance in IFRS 15.

CAM may include various activities. However, to the extent that they are performed over time and a single measure of progress applies, there will be no material difference between accounting for them separately or as a single non-lease component.

However, the provision of utilities – e.g. heating, electricity and water – is distinct from CAM and is generally a separate non-lease component because it does not relate to the maintenance of the common areas. The performance of non-routine maintenance will typically be a separate performance obligation and have a different measure of progress, and therefore will be accounted for separately.

Facts and circumstances will need to be considered when assessing what activities are part of the CAM and what services need to be accounted for separately.

4.4

IFRS 16.B33

Property taxes and insurance

Amounts payable for activities and costs that do not transfer a good or service to the tenant do not give rise to a separate component. They are part of the total consideration that the landlord allocates to the lease and non-lease components identified in the contract. Common examples of activities or costs of the landlord included in real estate contracts that do not transfer a good or service to the tenant include administrative costs to initiate the lease and the tenant's payments for administrative tasks, insurance costs and property taxes.

Real estate is often subject to property taxes, calculated as a tax 'rate' multiplied by an assessed value of the property.

Depending on the jurisdiction, the legal obligation to pay the property tax is either levied on the property owner or on the occupier. This distinction is important in determining how to account for taxes levied on leased properties.

The identity of the party who makes the cash payment to the tax authority is less relevant.

Who has the statutory obligation to pay property tax?	
Landlord	Tenant
<p>When the landlord has a statutory obligation to pay the property taxes, the landlord accounts for the property taxes as levies under IFRIC 21 <i>Levies</i>.</p> <p>It appears that if the owner has the statutory obligation to pay the property taxes, but the lease agreement requires it to be reimbursed, or paid, by the tenant, then the landlord should account for the reimbursement of property taxes by the tenant as part of the total consideration that is allocated to the separately identified components of the contract.</p> <p>If property taxes are determined as a percentage of an 'assessed value' of the property, then reimbursements thereof are typically variable payments that <i>do not</i> depend on an index or rate – see 6.3.1.</p>	<p>It appears that if the statutory obligation for the payment of property taxes lies with the tenant, then the tenant should account for the property taxes under IFRIC 21.</p>

IFRS 16.A, 28, B33

IFRS 16.B33

**Example 8 – Property taxes reimbursed by the occupier**

Landlord L enters into a five-year lease for an apartment with Tenant B. The lease payments are 100,000 per year. The contract includes additional maintenance costs of 4,000 per year.

In this jurisdiction, property taxes are levied on property owners, with the annual tax calculated as 0.2% of the assessed value of the property. The tax authority determines the assessed value at irregular intervals. That value of the property for tax purposes is currently 5 million.

Under the lease agreement, B is contractually obliged to reimburse the landlord for property taxes.

To determine how to account for the property taxes, L considers the following.

- Annual lease payments of 100,000 are fixed.
- The non-lease component for maintenance services of 4,000 is also fixed.
- Property taxes are levied on the owner and reimbursed by B.
- Payment of property taxes does not transfer a distinct good or service to B and therefore it is not a separate component.
- The property taxes are variable payments that do not depend on an index or rate, because neither the tax rate (i.e. 0.2%) nor the assessed property value as determined by the tax authority (i.e. 5 million) typically represents an index or rate (see 6.3.1).

Accordingly, L allocates the variable property tax payments from B (e.g. 10,000, calculated as 0.2% of 5 million in Year 1) to the lease and non-lease components identified in the contract.

Because L has a statutory obligation to pay the property taxes, it accounts for the property taxes as levies under IFRIC 21.

**What if the landlord and tenant are jointly liable for property tax?**

In some jurisdictions, the landlord and tenant may be 'jointly liable' for the property taxes – i.e. both parties are equally liable to pay the *full amount*.

This may be the case if:

- joint liability is specified by law; or
- liability is initially placed on the landlord but, in the event of non-payment, there are legal mechanisms in place that allow the tax authority to demand payment from the tenant.

When both parties are jointly liable, we believe that the landlord and tenant should account for the property taxes in the same way as they would if they were solely liable for them.

**If a tenant reimburses a landlord's general insurance costs, then is this a non-lease component?**

Generally, no. In practice, a landlord may obtain an insurance policy to cover damage to the underlying asset and a tenant reimburses the landlord's insurance costs during the lease term. The payment could be identified separately and determined based on the landlord's actual costs, or included in a fixed, gross payment to the landlord.

Under either payment mechanism, the insurance does not represent a service provided by the landlord to the tenant because it serves to protect and benefit the landlord, not the tenant, and therefore it is not a separate component. The payment is included in the consideration of the contract, which is allocated to the components.

4.5

IFRS 16.17, 15.76, 81–86

IFRS 15.76–77

IFRS 15.78–79, BC268

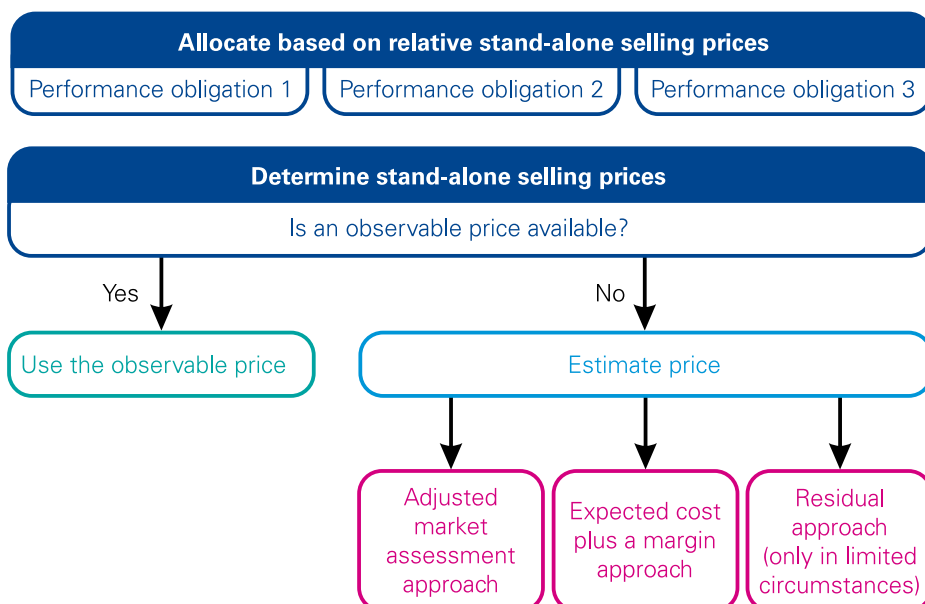
Allocation of consideration

Landlords allocate the consideration in the contract to the identified components using the allocation guidance in IFRS 15. Under that standard, consideration is allocated on a relative stand-alone selling price basis. However, when specified criteria are met a discount or variable consideration is allocated to one or more, but not all, of the performance obligations in the contract.

Stand-alone selling price is determined at inception of the contract and is the price at which a company would sell a promised good or service separately to a customer. It is best evidenced by the observable price of the same good or service when the company (lessor) sells (or leases) that good or service separately. A contractually stated price is not presumed to be a stand-alone selling price.

A lessor considers all information that is reasonably available when estimating a stand-alone selling price – e.g. market conditions, company-specific factors and information about the customer or class of customers. It also maximises the use of observable inputs and applies consistent methods to estimate the stand-alone selling price of other goods or services with similar characteristics. IFRS 15 does not preclude or prescribe any particular method for estimating the stand-alone selling price for a good or service when observable prices are not available, but describes the estimation methods listed in the following flowchart as possible approaches.

IFRS 15.79



A practical issue arises if the contract contains a renewal option covering the lease and non-lease components, because the lessor may determine that the contract period under IFRS 15 differs from the lease term under IFRS 16. The lease term as determined under IFRS 16 includes optional renewal periods over which the lessee is reasonably certain to extend, whereas the contract term under IFRS 15 includes periods during which the parties have presently enforceable rights and obligations. In these cases, it appears that a company should allocate the consideration to each component based on the lease term as determined under IFRS 16 (see [Example 9](#)).

Reallocation of the consideration is required on a lease modification (see [Chapter 7](#)). See our [Lease components](#) publication for more guidance on lessor estimation of stand-alone selling prices and allocation of consideration.



Example 9 – Landlord allocation to lease and non-lease components based on the lease term

Landlord R leases a property to Tenant T under an operating lease. Under the arrangement, R is also required to provide maintenance services for the building throughout the entire lease term.

The original contract term is five years, with a renewal option that would apply to both the lease and the maintenance for another two years. Annual payments, including maintenance, are determined at 160 for the initial five years. For the extension period, annual payments including maintenance are reduced to 150. Therefore, if the contract runs for five years then the total consideration will be 800, whereas if the contract runs for seven years then the total consideration will be 1,100.

The stand-alone selling price of the lease without maintenance is estimated at 120 per year, and the stand-alone selling price for the maintenance is 50 per year.

At the commencement date, R and T conclude that the lease term is seven years, because it is reasonably certain that T will exercise the renewal option.

If the contract were wholly accounted for under IFRS 15, then the contract term would be five years because this is the period for which the two parties are contractually committed.

We believe that R should allocate the consideration to the lease component and maintenance services based on the lease term as determined under IFRS 16 – i.e. seven years. Therefore, R allocates the total consideration based on seven years (1,100) to the lease and non-lease components as follows.

	Stand-alone selling price	%	Allocation
Building lease	120 x 7 = 840	70.59%	776
Maintenance	50 x 7 = 350	29.41%	324
	1,190		1,100

IFRS 16.17, BC135–BC136



Can a lessor elect to combine lease and non-lease components?

No – a lessor always accounts for lease and non-lease components separately.

As a practical expedient, a lessee can elect to combine lease and associated non-lease components, and account for the combined component as a lease component. However, there is no equivalent practical expedient for lessors.

The Board believes that lessors will generally have the information required to allocate consideration between lease and non-lease components. It therefore considers that a practical expedient similar to that offered to lessees is not necessary for lessors.

IFRS 16.14



How does a landlord estimate the stand-alone selling prices of lease and non-lease components?

The stand-alone selling price is a price that the landlord would charge a tenant for that component or a similar component. The estimation of a stand-alone selling price would reflect the economic return that a landlord would require for each separate component.

For example, a stand-alone selling price for a lease component would reflect compensation for the cost of the leased asset and administrative tasks, taxes and insurance that landlords would reasonably incur.

For non-lease components – e.g. cleaning services – the price would include compensation for the actual costs, an appropriate profit margin and compensation for certain administrative tasks.

**Should the stand-alone selling price of CAM include a profit margin, even if the landlord provides CAM at a loss?**

Yes. The stand-alone selling price is the price at which a company would sell a promised good or service separately to a customer. CAM is a service that would not generally result in a loss.

IFRS 16.14, 15.77–78

**How is an observable stand-alone price for a tenant different from an observable stand-alone selling price for a landlord?**

For the *tenant*, observable stand-alone prices include those charged not only by the landlord but also by other suppliers for the same or a similar component – e.g. the price charged for the lease of a similar property or for similar services.

For the *landlord*, the definition of observable stand-alone selling price is more specific. Taken from IFRS 15, an observable stand-alone selling price is the price for which the company sells that good or service separately in similar circumstances and to similar customers.

However, applying a market assessment approach under IFRS 15 might include referring to prices from the landlord's competitors for similar goods or services (and adjusting those prices as necessary to reflect the landlord's costs and margins) as an acceptable technique for estimating the stand-alone selling price. Therefore, although the landlord might use similar information to the tenant, its stand-alone selling price of a component may be considered 'estimated', whereas the tenant's stand-alone price may be considered 'observable'.

IFRS 16.90, 15.110, 114, B87–B89

**Does the landlord need to allocate consideration when the allocation does not have an impact on income recognition?**

Yes, the landlord allocates the consideration to each of the lease and non-lease components, even if there is no impact on the profile of income recognised. This is necessary for presentation and disclosure purposes – i.e. IFRS 16 requires a landlord to disclose lease income. IFRS 15 also requires a company to disclose revenue from contracts with customers separately.

For example, when the lease is classified as an operating lease and the non-lease component is a service satisfied over time using a time-based measure, the income from both the lease and non-lease components is recognised over the period, and the allocation does not impact the income recognised during the period. However, separate disclosure is required.

IFRS 16.13, 15.76



How does the allocation of the consideration to each component differ between landlords and tenants?

Landlords allocate the consideration in the contract to each separate lease and non-lease component, based on the relative stand-alone selling price of each component, under IFRS 15.

Tenants allocate the consideration in the contract on the basis of the relative stand-alone price of each separate lease component and the aggregate stand-alone price of the non-lease components.

One of the differences is that the non-lease components are aggregated by the tenant to determine the initial allocation of amounts allocated to the lease components.

The tenant then accounts for the non-lease components within a lease contract under other applicable standards, which may have different measurement or allocation requirements.

4.6

Allocation of variable consideration

If the contract contains more than one component and includes both variable and fixed payments, then a question arises about how to allocate the variable payments – e.g. whether the variable payments can be allocated to one or more, but not all, of the components. This could be more relevant when the payment is dependent on the performance of, or changes in, one of the components.

IFRS 15.84–86

Under IFRS 15, variable consideration is allocated entirely to one or more, but not all, performance obligations in the contract if the following criteria are met:

- the terms of a variable payment relate specifically to the company's efforts to satisfy the performance obligation; and
- allocating the variable amount of consideration entirely to the performance obligation is consistent with the allocation objective when considering all of the performance obligations and payment terms in the contract.

This guidance applies directly to lessors.



Example 10 – Landlord's allocation: Variable payments allocated between all components

Landlord D enters into a property lease for five years with Tenant L, including maintenance services. L's payments for five years comprise:

- total fixed payments of 500 for five years (i.e. 100 per year); and
- variable payments based on 2% of sales each year – estimated to be 100 for five years.

D concludes that the contract includes two components – the lease of a property, and the maintenance services (non-lease component). The stand-alone selling prices for both components are as follows:

- observable stand-alone selling price for the lease: 500; and
- estimated stand-alone selling price for the maintenance, based on the expected costs plus an appropriate margin: 200.

D allocates the total contract consideration of 600 (fixed payments of 500 and variable payments of 100) to the components as follows.

Component	Stand-alone selling price	%	Allocation of fixed consideration	Allocation of variable consideration
Lease of property	500	71.43%	357	72
Maintenance	200	28.57%	143	28
	700		500	100

In this case, the variable payments based on 2% of sales each year do not represent a stand-alone selling price for the maintenance. Therefore, both fixed and variable payments are allocated to the lease and non-lease components based on the relative stand-alone selling prices for the two components. Variable payments are recognised as income as the related sales occur for both lease and non-lease components.

In contrast, the variable lease payments would be allocated only to the non-lease component if they would represent the stand-alone selling price of the maintenance.



Example 11 – Allocation of property taxes

IFRS 16.B33

Landlord D enters into a five-year lease for an apartment with Tenant B. The lease payments are 100,000 per year. The contract includes additional maintenance costs of 4,000 per year.

Under the lease agreement, B is contractually obliged to reimburse D for property taxes levied on property owners. Annual property tax is determined at 0.2% of the assessed value.

Payment of property taxes does not transfer a good or service to B and is therefore not a component. Therefore, D includes the reimbursement of property taxes in the consideration that it allocates to the lease and non-lease components identified in the contract.

D concludes that:

- the stand-alone selling price of the lease is 100,000 per year plus reimbursement of property taxes; and
- the stand-alone selling price of the maintenance services is a fixed payment of 4,000 per year.

D allocates 100,000 and any reimbursement of property taxes to the lease component and 4,000 to the non-lease component.

IFRS 16.17, B33, 15.85



Can a landlord allocate costs that do not transfer a good or service to the tenant (e.g. property tax) entirely to the lease component?

It depends.

A real estate lease contract often requires the tenant to compensate the landlord for costs relating to the asset – e.g. property tax and insurance cost.

A question arises over whether the property tax and insurance cost can be allocated fully to the lease component when the contract also includes a non-lease component. IFRS 16 does not provide any exception to the allocation requirements, which means that the total fixed consideration (including property tax or insurance) is allocated to all identified components based on the relative stand-alone selling prices.

However, if all components in the contract are priced at stand-alone selling prices and the stand-alone selling price of the lease component includes property tax and insurance cost, then a relative stand-alone selling price basis allocation would result in these fixed payments being allocated entirely to the lease component (see [Example 11](#)).

On the other hand, property taxes and insurance may be variable. Under IFRS 15 variable consideration is allocated to only part of the contract if the terms of a variable payment relate directly to that part of the contract and allocating the variable payment to only that part of the contract is consistent with the allocation objective.



See our [Lease components](#) publication for more guidance on identifying lease and non-lease components and allocating consideration.

5

Lease term

New guidance on lease term could impact the period over which operating lease incentives are recognised in profit or loss, particularly for renewable and cancellable leases.

5.1

Overview of lease term

Determining the lease term is a critical estimate that is significant for the lessor. The lease term may affect the lease classification. For operating leases, it impacts the period over which lease incentives are recognised.

IFRS 16.18

The lease term is the non-cancellable period of the lease, together with:

- optional renewable periods if the lessee is reasonably certain to extend; and
- periods after an optional termination date if the lessee is reasonably certain not to terminate early.

To determine the lease term, a lessor first determines the length of the non-cancellable period of a lease and the period for which the contract is enforceable. It can then determine – between those two limits – the length of the lease term.

The lessor determines the lease term at the commencement date.

IFRS 16.A, B36

The lease term starts when the lessor makes the underlying asset available for use by the lessee. It includes any rent-free periods.

IFRS 16.A

When the 'period of use' includes any non-consecutive periods of time, the lease term is evaluated on the basis of the aggregate period of use – i.e. the sum of the non-consecutive periods.

IFRS 16.20

IFRS 16 provides guidance on when a lessee should reassess the lease term and remeasure the lease liability and right-of-use asset. However, it is silent for lessors.



How do landlords recognise operating lease income in a lease with non-consecutive periods of use?

In most commercial real estate leases, the benefit conveyed by the landlord to the tenant is the right to use the underlying property over the lease term. Therefore, operating lease income is recognised only during the periods the lessee has the right to use the underlying asset.

For example, a landlord leases a retail store space in a shopping mall to a tenant during the holiday season (15 October to 15 January) each year for three years. The lease is classified as an operating lease. In this case, the landlord recognises operating lease income, including variable lease income, only during the period from 15 October to 15 January each year. No lease income is recognised outside that time window.

See [Section 7.4](#) for a discussion on revenue recognition when the tenant's business is impacted by COVID-19 or government restrictions.

5.2

IFRS 16.B35, BC127–BC128

IFRS 16.B35, BC128

Non-cancellable period

The 'non-cancellable period' is the period during which the lessee cannot terminate the contract. The lease term cannot be shorter than the non-cancellable period.



If a lessor can cancel the lease, then does this affect the non-cancellable period?

No. If only the lessor has the right to terminate a lease, then the non-cancellable period of the lease includes the period covered by the lessor's option to terminate the lease. In this situation, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless and until the lessor decides to terminate the lease.

Any non-cancellable period or notice period in a lease would meet the definition of a contract and be included as part of the lease term.



How does a company determine the non-cancellable period when it is not fixed at lease commencement?

In some lease arrangements, at commencement the non-cancellable period is not fixed, and becomes fixed only after the lease commencement date. For example, a company may lease an asset to use on a specific project and the lease will state that the period of use is for the duration of the project, with no termination or renewal options.

The standard does not specifically address situations in which the non-cancellable period of the lease is not fixed at lease commencement.

In these cases, it appears that a company should estimate the non-cancellable period at the commencement date. Subsequently, the company should reassess the lease term when the non-cancellable period becomes fixed (see [Section 5.6](#)).

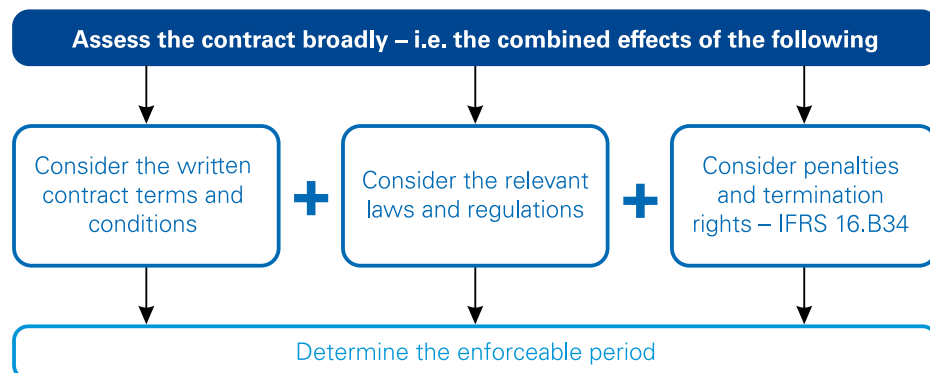
5.3

IFRS 16.2, B34, BC127

The enforceable period

To determine the lease term, a lessor determines the period for which the lease is enforceable using the definition of a contract. For this purpose, the contract comprises the written agreement and applicable laws and regulations in the local jurisdiction that stipulate and govern the parties' rights and obligations. Enforceability is a matter of law in the relevant jurisdiction and each contract will need to be evaluated based on its terms and conditions. This includes considering the guidance on enforceability in paragraph B34 of IFRS 16, including the role of penalties in assessing the enforceable period.

The key steps to determining the enforceable period are as follows.



IFRS 16.B34, BC127

Renewal and termination options are considered in the assessment of the lease term if they are enforceable. The 'enforceable period' is the period for which enforceable rights and obligations exist between the lessee and lessor. This is the maximum potential length of the lease term.

IFRS 16.B34, BC127, IU 11-19

Although the standard does not define 'enforceability', paragraph B34 describes when a contract is (and is no longer) enforceable under the standard. A lease is no longer enforceable beyond the point at which both the lessee and the lessor have the unilateral right to terminate the lease without permission from the other party, and with no more than an insignificant penalty.

Consequently, a contract is enforceable beyond the date on which it can be terminated if:

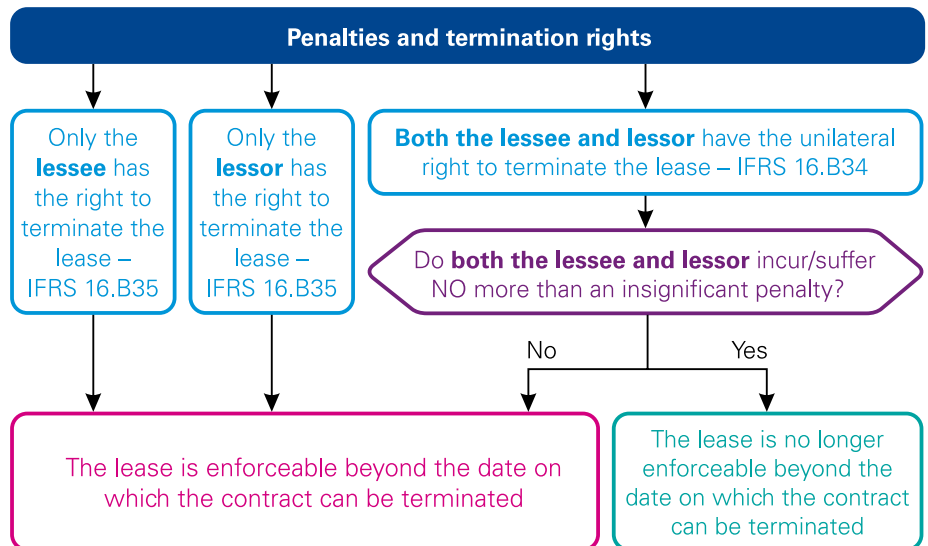
- both parties have the right to terminate but one party, or both, would incur a penalty on termination that is more than insignificant; or
- only one party has the right to terminate the lease without the permission of the other party.

IFRS 16.B34–B35, BC127, IU 11-19

A lease is no longer 'enforceable' when both the lessee and lessor have the right to terminate it without agreement from the other party with no more than an insignificant penalty. If only the lessee has the right to terminate a lease, then that right is considered to be an option available to the lessee to terminate the lease that a company considers when determining the lease term. Termination options held by the lessor only are not considered when determining the lease term because, in this situation, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless the lessor decides to terminate the lease.

The following summarises the impact of penalties and termination rights on the determination of the enforceable period.

IFRS 16.B34–B35, BC127–BC128, IU 11-19



IU 11-19

IFRS 16 does not define the term 'penalty'. Therefore, questions have arisen in practice about whether a company considers the broader economics of the contract or only contractual termination payments when applying paragraph B34 of the standard. The IFRS Interpretations Committee discussed this issue and noted that when determining the effect of termination rights under paragraph B34, a company considers the broader economics of the contract and not only contractual termination payments.

Example 12 – Impact of termination rights on enforceable period

Scenario 1

Tenant B leases a retail store from Landlord C under the following terms.

- The written contract is for a stated maximum term of five years.
- B and C each have the unilateral right to terminate the lease at the end of Year 2 with no more than an insignificant penalty.
- Relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

On lease commencement, the enforceable period is two years, regardless of how likely it is that both parties will decide to extend the lease beyond the end of Year 2.

Scenario 2

Tenant D leases a warehouse from Landlord E under the following terms.

- The written contract is for a stated maximum term of five years.
- After Year 1, D and E each have the unilateral right to terminate the lease, but a one-month notice period is required – i.e. the lease terminates one month

after the termination notice is given. Notice cannot be given before the end of Year 1. If the lease is terminated in this way, then neither party will suffer a more-than-insignificant penalty.

- Relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

On lease commencement, the enforceable period is 13 months.



Can a lease be enforceable even if some terms and conditions remain open to negotiation between the parties?

It depends. Judgement is required to establish whether the combined effect of the written contract and applicable laws and regulations establishes terms and conditions under which the lease will continue after the date on which both parties can terminate the lease. For example, laws and regulations may establish some but not all of the terms and conditions under which a lease may continue after the date on which both parties can terminate the lease.

This is often the case for laws relating to real estate leases under which the tenant has certain statutory rights to remain in occupation. In some cases, a tenant may also have an enforceable right to renew a lease but the rent in the renewal period will be subject to negotiation within broadly defined parameters. For example, the future rent may depend on market rent or changes in market property values, or be subject to independent arbitration if it is not mutually agreed.

Depending on the facts and circumstances, this type of arrangement may be considered akin to a renewal option subject to a market rent review. When this is the case, the future rents are variable payments that depend on an index or a rate. For more discussion on how to account for these variable payments, see [Section 6.3](#).



What is the enforceable period when both the lessee and lessor have termination rights, but only one party would suffer a more-than-insignificant penalty?

The existence of a penalty affects the enforceable period in different ways, depending on which party would suffer a more-than-insignificant penalty.

In the following scenarios, relevant laws and regulations that govern the transaction do not stipulate any other rights and obligations of the parties in addition to those in the written contract.

Scenario 1 – Both parties have termination rights without the permission of the other, but only the lessor’s right gives rise to a more-than-insignificant penalty

In this case, the enforceable period ends when the lessor’s exercise of its termination option no longer gives rise to a more-than-insignificant penalty – i.e. when both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty.

IFRS 16.B34–B35, BC127, IU 11-19

In contrast, if the lessor's termination right will no longer result in a more-than-insignificant penalty before the lessee's termination option becomes exercisable, then the lessor's termination option is disregarded for accounting purposes until the lessee's termination option becomes exercisable. When the lessee's termination option becomes exercisable, both the lessee and the lessor have the unilateral right to terminate the lease with no more than an insignificant penalty, and the enforceable period does not extend beyond that point.

Scenario 2 – Both parties have termination rights without the permission of the other, but only the lessee's right gives rise to a more-than-insignificant penalty

In this case, the enforceable period ends when the lessee's exercise of its termination option no longer gives rise to a more-than-insignificant penalty.



If the lessor has the right to refuse a request from the lessee to extend the lease, then does this prevent the contract from being enforceable?

Not necessarily.

Some leases include a clause stating that the lessee may request a renewal of the lease, subject to agreement with the lessor.

The IFRS Interpretations Committee discussed this issue and observed that paragraph B34 of IFRS 16 applies because, in effect, the lessee's option not to request a renewal and the lessor's option to refuse the lessee's request are substantially equivalent to termination options. When discussing this, the Committee noted that the description of 'enforceable' in paragraph B34 is not strictly a legal concept, and includes reference to whether exercise of a termination option carries 'no more than an insignificant penalty'.

Therefore, in these cases a company considers whether the lessee or lessor would suffer a more-than-insignificant penalty to determine the enforceable period.

IFRS 16.B34–B35, BC127, IU 11-19

5.4

IFRS 16.19, B35, BC157

Reasonably certain threshold

The concept of 'reasonably certain' is integral to determining the lease term. IFRS 16 does not define 'reasonably certain' and there is no bright line when making the assessment. A lessor considers all of the relevant facts and circumstances that create an economic incentive for the lessee to exercise a renewal option or not to exercise a termination option. Termination options held solely by landlords are considered in determining the lease term because, in this situation, the lessee has an unconditional obligation to pay for the right to use the asset for the period of the lease, unless the lessor decides to terminate the lease.

IFRS 16.B37, B40

The standard provides examples of factors to consider when assessing whether it is reasonably certain that a lessee would exercise an option to renew or not exercise an option to terminate the lease. The assessment of the degree of certainty is based on the facts and circumstances at commencement of the lease, rather than on the lessee's intentions. The following table provides examples of factors that create an economic incentive either to exercise or not to exercise options to renew or terminate early.

Examples of relevant facts and circumstances

Contractual/market

- Level of rentals in any secondary period compared with market rates
- Contingent payments
- Renewal and purchase options
- Costs relating to the termination of the lease and the signing of a new replacement lease
- Costs to return the underlying asset

Asset

- Nature of item (specialised)
- Location
- Availability of suitable alternatives
- Existence of significant leasehold improvements

IFRS 16.B37, IU 11-19



Does the existence of non-removable significant leasehold improvements impact the lease term?

Yes. The IFRS Interpretations Committee considered the interaction between determining the lease term and the useful life of non-removable significant leasehold improvements in the context of its discussion on cancellable and renewable leases.

When assessing whether it is reasonably certain to extend (or not to terminate) a lease, a company considers all relevant facts and circumstances that create an economic incentive for the lessee. This includes significant leasehold improvements (made or planned to be made) over the term of the contract that are expected to have significant economic benefit when the option to extend (or terminate) becomes exercisable.



Can lessees and lessors reach different conclusions about whether it is reasonably certain that an option will be exercised?

Yes. Lessees and lessors may reach different conclusions about whether the lessee is reasonably certain to exercise an option to renew or not to exercise an option to terminate early.

Lessees and lessors may also reach different conclusions about lease term because of information asymmetry and the judgemental nature of the assessment. The assessment of reasonably certain is based on judgements (e.g. about the importance of an underlying asset to the lessee) and estimates (e.g. of the fair value of the underlying asset in the future). In addition, lessors will not necessarily be familiar with the lessee's specific facts and circumstances, which may result in a different conclusion.

5.5 Renewable and cancellable leases – Application issues

IFRS 16.B34, IU 11-19

In some cases, a real estate lease contract may continue indefinitely until either party gives notice to terminate it (i.e. cancellable lease), or may renew indefinitely unless it is terminated by either party (i.e. renewable lease). For example, evergreen leases are leases that automatically renew on a day-to-day, week-to-week or month-to-month basis – i.e. they are cancellable leases. A question arises over how to determine the non-cancellable and enforceable period of such leases. The IFRS Interpretations Committee discussed this issue and noted that in doing so a company considers the broader economics of the contract and not only contractual termination payments. If only one party has the right to terminate the lease without permission from the other party and with no more than an insignificant penalty, then the contract is enforceable beyond the date on which the contract can be terminated by that party.

IFRS 16.19, B37–B40

If a company concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), then it applies the reasonably certain threshold assessment to determine the lease term.

A penalty may expire or, over a period of time, the effect of a penalty that is initially more than insignificant may become insignificant. For example, a termination penalty that is more than insignificant if it is incurred after only one year of a lease may be insignificant if it is incurred after four or five years when considered in the context of the broader economics of the contract.

IFRS 16.B34, IU 11-19



Example 13 – Termination rights: No more than an insignificant penalty

Tenant L enters into a five-year lease of a warehouse with Landlord M.

L designs and sells furniture internationally online and is testing use of the warehouse as a showroom. The cost to fit out the warehouse space to serve as a showroom is not significant. If the showroom is unsuccessful, then L does not plan to use the space as a warehouse.

Under the lease agreement, L and M each have the right to terminate the lease without a contractual penalty on each anniversary of the lease commencement date.

M considers the following when evaluating whether L will incur a more-than-insignificant penalty if it terminates the lease.

- The leasehold improvements are minor. Therefore, L's loss of economic value if the contract is terminated before the end of their economic life is not significant.
- The cost to dismantle the leasehold improvements is not significant.
- The cost to restore the warehouse to its original condition is not significant.
- The potential impact of early termination on customer relationships is low. L mostly interacts with its customers through its website, with a small number expected to visit the showroom in person.

M determines that it can easily find a new tenant considering that the demand for a warehouse is high for this location.

Enforceable period and lease term

Based on its analysis of the facts and circumstances, M determines that both parties can terminate the lease with no more than an insignificant penalty after one year. In this case, the enforceable period and the non-cancellable period of the lease are both one year. This is because – after both parties' termination rights become exercisable at the end of Year 1 – neither party has enforceable rights (i.e. L to use the warehouse or M to receive lease payments) or obligations (i.e. L to make lease payments or M to permit continued use of the warehouse).

Because both the enforceable period and the non-cancellable period of the lease are one year, the lease term is also one year.

IFRS 16.B34, IU 11-19



Example 14 – Renewable lease: More than an insignificant penalty

Tenant K leases a property from Landlord M under the following terms.

- The written contract is for five years and does not contain any extension or termination options.
- There is a local law that states that if K remains in occupation after the end of Year 5, then the terms of the original contract will continue to apply. However, it remains the case that both parties have the unilateral right to terminate the contract at the end of Year 5 (i.e. because the written contract that is for five years expires). This will be the case as long as K continues to make the lease payments and complies with its other obligations under the original contract with M.
- At the end of Year 5, because of the existence of significant economic incentives for each party to continue the lease for longer, K continues to occupy the property and make the lease payments. M accepts the payments and does not seek to evict K.

The significant economic incentives for M and K include the following.

- At the commencement date, K undertakes significant, non-removable leasehold improvements. If the contract were terminated before the end of their economic life, then this would create a significant loss of economic value (which would exceed the benefits that K might receive from terminating this lease with above-market payments; see last bullet below) that would remain significant in the future beyond the end of Year 5.
- The property location is ideal for K's business (i.e. for strategic relationships with suppliers and customers) and cannot be replaced in the near term.
- The lease rentals that K will continue to pay are above current market rates: i.e. M may be unable to lease the property to another tenant on equivalent terms.

Enforceable period

Under paragraph B34 of IFRS 16, M and K determine the enforceable period based on the broader economics of the contract. Considering the existence and significance of identified penalties, M and K determine at the commencement date that the enforceable period extends beyond five years and will extend as long as the termination penalties remain more than insignificant.

M and K apply their own judgement separately when making these assessments. They may need to consider additional factors in more complex arrangements.

IFRS 16.B37, B39



Example 15 – No stated terms

Landlord R leases a retail space to Tenant E. There is no stated duration for the lease in the contract. E can terminate the lease at the end of any month by leaving the premises. For each month that the asset is used by E, E will pay a fixed fee to R for the right to use that asset.

The non-cancellable period of the lease is one month because E could elect to leave the premises before the start of Month 2. If E has an ongoing need to use an asset similar to the underlying asset in its business, then the costs to E of terminating the lease (e.g. cost of non-removable leasehold improvements) and entering into a new lease (e.g. identifying another asset, entering into a different contract and moving costs) may provide a compelling economic reason for E to continue to use the space for a period that is longer than the non-cancellable period – i.e. the lease term may be more than one month.

IFRS 16.A, B37, B39



How does the assessment of reasonably certain differ for evergreen leases?

It does not differ. The lease term for evergreen leases is determined in the same manner as for all other leases, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options.

Determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgement. In general, the shorter the non-cancellable period of a lease, the more likely it is that a lessee is reasonably certain to exercise one or more renewal options. This is because, in many cases, it may be prohibitive to continually substitute leased assets.

For example, if a lessee leases a retail or warehouse space on a monthly basis and expects to need a substantially similar space for the next 18–24 months, then there may be a significant economic incentive (e.g. to avoid moving costs or customers having to find the lessee's new location) to renew the lease rather than continually move to a similar space throughout the period.

5.6

IFRS 16.21

Changes in the lease term

After the commencement date, the lessor reassesses the lease term when there is a change in the non-cancellable period of a lease. This requirement applies to both lessees and lessors. For example, the non-cancellable period of a lease will change if:

- the lessee exercises an option not previously included in the lessor's determination of the lease term;

- the lessee does not exercise an option previously included in the lessor’s determination of the lease term;
- an event occurs that contractually obliges the lessee to exercise an option not previously included by the lessor; or
- an event occurs that contractually prohibits the lessee from exercising an option previously included by the lessor.

For example, a lessor determined at commencement that the lease term was the non-cancellable period of five years, considering that it was not reasonably certain that the tenant would exercise a renewal option for an additional five years. However, if at the end of Year 4 the tenant exercises the renewal option for the additional five years by giving formal notification to the lessor, then the lessor revises the remaining lease term to six years to reflect the new non-cancellable period.

IFRS 16.21



Example 16 – Date of the change in the non-cancellable period

Tenant L leases a retail store from Landlord R. The lease is non-cancellable for 10 years and includes a five-year renewal option. L is required to notify R if it intends to exercise the renewal option by the end of Year 9. At lease commencement, R concludes that L is not reasonably certain to exercise the renewal option and, therefore, the lease term is 10 years.

The retail location performs better than expected for reasons not anticipated at lease commencement. In Year 7, L decides that it will exercise the renewal option. However, L decides not to notify R until it is required to do so – i.e. at the end of Year 9.

In this case, the better-than-expected trading performance is a market-based factor, which does not in isolation trigger a reassessment of the lease term. Therefore, both R and L reassess the lease term only when L formally notifies R that it will renew the lease – i.e. at the end of Year 9.

IFRS 16.20–21



Is a lessor required to reassess the lease term when the lessee reassesses whether it is reasonably certain to exercise an option?

No. Lessors reassess the lease term and remeasure the lease payments only when there is a change in the non-cancellable period of the lease, as described in paragraph 21 of IFRS 16. In contrast, paragraph 20 requires reassessment in additional circumstances, but this applies only to lessees.

The Board intended to minimise changes to lessor accounting under IAS 17, under which lessors generally determined the lease term at commencement and did not reassess unless there was a change in the contract. IFRS 16 provides detailed guidance on the lessor accounting for lease modifications (see [Chapter 7](#)).

IFRS 16.21, BC184, BC187



If the non-cancellable period becomes fixed only after lease commencement, then should a company reassess the lease term?

Yes, if the fixed period is different from the initial estimate.

If the non-cancellable period of the lease is not fixed at lease commencement, then the company should estimate the non-cancellable period. In this case, it appears that a company should reassess the lease term when the non-cancellable period of the lease becomes fixed and differs from the initial estimate.

We believe that not updating the lease term could result in counter-intuitive accounting results. For example, the lessor might recognise lease income (or lease expense for the lessee) over a period that is unrelated to the non-cancellable period of the lease.

IFRS 16.21



How should a lessor account for the remeasurement of the net investment in a finance lease when there is a change in the non-cancellable period?

IFRS 16 is silent on how a lessor accounts for the remeasurement of the net investment in a finance lease when it revises the lease term. It appears that the lessor should choose an accounting policy, to be applied consistently, to remeasure the net investment in the lease by applying by analogy the guidance in:

- IFRS 9 on accounting for a change in expected cash flows, using the original discount rate determined at inception; or
- IFRS 16 on remeasurement of a lease liability by the lessee, using a revised discount rate.

It appears that when the lessor changes its assessment of the lease term, it should also update the unguaranteed residual value to reflect the revised date on which the lease term ends and the landlord obtains possession of the real estate property.



See our [Lease term](#) publication for more guidance on determining the lease term.

6

Lease payments

Distinguishing between fixed and variable lease payments will impact the profile of a landlord's earnings.

6.1

IFRS 16.A, 70

Overview

At commencement, a lessor identifies the lease payments, which include:

- fixed payments, including in-substance fixed payments, less any lease incentives;
- variable lease payments that depend on an index or a rate;
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option;
- payments of penalties for terminating the lease, if the lease term reflects the assessment that the lessee will exercise an option to terminate the lease; and
- the full amount (regardless of the likelihood that payment will be due) of any residual value guarantees provided to the lessor by the lessee, by a party related to the lessee or by a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

Real estate leases will often include some or all of the following:

- fixed payments (including in-substance fixed payments) (see [Section 6.2](#)), less any lease incentives (see [Section 6.4](#));
- variable lease payments (see [Section 6.3](#));
- payments for terminating the lease early; and
- payments for non-lease components: e.g. maintenance or utilities (see [Section 4.3](#)).

6.2

IFRS 16.A, 70

Fixed and in-substance fixed payments

Fixed and in-substance fixed payments are always included in a lessor's lease payments. 'In-substance fixed payments' are payments that are structured as variable lease payments but that – in substance – are unavoidable. Sometimes, payments that at first glance seem to be variable are actually fixed.

IFRS 16.B42(a)(ii)

A lease payment may initially be variable, but subsequently become in-substance fixed when the underlying variability is resolved.

IFRS 16.A, 75–76, 81

**How should a landlord recognise lease income if uneven payments are intended to reflect expected changes to CPI or market rent?**

Landlords may enter into a lease of real estate with scheduled rent increases. For example, the lease agreement may include a fixed increase of two percent per year over the five-year term of the lease. The fixed yearly increase may be intended to reflect the parties' expectations of the increase in the consumer price index (CPI) or in market rental rates over the five-year period. The question is how a landlord should recognise lease income each year.

Operating lease

Generally, lease income from operating leases is recognised by the landlord in income on a straight-line basis from the commencement date over the lease term.

Fixed increases (or decreases) in rental payments over a period of time, other than variable lease payments, are reflected in the determination of lease income, which is recognised on a straight-line basis. For example, a contractual two percent per annum escalation of rents over the lease term is anticipated from commencement of the lease. Consequently, the landlord recognises lease income in excess of cash lease payments received in early periods. In later years, lease income will be lower than lease cash payments received.

In the example above, the fixed increase is not a variable payment that depends on an index or rate, but rather an unavoidable fixed payment. In addition, the straight-line basis appears to be the more representative pattern in which the landlord expects the tenant to derive the benefit from use of the asset.

Finance lease

In a finance lease, a landlord recognises a finance lease receivable at an amount equal to its net investment in the lease, which comprises the present value of the lease payments and any unguaranteed residual value accruing to the landlord. The lease payments include fixed and in-substance fixed payments. Therefore, fixed increases in rental payments over the lease term are included in the initial measurement of the net investment in the lease.

6.3

Variable lease payments

6.3.1

IFRS 16.70(b)

IFRS 16.A, 28

Payments that depend on an index or rate

Variable lease payments that depend on an index or rate are included in the initial measurement of the lessor's net investment in the lease, initially measured using the index or rate as at the commencement date.

This approach applies to, for example, payments linked to a CPI, payments linked to a benchmark interest rate (e.g. IBOR) or payments that are adjusted to reflect changes in market rental rates.

After the commencement date, unlike for a lessee, IFRS 16 is silent on how a lessor should account for any subsequent change in the index or rate.

IFRS 16.28, 70(b)**What if lease payments depend on property valuations 'based on a market' – are these payments that depend on an index or rate?**

In some jurisdictions, lease payments are calculated as a percentage of an 'assessed value' of the property, which is updated on a regular basis.

Determination of this value is regulated by the tax authority or government, and it may include market rents or values for similar properties in the area as the key input, adjusted for specific features of the property such as:

- size;
- facilities;
- furniture and furnishings; and
- maintenance or other services.

When the assessed values are closely related to market rents or property values, as described above, they may represent market rental rates (except when they are used to determine property taxes – see below). Accordingly, it appears that lease payments that are adjusted for changes in the assessed values of lease properties may be considered 'variable lease payments that depend on an index or rate' in those cases.

For example, we believe that if the assessed value is determined by the authorities, is updated on a regular basis and includes sufficient inputs that mean it represents a 'market' rent/value of the property, then lease payments that are calculated as a percentage of the assessed value are variable lease payments that depend on an index or rate.

The precise determination of the assessed values will vary – between jurisdictions and depending on further adjustments that may be included in the lease agreement – so companies will need to exercise judgement when evaluating whether the lease payments do in fact depend on 'an index or rate'.

The percentage that is applied to the assessed value is not in itself a 'rate'.

6.3.2*IFRS 16.A, 70***Variable payments other than those that depend on an index or rate**

Variable lease payments other than those that depend on an index or rate – e.g. payments that depend on sales or usage of the underlying asset – are excluded from the lease payments and therefore from the initial measurement of the net investment in the lease or calculation of the total payments to be recognised on a straight-line basis.

IFRS 16.BC231

IFRS 16 is silent on the lessor's accounting for those variable lease payments. Considering that the Board has decided to carry forward substantially all of the guidance from IAS 17 on lessor accounting, the same treatment would apply. Therefore, these payments are recognised as income in the period in which the event or condition that triggers those payments occurs.

IFRS 16.65

One key consideration for a lessor is that the presence of variable lease payments may affect lease classification.

**Example 17 – Landlord accounting: Percentage rent in a real estate**

Landlord D enters into a five-year lease with Tenant T to be an anchor tenant at a regional mall.

Under the contract, T will:

- pay a percentage rent to D equal to 5% of the first 2,000,000 in gross annual sales and 3% on any sales in excess of 2,000,000 during the period;
- reimburse D for its portion of D's actual property tax assessments and building insurance costs; and
- reimburse D for its share of CAM costs.

D estimates T's portion of property and insurance costs to be approximately 20,000 per year. D also estimates T's portion of CAM costs to be 10,000 per year.

Landlord accounting

D needs to identify the lease and non-lease components and allocate the consideration to account for the transaction. D determines the following:

- there is one lease component: the retail space;
- property tax and insurance are not separate components: they do not transfer a good or service to the tenant;
- D has the statutory obligation to pay the property tax; therefore, the reimbursement by the tenant is part of the total consideration (variable payments that do not depend on an index or rate); and
- there is one non-lease component, CAM, which transfers a service to the tenant, separate from the right to use the retail space.

The percentage rent payments are genuinely variable, even if D and T can reliably forecast the annual sales.

In this scenario, the nature of the variable payments and their materiality in the context of the lease as a whole provide evidence that the landlord has not transferred substantially all of the risks and rewards of ownership of the property to the tenant. There are no other indicators that the lease is a finance lease. Therefore, D classifies the lease as an operating lease.

D estimates the stand-alone selling prices as follows:

- the stand-alone selling price for the lease component includes property tax and insurance cost; and
- the price charged for CAM represents the stand-alone selling price.

D allocates the variable consideration between the lease and non-lease (CAM) components. The portion allocated to the lease is variable and is recognised as income in the period in which the event or condition that triggers those payments occurs.

Revenue arising from CAM will be recorded in accordance with IFRS 15.

IFRS 16.63

IFRS 16.65

**What is the impact of variable payments on lease classification for a lessor?**

Under IFRS 16, lessors retain the IAS 17 dual accounting model and continue to classify leases as either an operating or a finance lease.

Like IAS 17, IFRS 16 includes indicators that individually or in combination would normally result in a lease being classified as a finance lease – e.g. if the lease term represents a major part of the economic life of the underlying asset.

However, if a lease includes a high proportion of lease payments based on sales or usage (as illustrated in [Example 17](#) above), then this could indicate that the lease should be classified as an operating lease. This is because the lessor does not transfer substantially all of the risks and rewards incidental to ownership of the underlying asset due to the variability in the lease payments.

**How should a landlord account for a co-tenancy clause that reduces the tenant's rent when it is triggered?**

Many retail leases include co-tenancy clauses that change the tenant's contractual rent if, for example, a key (or anchor) tenant or a certain number of tenants vacate the property. In some cases, a tenant's rent is reduced when the clause is triggered; in other cases, fixed rent becomes variable based on the tenant's sales. Typically, these clauses stipulate that the tenant must resume paying the contractual rent either after a specified period of time or when the co-tenancy event is cured – e.g. a new anchor tenant occupies the vacant space.

It appears that the landlord should assess the substance of a co-tenancy clause on lease inception, or at the date of a lease modification if such a clause is added to a lease via a modification. In particular, the landlord should assess whether the co-tenancy clause is protective in nature – i.e. it serves to protect tenants from a potential drop in sales when a key tenant vacates its space or overall occupancy of the retail space declines. When this is the case, we believe that the landlord's accounting for the lease should not consider the co-tenancy clause being triggered.

Indicators that the co-tenancy clause is protective in nature include the presence of one or more high-quality key tenants, a high level of occupancy and the property having a track record of retaining tenants.

For example, assume that a landlord signs an operating lease with a tenant in a shopping mall. The base rent is 100 per month and is payable in each period in which there is an anchor tenant in the mall. However, if the anchor tenant leaves, the rent is reduced to 80 per month. The rent reverts to the base level of 100 per month on the earlier of commencement of a lease with a new anchor tenant or expiration of six months.

On lease commencement, the landlord assesses the substance of the co-tenancy clause. The landlord notes that the shopping mall is well established, with a history of high occupancy. There is a high-quality anchor tenant in place. The landlord therefore concludes that the co-tenancy clause is protective in nature.

On lease commencement, the landlord assumes that the co-tenancy clause will not be triggered and measures its lease income based on fixed lease payments of 100 per month. Subsequently, if the anchor tenant leaves, then in the months in which the co-tenancy clause is operative the landlord recognises rental income of 80 per month and discloses operating lease income of 100 and negative variable lease income of 20.

6.4

IFRS 16.A

Lease incentives

Lease incentives are payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of the costs of a lessee. Payments made by the lessor to the lessee are not lease incentives when they are associated with other obligations of the lessee to transfer distinct goods or services to the lessor.

Examples of lease incentives provided by landlords include up-front cash payments to the tenant or assumption of costs of the tenant such as leasehold improvements, relocation costs and costs associated with a pre-existing lease commitment. Alternatively, initial periods of the lease term may be agreed to be rent-free or at a reduced rent.

Irrespective of its form, a lease incentive is part of the lease payments – i.e. the net consideration for the lease.

For an operating lease, this means that any lease incentive is recognised by the landlord as a reduction in income over the lease term.

IFRS 16.70(a)

For a finance lease, at commencement the landlord deducts any lease incentive payable from the lease payments included in the measurement of the net investment in the lease.



Does the determination of the 'accounting owner' of leasehold improvements affect the accounting for payments made by a landlord to a tenant for the cost of leasehold improvements?

Yes. In some cases, a landlord may reimburse the tenant for the cost of leasehold improvements. The standard does not contain specific guidance on the accounting for such landlord reimbursements. In our view, the appropriate accounting depends on whether the tenant or the landlord is the 'accounting owner' of the leasehold improvements – i.e. whether the tenant or the landlord accounts for the leasehold improvements as its property, plant and equipment. The company that controls the asset is the accounting owner.

For example, a tenant may construct the leasehold improvements and the landlord may subsequently reimburse the tenant. If the tenant constructs leasehold improvements that are its own asset, then we believe that any reimbursement of the tenant's costs by the landlord is a lease incentive that should reduce the lease payments. However, if the tenant constructs the leasehold improvements for the landlord – i.e. the leasehold improvements are an asset controlled by the landlord – then the landlord's payment represents consideration for a distinct good or service provided by the tenant.

In our experience, indicators that the tenant is the accounting owner of the leasehold improvements may include the following:

- the tenant is not contractually required to construct or install the leasehold improvements;
- the tenant is permitted to alter or remove the leasehold improvements without the consent of the landlord or without adequately compensating the landlord;
- the tenant is not required to provide evidence of costs incurred to receive reimbursement;
- the tenant bears the risk of cost overruns;
- the leasehold improvements are unique to the tenant’s intended use of the leased asset; and
- the leasehold improvements are not available to the landlord in a lease to other parties.

This list of indicators is not exhaustive and judgement is required in determining the weighting of indicators based on the specific facts and circumstances.



Should lease incentives granted by a landlord in an operating lease be recognised over the full lease term if the lease includes market rent reviews or lease payments based on an index or rate?

IFRS 16.A, 81

Yes. Lease incentives granted to the tenant in negotiating a new or renewed operating lease are recognised as an integral part of the lease payments relating to the use of the underlying asset. They are recognised as a reduction of rental income over the lease term using the same recognition basis as for the lease income – i.e. on a straight-line basis unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished.

The fact that a lease agreement includes market rent reviews or lease payments based on an index or rate does not impact the accounting treatment of lease incentives.



See our [Lease payments](#) publication for more in-depth discussion of determination of the lease payments.

7

Lease modifications

Accounting for lease modifications has become a hot topic due to the COVID-19 pandemic, with many tenants seeking rent concessions and other changes to lease agreements.

7.1

Overview

Unlike IAS 17, IFRS 16 provides detailed guidance on the lessor accounting for lease modifications, with separate guidance for modifications to finance leases and operating leases.

IFRS 16.A

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of its original terms and conditions. Common examples are:

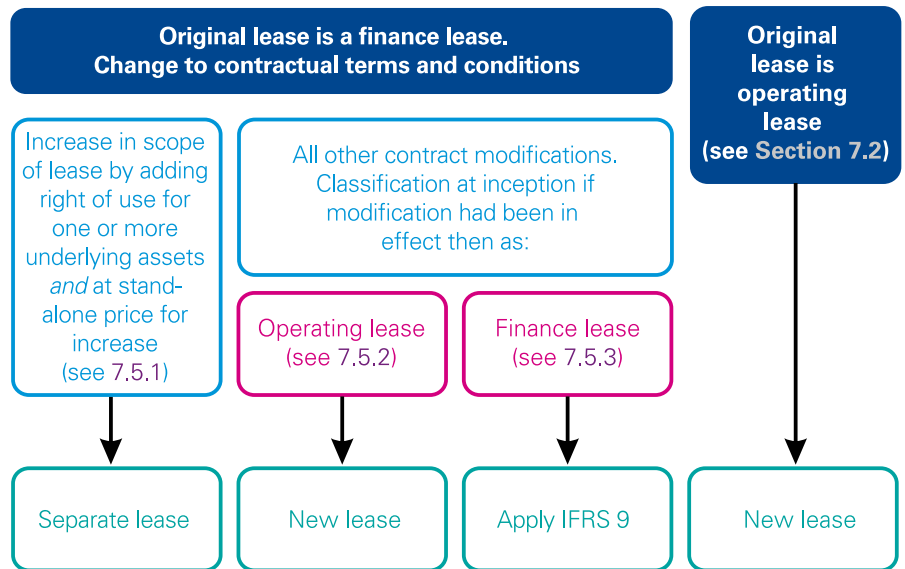
- decreasing the scope of the lease by removing the right to use one or more underlying assets;
- decreasing the scope of the lease by shortening the contractual lease term; and
- changing the consideration in the lease by increasing or decreasing the lease payments.


Changes that result from renegotiations of the original contract are lease modifications.

The exercise of an option included in the original lease contract is not a modification. There is no lease modification when a lessor reassesses the lease term if:

- the lessee exercises an option not previously included in the lessor's determination of the lease term;
- the lessee does not exercise an option previously included in the lessor's determination of the lease term;
- an event occurs that contractually obliges the lessee to exercise an option not previously included by the lessor; or
- an event occurs that contractually prohibits the lessee from exercising an option previously included by the lessor (see [Section 5.6](#)).


The following diagram summarises the accounting for lease modifications by a lessor.



 **When does a lessor account for a lease modification?**

Similar to a lessee, a lessor accounts for modifications to operating and finance leases on the effective date of the modification. This is the date when both parties agree to the lease modification.

IFRS 16.A, 79–80, 87

 **Is a single, one-off cash payment from a landlord a variable lease payment or a lease modification?**

For example, assume a scenario where, as a result of significantly reduced footfall in a shopping mall due to economic factors, a landlord and tenant negotiate short-term relief for the tenant. As a result, the landlord agrees to make a one-off cash payment to the tenant.

Assume that this payment was not contemplated in the terms and conditions of the original contract entered into at lease commencement, and the written contract is not changed as a result of the renegotiation. There are no other changes to the terms and conditions of the contract.

The one-off payment is a reduction in the consideration that was not included in the original terms and conditions of the contract. Therefore, it is a lease modification and not a variable lease payment. Therefore, the landlord applies paragraphs 79–80 of IFRS 16 for a finance lease or paragraph 87 for an operating lease.

IFRS 16.A

7.2 Modifications to operating leases – General considerations

IFRS 16.87

A lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification. As part of the lease payments for the new lease, it considers any prepaid or accrued lease payments relating to the original lease.

A lessor recognises lease income on a systematic basis that is representative of the pattern in which the benefit of the underlying asset is diminished. This pattern of income recognition reflects the lessee’s right to use the asset.



Example 18 – Landlord modifications to operating leases

IFRS 16.87

Landlord Y enters into a five-year lease with Tenant X for office space. Y classifies this lease as an operating lease because it does not transfer substantially all of the risks and rewards incidental to ownership of the office space to X.

The lease agreement specifies a starting rent of 100,000 payable in arrears and requires the lease payments to be increased by 2% per annum – i.e. 520,404 for the five-year period. X does not provide any residual value guarantee. There are no initial direct costs, lease incentives or other payments between X and Y.

The accounting for lease payments on a straight-line basis is performed by first determining the annual rental income of 104,081 (520,404 / 5), which takes into account the annual indexation. Therefore, Y accounts for the lease payments for the first two years as follows.

Year	Lease payment (A)	Annual rental income (B)	Accrual period end balance (C)
Year 1	100,000	104,081	4,081
Year 2	102,000	104,081	6,162

Due to high vacancy rates in the real estate market, Y would like to encourage X to commit to staying in the office space for longer. At the beginning of Year 3, Y and X enter into negotiations and agree to:

- extend the original lease of the floor of office space by an additional three years after Year 5; and
- fix the annual payments for the original lease at 105,000 payable in arrears for the remaining six years (i.e. three years on the initial five-year term plus a three-year extension).

The change in consideration and the extension of the lease term were not part of the original terms and conditions of the lease and are therefore lease modifications. Y accounts for these modifications as a new operating lease from the effective date of the modifications. This takes into account accrued lease payments relating to the original lease payments as follows.

Year	Lease payment (A)	Annual rental income (B) ¹	Accrual period end balance (C)
Year 3	105,000	103,973	5,135
Year 4	105,000	103,973	4,108
Year 5	105,000	103,973	3,081
Year 6	105,000	103,973	2,054
Year 7	105,000	103,973	1,027
Year 8	105,000	103,973	–

Note

1. B = sum of A (lease payments) / 6 - (C at end of Year 2) / 6 (remaining lease term).
 $B = (105,000 \times 6) / 6 - 6,162 / 6 = 103,973$.

7.3 Modifications to operating leases related to COVID-19

IFRS 16.A, 87, BC240A

Due to the impact of the COVID-19 pandemic on business conditions, many lessees are seeking rent concessions from lessors. The Board has issued amendments to IFRS 16 to simplify how lessees account for rent concessions (see our [Leases – Rent concessions](#) publication for more detail). The amendments do not include a practical expedient for lessors.

IFRS 16.A, BC240A

In the absence of a practical expedient, lessors are still required to assess whether a rent concession granted during the COVID-19 pandemic is a lease modification. If a lessor concludes that a rent concession is a lease modification, then it applies the specific guidance in the standard on accounting for lease modifications.

IFRS 16.87

A lessor accounts for a modification to an operating lease as a new lease from the effective date of the modification.

Occasionally a lessee terminates a lease earlier than the term contemplated in the original agreement and pays the lessor a termination penalty (which results from negotiation between the lessee and the lessor when they reach a modified agreement). It appears that these termination penalties should be considered part of the revised lease payments. [Example 21](#) illustrates the lessor accounting in a typical scenario.

IFRS 16.87

 **Example 19 – Decrease in scope and consideration: Lease modification**

Landlord L leases retail space to Tenant Z for five years and classifies the lease as an operating lease. The lease commences in June 2018 and includes fixed lease payments of 10,000 per month, which increase by 2% per annum.

L accounts for the lease payments on a straight-line basis by first determining the annual rental income of 124,897 (624,485 / 5), which takes into account the annual increase.

Date	Lease payment
2018	120,000
2019	122,400 ¹
2020	124,848 ¹
2021	127,345 ¹
2022	129,892 ¹
Total	624,485

Note

1. Includes 2% increase per annum.

L accounts for the lease payments in 2018 and 2019 as follows.

Date	Lease payment (A)	Annual rental income (B)	Accrual period end balance (C)
June 2018 – May 2019	120,000	124,897	4,897
June 2019 – May 2020	122,400	124,897	7,394 ¹

Note

1. $C = C \text{ prior year} + (B - A)$.

Z’s business has since been severely impacted as a result of the COVID-19 pandemic. Therefore, at the beginning of June 2020, L and Z agree to reduce the space from 1,500m² to 1,000m².

L and Z also agree to reduce the lease payments to a fixed amount of 90,000 per annum, payable in arrears for the remaining three years.

The decreases in scope (retail space) and consideration were not included in the original terms and conditions of the lease and are therefore a lease modification. L accounts for this modification as a new operating lease from the effective date of the modification. This takes into account accrued lease payments relating to the original lease as follows.

Date	Lease payment (A)	Annual rental income (B) ¹	Accrual period end balance (C)
June 2020	90,000	87,535	4,929
June 2021	90,000	87,535	2,464
June 2022	90,000	87,536	–

Note

1. $B = \text{sum of A (lease payments)} / 3 - (\text{C at end of May 2020}) / 3$ (remaining lease term).
 $B = (90,000 \times 3) / 3 - 7,394 / 3 = 87,535$.

IFRS 16.A, 87



Example 20 – Unamortised lease incentive: Lease modification

Landlord M enters into a 10-year lease of office space with Tenant K, which commences on 1 April 2015. The rental payments are 15,000 per month, payable in arrears. M classifies the lease as an operating lease. M reimburses K's relocation costs of 600,000, which M accounts for as a lease incentive. The lease incentive is recognised as a reduction in rental income over the lease term using the same basis as for the lease income – in this case, on a straight-line basis over 10 years.

On 1 April 2020, during the COVID-19 pandemic, M agrees to waive K's rental payments for May, June and July 2020.

This decrease in consideration is not included in the original terms and conditions of the lease and is therefore a lease modification.

M accounts for this modification as a new operating lease from its effective date – i.e. 1 April 2020. M recognises the impact of the waiver on a straight-line basis over the five-year term of the new lease. M also takes into account the carrying amount of the unamortised lease incentive on 1 April 2020 of 300,000. M amortises this balance on a straight-line basis over the five-year term of the new lease.

**Example 21 – Termination/break of the lease not included in original contract**

Landlord M enters into a 10-year contract with Tenant L to lease a building. There are no termination or break clauses in the original contract.

M classifies the lease as an operating lease.

During Year 5, L begins experiencing financial difficulties and wants to end the lease earlier than originally planned. At the end of Year 5, M and L enter into negotiations and agree to terminate or break the lease at the end of Year 7 (i.e. in two years' time, three years earlier than the original expiry of the lease).

L agrees to pay M a termination or break fee. M and L also agree to reduce the lease payments for the remaining term until the end of Year 7.

The original terms and conditions of the lease did not include an option to terminate or break the lease, reduce the lease term or reduce lease payments. Therefore, M treats this as a modification to an operating lease. That is, M treats the modification as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

In this case, the lease contains only a single lease component; therefore, the termination or break fee forms part of the revised lease payments.

IFRS 16.87

**Why didn't the Board provide a practical expedient to lessors for the accounting for rent concessions related to COVID-19?**

The Board supported its decision for a number of reasons, including the following:

- IFRS 16 does not provide guidance to lessors for a change in lease payments that is not a lease modification like it does for lessees, so a practical expedient would have to include new recognition and measurement requirements;
- the Board believes that a practical expedient for lessors would adversely affect the comparability of, and interaction between, the lessor accounting requirements in IFRS 16 and related requirements in other standards, such as IFRS 9 for finance leases and IFRS 15 for operating leases; and
- IFRS 16 does not introduce a new accounting model for lessors.

In April 2020, the Board released a document¹, prepared for educational purposes, responding to questions about the application of the standard to rent concessions granted as a result of the pandemic. Educational materials prepared by the Board do not change, remove or add to the requirements in the standards. However, the document provides helpful guidance for lessors when accounting for rent concessions granted.

IFRS 16.A, 87, BC240A

1. [IFRS 16 and COVID-19: Accounting for COVID-19-related rent concessions in applying IFRS 16 Leases.](#)

IFRS 9.5.5.1, 16.85, IAS 40.40



What other matters does an operating lessor consider when there is a change to the scope or consideration of a lease during the COVID-19 pandemic?

An operating lessor assesses whether the underlying asset and related balances are measured appropriately.

The lessor applies IAS 36 if the underlying asset is:

- property, plant and equipment;
- a right-of-use asset that is not investment property; or
- investment property measured at cost.

If the underlying asset is investment property measured at fair value, then the lessor will need to ensure that the fair value reflects the revised terms of the in-place leases and the current expectations of market participants for the value of the property.

In addition, the lessor applies the impairment requirements of IFRS 9 to operating lease receivables. For example, if a lessee does not pay the lease payments due to financial difficulties, then the lessor will recognise a loss allowance for expected credit losses on the operating lease receivable in accordance with IFRS 9.

IFRS 16.A, 87



Can a lessor capitalise incremental initial direct costs incurred as a result of a modification to an operating lease?

Yes. IFRS 16 defines initial direct costs as “incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained”. Considering that IFRS 16 requires a lessor to account for an operating lease modification as a new lease, incremental costs incurred can be capitalised.

IFRS 16.A, 87



How should a lessor account for a lease incentive when it waives lease payments for a portion of the lease?

Assume that a lessor in an operating lease has recognised a lease incentive asset for its initial contribution to the lessee’s leasehold improvements. The lease incentive is amortised over the lease term.

When a lessor agrees to waive rental payments – e.g. for the next three months – the question arises whether a proportionate amount of the lease incentive should be derecognised.

Assume that there are no terms in the original lease that could contractually have given rise to the waiver of lease payments. Therefore, the waiver of lease payments is a lease modification. Paragraph 87 of IFRS 16 provides guidance on the accounting for a modification to an operating lease.

Under paragraph 87, prepaid lease payments relating to the original lease are considered part of the lease payments for the new lease. Therefore, no portion of the lease incentive is derecognised.

7.4 Changes to operating leases that are not lease modifications

IFRS 16.A, 81

Changes in lease payments that result from terms in the original lease contract or in applicable law or regulations are part of the original terms and conditions of the lease, even if the effect of those clauses was not previously considered. If there is no change in either the scope of or the consideration for a lease, then there is no lease modification and IFRS 16's other requirements are applied.



Example 22 – Deferral of lease payments not a lease modification

IFRS 16.A, 81

Landlord L leases retail space to Tenant Z and classifies the lease as an operating lease. The lease includes fixed lease payments of 10,000 per month.

Due to the COVID-19 pandemic, L and Z agree on a rent concession that allows Z to pay no rent in the period from July to September 2020 but to pay rent of 20,000 per month in the period from January to March 2021. There are no other changes to the lease.

L determines that the reduction in lease payments in July to September 2020 and the proportional increase in January to March 2021 do not result in an overall change in the consideration for the lease.

L does not account for the change as a lease modification. L continues to recognise operating lease income on a straight-line basis, which is representative of the pattern in which Z's benefit from use of the underlying asset is diminished.



Is a rent deferral that increases the future lease payments a lease modification?

Not necessarily.

[The Board's document](#) notes that if lease payments are deferred during the period of the COVID-19 pandemic and are subsequently increased 'proportionally', then the consideration for the lease is unchanged. In the absence of other changes to the lease, this means that there is no lease modification.

The Board's document does not elaborate on the meaning of the term 'proportionally' and the amendments do not use the term. This means that lessors will need to determine an appropriate definition of the term and apply it consistently.

For example, if the lease payments are deferred during the COVID-19 pandemic and the deferred payments are increased to compensate the lessor for the time value of money relating to the deferred payments, then the lessor assesses whether the lease payments have been increased 'proportionally'.

IFRS 16.76, 77, 81



What are the accounting implications for the landlord if a tenant does not make rent payments when they are due?

As discussed previously, a lease modification is a change to the terms and conditions of the lease. If the tenant fails to pay amounts due under the lease contract with no agreement with the landlord, then this is not a lease modification.

Instead, the landlord will continue to account for the lease under its original terms and conditions unless and until the landlord agrees to modify the contract.

However, if the tenant fails to pay amounts due under the lease contract, or the landlord is otherwise concerned that the tenant may be unable to pay amounts falling due in future periods, then there are a range of other issues that the landlord needs to consider.

For **operating leases**, these issues include but are not limited to the following.

- *Income recognition*: Operating lease income reflects the rental payments to which the landlord is entitled under the enforceable terms and conditions of the lease. In addition, the landlord will need to assess whether it remains appropriate to recognise income from non-lease components – e.g. maintenance income under IFRS 15.
- *Carrying amount of the underlying asset*: Landlords will need to ensure that the underlying asset is appropriately measured. For investment property measured at fair value, this will include ensuring that the fair value reflects current market participant expectations about in-place leases and residual values. For other underlying assets, this will include considering whether there is a trigger for impairment testing.
- *Lease receivables*: Operating lease receivables are subject to impairment testing under IFRS 9.

Example

Landlord L leases a store to a retailer for fixed lease payments of 100 per month. L classifies the lease as an operating lease. For the last six months of 2020, due to financial difficulty, the retailer pays only 50 per month, with the intention to repay the balance in 2021. No modification agreement is signed between the landlord and the tenant.

L recognises revenue of 1,200 for 2020, collects 900 and records a receivable of 300. The lease receivable is subject to impairment testing under IFRS 9.

Finance lease

In a finance lease, although the landlord will continue to account for the lease under its original terms and conditions, the carrying amount of the net investment in the lease and interest income related thereto may be impacted. The landlord applies IFRS 9's impairment requirements to the net investment in the lease and regularly reviews the estimated unguaranteed residual values used in computing the gross investment in the lease. The landlord applies IFRS 16 to recognise reductions in the unguaranteed residual value of the underlying asset.

IFRS 16.81

**Should a landlord continue to recognise operating lease income on a straight-line basis if the tenant's business is impacted by COVID-19 or government restrictions?**

Generally, yes.

In most commercial real estate leases, the benefit conveyed by the landlord to the tenant is the right to use the underlying property over the lease term. For this reason, operating lease income from real estate leases is typically recognised by the landlord on a straight-line basis from the commencement date over the lease term.

IFRS 16 states that it is possible to recognise operating lease income using another systematic basis if that is more representative of the time pattern in which the benefit of the underlying property is diminished. However, it is rare that a basis other than straight-line meets this test in a real estate lease. For example, a retailer that leases a retail store from a landlord may expect its sales at the store to vary seasonally, and may project year-on-year increases in sales. However, the benefit that the retailer receives under the lease is the right to use the store. Therefore, if the lease payments are fixed, then the landlord would recognise operating lease income on a straight-line basis in this fact pattern.

A question arises about whether this approach remains appropriate if the COVID-19 pandemic significantly reduces sales at the store and/or the government imposes restrictions that reduce footfall at the store.

In the absence of a change in the lease agreement, the tenant's benefit under the lease agreement remains the right to use the store. As long as the landlord continues to convey the right to use the store to the retailer, the landlord will typically continue to recognise operating lease income on a straight-line basis.

7.5

IFRS 16.79–80, BC238–BC239

Modifications to finance leases

The landlord's accounting for a modification to a finance lease depends on whether the modification in substance represents the creation of a new lease that is separate from the original lease. The landlord accounts for such a modification as a separate lease.

The accounting for a modification to a finance lease that is not accounted for as a separate lease further depends on whether the lease classification would have been different had the modified terms been in effect at the inception date.

7.5.1

IFRS 16.79

Separate lease

A landlord accounts for a lease modification as a *separate lease* if both of the following conditions exist:

- 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 equivalent to the stand-alone selling price for the increase in scope and any appropriate adjustments to that stand-alone selling price to reflect the circumstances of the particular contract.

One common type of modification to a real estate lease is that the lease is modified to include additional space. For example, a landlord that already leases space in an office building to a tenant may agree to lease additional space in the same office building. When the lease payments for the additional space reflect the stand-alone selling price for it, the landlord accounts for the space as a separate new lease.

In this case, the landlord:

- accounts for the separate lease (i.e. the lease of the additional floor) in the same way as any new lease; and
- makes no adjustment to the initial lease.

IFRS 16.79



Example 23 – Modification that is a separate lease

Landlord L entered into a lease contract with Tenant Z to lease one floor in an office building for 30 years. L classifies this lease as a finance lease because it transfers substantially all of the risks and rewards incidental to ownership of office space.

During the first 20 years, Z's business has expanded and Z now requires additional office space.

At the beginning of Year 21, L and Z amend the contract to grant Z the right to use one floor of office space in a new extension of the building for 10 years. The new office space is the same size as the original office space and similar in all significant respects.

The lease payments for the new office space are commensurate with market rentals for office space of that size and characteristic. However, Z receives a 5% discount for the new office rentals because its existing relationship with L enabled L to forego costs that it would have incurred if the additional floor had been leased to a new tenant – e.g. marketing costs, rental agent's commission and costs for undertaking credit checks.

The lease of the additional office space was not part of the original terms and conditions of the contract. Therefore, this is a lease modification.

L accounts for this modification as a separate lease at the effective date of the lease modification because:

- the modification increases the scope of the lease by adding the right to use an additional underlying asset – i.e. an additional floor of office space; and
- the lease payments for the additional floor are commensurate with market rentals for a similar office space, as adjusted for the circumstances of the contract. Even though the lease payments for the new office space are 5% below market rentals, the discount reflects L's sharing with Z of the benefit of not having to market the property or pay a broker's commission and not having to incur other common origination fees.

L does not modify the accounting for the original office space lease. L classifies the lease of the additional floor space as an operating lease because the lease term is not for the major part of the economic life of the underlying asset and no other features indicate that the lease transfers substantially all of the risks and rewards incidental to ownership of the underlying asset.

7.5.2

Not a separate lease – Finance to operating: Modifications related to COVID-19

IFRS 16.80(a)

When a modification to a finance lease is not a separate lease, the lessor first assesses whether the classification of the lease would have been different if the modified terms had been in effect at the inception date.

IFRS 16.A

The lessor does this at the effective date of the modification – i.e. when the modification is agreed, not on expiry of the original lease term.

IFRS 16.80(a)

If a modification to a finance lease is not a separate lease and the lease would have been classified as an operating lease if the modified terms had been in effect at the inception date, then the lessor:

- accounts for the lease modification as the termination of the original lease and the creation of a new lease from the effective date of the modification; and
- measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification.



Example 24 – Modification that is not a separate lease and lease would have been classified as an operating lease

IFRS 16.63–66, 79–80(a)

Landlord L enters into a lease contract with Tenant Z to lease one floor in an office building for 30 years. Initially, L classifies this lease as a finance lease because it transfers substantially all of the risks and rewards incidental to ownership of office space.

During the COVID-19 pandemic, M's business has contracted. In June 2020, four years after the commencement date, L and M amend the contract so that it now terminates on 31 December 2020.

Early termination was not part of the original terms and conditions of the lease and is therefore a lease modification. The modification does not grant M an additional right to use the underlying assets and therefore cannot be accounted for as a separate lease.

L determines that, had the modified terms been effective at the inception date, the lease term would not have been for the major part of the economic life of the asset. Furthermore, there are no other indicators that the lease would have transferred substantially all of the risks and rewards incidental to ownership of the office space. Consequently, the lease would have been classified as an operating lease.

In June 2020, L accounts for the modified lease as a new operating lease. L:

- derecognises the finance lease receivable and recognises the underlying asset in its statement of financial position according to the nature of the underlying asset – i.e. as investment property in this case; and
- measures the aggregate carrying amount of the underlying assets as the amount of the net investment in the lease immediately before the effective date of the lease modification.

7.5.3

IFRS 16.80(b)

Not a separate lease – Finance to finance: Modifications related to COVID-19

If a modification to a finance lease is not a separate lease and the lease would have been classified as a finance lease had the modification been effective at the inception date, then the lessor accounts for it under the requirements of IFRS 9.

The lessor adjusts its measurement of finance lease receivables to reflect any reduction in future contractual lease payments that arise from a rent concession arising directly from the COVID-19 pandemic.

IFRS 9.2.1(b)

For detailed guidance on the application of the principles of IFRS 9, see the 17th Edition 2020/2021 of our publication [Insights into IFRS](#). Lease receivables recognised by the lessor are subject to the derecognition and impairment requirements of IFRS 9.



See our [Lease modifications](#) publication for more guidance on accounting for modifications.

8

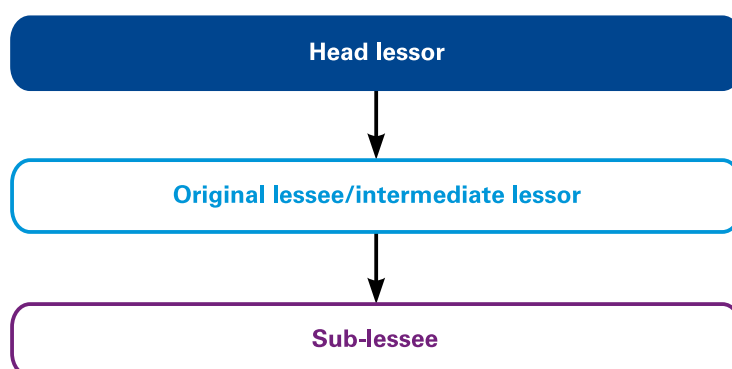
Sub-leases

New classification guidance means that more sub-leases are finance leases under IFRS 16 than previously, impacting the financial position and financial performance of intermediate landlords.

IFRS 16.3, A

A sub-lease is a transaction in which a lessee (or 'intermediate lessor') grants a right to use the underlying asset to a third party, and the lease (or 'head lease') between the original lessor and lessee remains in effect.

A company applies IFRS 16 to all leases of right-of-use assets in a sub-lease. The intermediate lessor accounts for the head lease and the sub-lease as two different contracts.



IFRS 16.B58

An intermediate lessor classifies the sub-lease as a finance lease or as an operating lease with reference to the right-of-use asset arising from the head lease. That is, the intermediate lessor treats the right-of-use asset as the underlying asset in the sub-lease, not the item of property, plant or equipment that it leases from the head lessor.

IFRS 16.68

At the commencement date of the sub-lease, if the intermediate lessor cannot readily determine the rate implicit in the sub-lease, then it uses the discount rate that it uses for the head lease to account for the sub-lease, adjusted for any initial direct costs associated with the sub-lease.

IFRS 16.B58

However, if the head lease is a short-term lease for which the company, as a lessee, has elected the short-term lease exemption, then as an intermediate lessor the company classifies the sub-lease as an operating lease.

When the leased property meets the definition of investment property, see [Chapter 10](#).

**Example 25 – Sub-lease classified as a finance lease with reference to the right-of-use asset in the head lease**

Head lease: Intermediate landlord L enters into a five-year lease for 5,000m² of office space (the head lease) with Company M (the head landlord).

Sub-lease: At the beginning of Year 3, L sub-leases the 5,000m² of office space for the remaining three years of the head lease to Sub-tenant N.

L classifies the sub-lease with reference to the right-of-use asset arising from the head lease. Because the sub-lease is for the whole of the remaining term of the head lease – i.e. the sub-lease is for the major part of the useful life of the right-of-use asset – L classifies it as a finance lease.

At the commencement date of the sub-lease, L:

- derecognises the right-of-use asset relating to the head lease that it transfers to N and recognises the net investment in the sub-lease;
- recognises any difference between the carrying amounts of the right-of-use asset and the net investment in the sub-lease in profit or loss; and
- continues to recognise the lease liability relating to the head lease, which represents the lease payments owed to the head landlord.

During the term of the sub-lease, L recognises both interest income on the sub-lease and interest expense on the head lease.

**Does entering into a sub-lease with a longer term than the remaining head lease term trigger a remeasurement of the head lease?**

Yes. Two parties may enter into a sub-lease in which the non-cancellable period of the sub-lease or the sub-lease term – i.e. including one or more optional periods – exceeds the lease term for the head lease. Because the act of entering into the sub-lease is a significant event within the intermediate lessor's control, it reassesses the head lease term. This results in the term of the head lease being equal to or longer than the term of the sub-lease. If this represents a change in the term of the head lease, then this will trigger a remeasurement of the intermediate lessor's liability under the head lease.

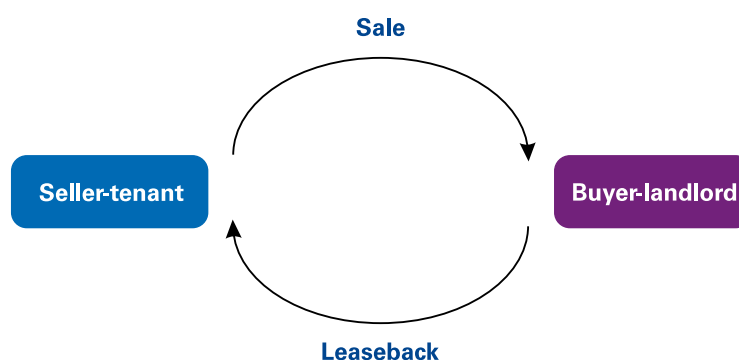
9

Sale-and-leaseback

New guidance on 'failed sales' means that some sale-and-leaseback transactions are accounted for as pure financing transactions by both landlords and tenants.

IFRS 16.98–103

In a sale-and-leaseback transaction, a company (the seller-tenant) transfers an underlying asset to another company (the buyer-landlord) and leases that asset back from the buyer-landlord.



To determine how to account for a sale-and-leaseback transaction, a company first considers whether the initial transfer of the underlying asset from the seller-tenant to the buyer-landlord is a sale. The company applies IFRS 15 to determine whether a sale has taken place. This assessment determines the accounting by both the buyer-landlord and the seller-tenant.

	Buyer-landlord
Transfer to buyer-landlord is a sale	<ul style="list-style-type: none"> – Recognise the underlying asset as property, plant and equipment or investment property* – Account for the leaseback in accordance with IFRS 16*
Transfer to buyer-landlord is not a sale	<ul style="list-style-type: none"> – Do not recognise the underlying asset – Recognise a financial asset under IFRS 9 for amounts transferred to or receivable from the seller-lessee

* Adjustments are required if the sale is not at fair value or the lease payments are off-market. A company is not required to assess both, however – only whichever one is more 'readily determinable'.

	Seller-tenant
Transfer to buyer-landlord is a sale	<ul style="list-style-type: none"> – Derecognise the underlying asset and apply the lessee accounting model to the leaseback* – Measure the right-of-use asset at the retained portion of the previous carrying amount (i.e. at cost)* – Recognise a gain or loss related to the rights transferred to the lessor*
Transfer to buyer-landlord is not a sale	<ul style="list-style-type: none"> – Continue to recognise the underlying asset – Recognise a financial liability under IFRS 9 for any amount received from the buyer-landlord

* Adjustments are required if the sale is not at fair value or the lease payments are off-market. A company is not required to assess both, however – only whichever one is more ‘readily determinable’.



Example 26 – Buyer-landlord accounting for a sale-and-leaseback transaction when transfer is a sale

IFRS 16.101–102, IE11

Company C sells an office building to Company D for cash of 1,000,000. At the same time, C enters into a contract with D for the right to use the building for 15 years with annual payments of 80,000 payable at the end of each year.

The transfer of the office building qualifies as a sale under IFRS 15. The fair value of the office building, which is deemed to be more readily determinable than market rentals on the leaseback, on the date of sale is 900,000. Because the consideration for the sale of the office building is not at fair value, D makes adjustments to recognise the transaction at fair value. The amount of the excess sale price of 100,000 (1,000,000 - 900,000) is recognised as additional financing provided by D to C.

At the commencement date, D makes the following entries.

	Debit	Credit
Building	900,000	
Financial asset	100,000	
Cash		1,000,000
<i>To recognise sale-and-leaseback of building</i>		

After the commencement date, D allocates the annual payments of 80,000 that it receives from C as follows.

- *Lease payments*: Assuming that D classifies the lease as an operating lease, D will probably recognise these payments on a straight-line basis over the lease term of 15 years.
- *Repayment of the financing*: i.e.:
 - payments received to settle the financial asset of 100,000; and
 - interest income, applying the effective interest rate method.

IFRS 16.103(b)

**Example 27 – Buyer-landlord accounting for a sale-and-leaseback transaction when transfer is not a sale**

Modifying Example 26, Company C has an option to repurchase the building at the end of 15 years.

D notes that C has a call option over the building. Therefore, D applies the guidance in IFRS 15 on sale-and-repurchase agreements and concludes that the transfer does not qualify as a sale. This is because C retains control of the building through the call option, which is considered to be substantive.

Because the transfer does not qualify as a sale, D does not recognise the building as property, plant and equipment or investment property. Instead, D accounts for the transaction as a financing arrangement under IFRS 9.

At the commencement date, D makes the following entries.

	Debit	Credit
Financial asset	1,000,000	
Cash		1,000,000
<i>To recognise receivable due from C</i>		

**How does a buyer-landlord assess whether a transaction qualifies for sale-and-leaseback accounting?**

The buyer-landlord assesses whether the transfer leg meets the requirements for determining when a performance obligation is satisfied under IFRS 15. Put another way, the buyer-landlord assesses whether the seller-tenant has transferred control of the property. This assessment is made from the perspective of the seller-tenant.

There is no specific or additional guidance in IFRS 16 about how to make this assessment. Instead, the parties apply the guidance in IFRS 15.

Cases in which the assessment is clear – Repurchase options

In some cases, it will be clear that the transfer leg does *not* meet this test, and therefore the transaction should be accounted for as a financing transaction.

For example, some transactions contain a call option under which the seller-tenant can, at its option, repurchase the property. Such an option generally precludes sale accounting under IFRS 15, because the existence of the call option means that the seller-tenant retains control of the property. Therefore, sale-and-leaseback accounting does not apply and both parties account for the transaction as a financing transaction.

Cases in which the assessment is less clear

In the absence of a substantive call option or other feature that generally precludes the transfer leg being a sale, judgement is required to assess the appropriate accounting.

For example, whether the leaseback would be classified as a finance or operating lease by the buyer-landlord would not in itself determine whether the transfer leg qualifies as a sale. The standard does not preclude the possibility that the transfer leg is a sale when the classification of the leaseback is a finance lease – i.e. sale-and-finance-leaseback accounting is not prohibited under IFRS 16. However, in our experience, only in rare circumstances would the transfer qualify as a sale in this case.

IFRS 16.C16



Does a buyer-landlord assess whether historical transactions qualify for sale-and-leaseback accounting?

No. This test applies only to transactions entered into after the date of initial application of IFRS 16. A buyer-landlord does not reassess transactions classified as sale-and-leaseback transactions under IAS 17 to determine whether the transfer qualifies as a sale.

Even if a buyer-landlord applies IFRS 16 retrospectively, it does not reassess transactions classified as sale-and-leaseback transactions under IAS 17.

IFRS 16.100, IU 06-20



How should a company account for a sale-and-leaseback transaction with variable payments?

Seller-lessee

In some cases, the payments for the lease in a sale-and-leaseback transaction may include variable lease payments depending on sales or usage. In these cases, a question arises over how the seller-lessee measures the right-of-use asset arising from the leaseback and determines the amount of any gain or loss to be recognised at the date of the transaction.

The IFRS Interpretations Committee received a request to address this issue from the perspective of the seller-lessee. It issued an agenda decision stating that the right-of-use asset should be measured as a proportion of the previous carrying amount of the underlying asset, reflecting the rights retained under the leaseback. It also addressed how to determine the gain or loss relating to the rights transferred to the buyer-lessor. The initial measurement of the liability that is recognised at the transaction date is a consequence of how the right-of-use asset is measured.

The Committee recommended that the Board discuss how to subsequently measure the lease liability. The Board issued an exposure draft in November 2020 proposing to amend IFRS 16 to add subsequent measurement requirements for sale-and-leaseback transactions.

Buyer-lessor

The Committee's agenda decision and the Board's exposure draft do not address the accounting for the buyer-lessor in these circumstances. The buyer-lessor applies the guidance in IFRS 16, recognising the purchase of the asset applying applicable standards and accounting for the lease under the lessor accounting requirements in IFRS 16.

If the leaseback is an operating lease, then the lessor recognises lease payments on either a straight-line or another systematic basis. Variable lease payments are recognised as income in profit or loss. They are recognised in the period in which a change occurs in the facts and circumstances on which the variable payments are based.

If the leaseback is a finance lease, then the lessor recognises a net investment in the lease according to the guidance provided in IFRS 16.



What does a buyer-landlord need to consider when accounting for a financial asset recognised in a failed sale-and-leaseback transaction?

IFRS 16.103(b), 9.4.1.3(b), B4.1.16

A sale-and-leaseback transaction often fails to meet the requirements for a sale under IFRS 15 because the seller-tenant ('the borrower') has an option to repurchase the underlying property – i.e. the option gives the borrower an interest in the leased property. This means that the buyer-landlord ('the lender') recognises a financial asset ('loan') equal to the transfer proceeds, and accounts for the loan under IFRS 9. A question arises over whether the terms of the loan recognised are SPPI-compliant.

A financial asset is 'SPPI-compliant' if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. IFRS 9 provides guidance on what is meant by 'interest'. Also, IFRS 9 provides guidance on when a financial asset fails SPPI because it represents an investment in a particular asset.

For example, in a failed sale-and-leaseback transaction, the seller-tenant may have an option to purchase the underlying property at the end of the financing agreement at a price determined at inception of the contract that aims to approximate the value of the property at that time. Assuming that the option price is not de minimis, the contractual cash flows of the loan are not consistent with the SPPI criterion. This is because:

- not only is the borrower obliged to make payments of interest and principal, but also as part of the contract the borrower can hand the underlying property back to the lender;
- the underlying property is not just collateral for the loan but under the terms of the contract the borrower can choose whether to keep the underlying property, or not keep it and avoid making the final payment by handing it back to the lender; and
- even if there is no default, the lender is exposed to the changes in the value of the underlying property.

In other facts and circumstances – e.g. where the option exercise price is trivial – a different analysis may apply. Judgement is required when making this assessment. A company may need to consider additional factors in more complex arrangements.

10

Investment property

It is mandatory rather than optional for landlords to apply IAS 40 to account for leased investment property, requiring landlords to disclose fair value information for all leased investment property.

IAS 40.2, 30, IFRS 16.48, 56

IFRS 16.34, 56, IAS 40.30

A company applies IAS 40 to account for a right-of-use asset if the underlying asset would otherwise meet the definition of investment property.

Under IAS 40, a company chooses as its accounting policy either the fair value model or the cost model for measuring its investment property. The company applies the policy to all of its investment property – i.e. it applies the same policy to owned and leased investment property. However, in either case the company complies with the disclosure requirements of IAS 40 – including disclosures of the fair value of the investment property.

If a lessor enters into an operating lease of investment property, then it continues to recognise the investment property. In contrast, if a lessor enters into a finance lease of investment property, then it derecognises the investment property and instead recognises a net investment in the lease, which is accounted for under IFRS 16.

IFRS 16.B58

An intermediate lessor classifies a sub-lease as a finance lease or an operating lease with reference to its right-of-use asset under the head lease rather than the underlying asset – see [Chapter 8](#).



How does the accounting for leased investment property differ under IFRS 16?

IFRS 16 contains important guidance for investment property companies that hold leasehold interests, as is common in the UK, Hong Kong, some parts of the Middle East and elsewhere. There are two key differences from the previous requirements in IAS 17 and IAS 40.

- *The election becomes a requirement:* Previously, a company could elect on a property-by-property basis to recognise investment property held under an operating lease on-balance sheet. Now, all leasehold property will be on-balance sheet, and treated as investment property if the definition of investment property is met.
- *There is a choice of valuation basis:* Previously, if a company elected to recognise investment property held under an operating lease on-balance sheet, then it was required to apply the fair value model to all of its investment property. Now, a company has a free choice over whether to apply the cost or fair value model to its investment property.

This new guidance may also affect companies that do not think of themselves as investment property companies. For example, a company that is managing a portfolio of leasehold properties following a restructuring or change in business model – e.g. a retailer or bank that has reduced its number of stores/branches as its business moves online – will need to assess whether each property meets the definition of investment property. If so, then the company will be required to prepare a valuation of the property, either for inclusion in its statement of financial position or for disclosure, depending on its accounting policy choice.



Are there special rules for accounting for right-of-use assets classified as investment property?

No. A right-of-use asset classified as investment property is measured:

- *on initial recognition*: under IFRS 16 – i.e. at the present value of the future lease payments, adjusted for any lease payments made on or before lease commencement (e.g. initial direct costs); and
- *on subsequent measurement*: under IAS 40 – i.e. under either the cost model or the fair value model, consistent with the landlord's accounting policy for other investment property (subject to very limited exceptions when fair value cannot be measured reliably).

After initial recognition, the general IAS 40 guidance on transfers and redevelopment, for example, applies equally to owned and leased investment property.



How does a landlord apply the fair value model to a right-of-use asset?

A landlord that applies the fair value model for investment property applies that model to owned and leased investment property. In the case of leased investment property, the landlord measures the fair value of its right to use the underlying asset, not the underlying asset itself.

When measuring the fair value of leased investment property, a company needs to consider rental income from current leases. In addition, care is needed to ensure that the landlord's obligation to make payments to the head lessor (owner) of the underlying asset is neither ignored nor double-counted when valuing and presenting investment property in the statement of financial position.

One common approach is to obtain a valuation of the landlord's leasehold interest in the underlying asset – that is, the amount that a market participant would pay to:

- acquire the right to receive rental income over the remaining term of the landlord's leasehold interest, including rental income under current leases and expected rental income under future new leases that a market participant would expect to enter into subsequently; and
- assume the obligation to pay rentals to the head lessor (owner) of the underlying asset.

Taking a very simple example, suppose the landlord has obtained a valuation of its leasehold interest of 50 and has calculated that its lease liability measured under IFRS 16 is 25. In this case, the landlord would present in its statement of financial position:

- a right-of-use asset, presented as investment property and measured at 75 (50 + 25); and
- a lease liability, presented with other lease liabilities and measured at 25 under IFRS 16.

Appendix I – IFRS 16 at a glance

Topic	Key facts
Lease definition	<ul style="list-style-type: none"> – New lease definition with an increased focus on control over the use of the underlying asset
Lessee accounting model	<ul style="list-style-type: none"> – Single lease accounting model – No lease classification test – Most leases on-balance sheet: <ul style="list-style-type: none"> – lessee recognises a right-of-use asset and lease liability – treated as the purchase of an asset on a financed basis
Lessor accounting model	<ul style="list-style-type: none"> – Dual lease accounting model for lessors – Lease classification test based on IAS 17 <i>Leases</i> classification criteria – Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset – Operating lease accounting model based on IAS 17 operating lease accounting
Practical expedients and targeted reliefs	<ul style="list-style-type: none"> – Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under IFRS 16 is 12 months or less and that do not contain a purchase option – Portfolio-level accounting permitted for leases with similar characteristics if the effect on the financial statements does not differ materially from applying the requirements to individual leases – Optional lessee exemption for leases of low-value items – e.g. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate
Effective date	<ul style="list-style-type: none"> – Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 <i>Revenue from Contracts with Customers</i> is also adopted – Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

Appendix II – Comparison with US GAAP

Key aspects of the IFRS® Standards and US GAAP versions of the new leases standard are converged. However, there are a number of differences between the two versions of the standard.

The following table summarises the key differences impacting landlords.

Topic	IFRS 16	US GAAP standard
Lessor classification	<p>A lessor classifies each lease as either an operating or a finance lease.</p> <p>IFRS 16 includes a series of indicators that individually or in combination normally lead to classification as a finance lease. Ultimately, the lease classification is based on an overall assessment of whether substantially all of the risks and rewards incidental to ownership of the asset have been transferred from the lessor to the lessee.</p> <p>A ‘finance lease’ is a lease that transfers substantially all of the risks and rewards incidental to ownership of an underlying asset; title to the asset may or may not transfer under such a lease. IFRS 16 does not have different types of finance leases. However, there is specific guidance for manufacturer or dealer lessors.</p> <p>An ‘operating lease’ is a lease other than a finance lease.</p> <p>The classification of a lease is determined at its inception and is not revised unless the lease is modified and that modification is not accounted for as a separate lease.</p>	<p>Unlike IFRS 16, a lessor classifies each lease as an operating lease, sales-type lease or direct financing lease.</p> <p>Unlike IFRS 16, the classification is determined by a series of fail/pass tests and each one is determinative, such that a met criterion cannot be overridden by an assessment of other factors or qualitative considerations. Also unlike IFRS 16, the ‘lease term’ and ‘lease payments’ criteria may be evaluated using ‘bright-line’ thresholds under US GAAP.</p> <p>Unlike IFRS 16, lessors have to determine which of the two types of finance lease an arrangement is – sales-type or direct financing. The population of ‘sales-type’ and ‘direct financing’ is generally equivalent to the population of finance leases under IFRS 16. However, US GAAP distinguishes between leases that:</p> <ul style="list-style-type: none"> – effectively transfer control (i.e. the ability to direct the use and obtain substantially all of the remaining benefits) of the underlying asset to the lessee (sales-type leases); and – transfer substantially all of the risks and rewards incidental to ownership of an underlying asset to the lessee and one or more third parties unrelated to the lessor (direct financing leases). <p>An ‘operating lease’ is a lease other than a sales-type or direct financing lease, like IFRS 16.</p> <p>Unlike IFRS 16, when title to the asset transfers by the end of the lease term, the lease is a sales-type lease.</p> <p>Unlike IFRS 16, the classification of a lease is determined at its commencement. Like IFRS 16, the classification is not revised unless the lease is modified and that modification is not accounted for as a separate lease.</p>

Topic	IFRS 16	US GAAP standard
Classification issues related to land	A lease of land is classified as an operating or finance lease with reference to the general indicators used for lease classification. However, the fact that the lease term is normally shorter than the economic life of the land does not necessarily mean that a lease of land is always an operating lease. Ultimately, as for any other lease, the lease classification is based on an overall assessment of whether substantially all of the risks and rewards incidental to ownership of the asset have been transferred from the lessor to the lessee.	A lease of land is classified with reference to the same pass/fail tests as other assets, which differ in some respects from IFRS 16. Like IFRS 16, the fact that land normally has an indefinite economic life will influence the analysis; however, unlike IFRS 16, that influence only extends to the 'lease term' criterion – it does not factor into any overriding assessment of a principle as it does under IFRS 16.
Accounting for finance leases	A finance lessor may recognise a gain or loss on commencement of a finance lease. However, only a manufacturer or dealer lessor recognises revenue and cost of sales.	<p>Unlike IFRS 16, any selling profit in a direct financing lease is recognised as a reduction in the measurement of the net investment in the lease, and is instead recognised over the lease term. Any selling loss is recognised at lease commencement, like IFRS 16.</p> <p>In addition, unlike IFRS 16, there is specific guidance on collectability that may affect the timing of recognition of income for a sales-type lease and require classification of a lease as operating that would otherwise be classified as direct financing.</p>
Accounting for operating leases	Initial direct costs incurred by the lessor are added to the carrying amount of the underlying asset. These initial direct costs are recognised as an expense on the same basis as the lease income.	<p>Like IFRS 16, initial direct costs incurred by the lessor are deferred and recognised over the life of the lease. Unlike IFRS 16, initial direct costs are recognised as a separate asset (not included in the carrying amount of the underlying asset).</p> <p>In addition, unlike IFRS 16, there is specific guidance on collectability that may result in operating lease income being recognised on a cash basis rather than on a straight-line basis.</p>
Lease and non-lease components	A lessor always separates lease and non-lease components and allocates the consideration in the contract under the requirements of the revenue standard – i.e. according to the stand-alone selling prices of the goods and services included in each component.	<p>Unless the practical expedient discussed below is elected, a lessor separates lease and non-lease components and allocates the consideration in the contract under the requirements of the revenue Codification Topic, like IFRS 16 – i.e. according to the stand-alone selling prices of the goods and services included in each component.</p> <p>Unlike IFRS 16, a lessor may elect, by class of underlying asset, not to separate lease components from any associated non-lease components and instead account for them as a single component if:</p> <ul style="list-style-type: none"> – the non-lease component(s) would otherwise be accounted for under the revenue Codification Topic;

Topic	IFRS 16	US GAAP standard
Lease and non-lease components (continued)		<ul style="list-style-type: none"> – the timing and pattern of transfer for the lease component and non-lease component(s) are the same; and – the lease component, if it were accounted for separately, would be classified as an operating lease. <p>If the practical expedient has been elected and a contract includes multiple non-lease components, then the lessor combines the non-lease component(s) that meet the criterion with the lease component and separates any non-lease components that do not.</p> <p>If the non-lease component(s) is (are) the predominant component, then the lessor should account for the combined component as a single performance obligation under the revenue standard.</p>
Modifications	There is specific guidance on accounting for lease modifications by lessors.	There is specific guidance on accounting for lease modifications by lessors, which differs in some respects from IFRS 16.
COVID-19 rent concessions	<p>IFRS 16 was amended in May 2020 to introduce an optional practical expedient that allows lessees not to assess whether eligible COVID-19-related rent concessions are lease modifications, and instead to account for them as if they were part of the original contract if all the following conditions are met:</p> <ul style="list-style-type: none"> – the revised consideration is substantially the same as or less than the original consideration; – any reduction in lease payments relates to payments originally due on or before 30 June 2021; and – no other substantive changes have been made to the terms of the lease. <p>The practical expedient does not apply to lessors.</p>	<p>The FASB staff has provided similar practical relief to lessees and lessors under US GAAP.</p> <p>Lessees and lessors may elect not to assess whether COVID-19-related rent concessions were required under the original contract, and instead account for those rent concessions either (1) as if they were required under the original contract, or (2) as lease modifications. The practical expedient is available when the changes to the lease do not result in a substantial increase to the rights of the lessor or the obligations of the lessee.</p> <p>Unlike IFRS 16, the practical expedient:</p> <ul style="list-style-type: none"> – applies to both lessees and lessors; and – does not require either (1) that the concession be a direct consequence of COVID-19 (merely that it be related to COVID-19) or (2) that any reduced payments be only through 30 June 2021.
Sub-leases	An intermediate lessor classifies a sub-lease with reference to the right-of-use asset arising from the head lease. Therefore, a ‘head-lessor’ might account for a head lease as an operating lease, but an intermediate lessor entering into a sub-lease on largely back-to-back terms might account for the sub-lease as a finance lease.	Unlike IFRS 16, an intermediate lessor classifies a sub-lease with reference to the underlying asset. This means that more sub-leases will be classified as operating leases by intermediate lessors applying US GAAP.

Topic	IFRS 16	US GAAP standard
Sale-and-leaseback	<p>In a sale-and-leaseback transaction, the seller-lessee first determines whether the buyer-lessor obtains control of the asset based on the revenue standard.</p> <p>If the seller-lessee has a substantive option to repurchase the underlying asset, then the transfer is not a sale.</p> <p>If the transaction does not qualify for sale accounting, then it is accounted for as a financing.</p>	<p>Like IFRS 16, in a sale-and-leaseback transaction the seller-lessee first determines whether the buyer-lessor obtains control of the asset based on the revenue Codification Topic.</p> <p>Unlike IFRS 16, additional considerations apply if there is a seller-lessee repurchase option for an underlying asset that is not real estate. However, a seller-lessee repurchase option involving real estate always results in a failed sale/purchase.</p> <p>Unlike IFRS 16, if the leaseback would be classified as a finance lease by the seller-lessee, then sale recognition is precluded.</p> <p>Like IFRS 16, if the transaction does not qualify for sale accounting, then it is accounted for as a financing. However, differences arise from the application of the financial instruments standards.</p>

Appendix III – List of examples

Title	Section
Example 1 – Lease of office space	3.3
Example 2 – Capacity portion is an identified asset	3.3
Example 3 – Capacity portion is not an identified asset	3.3
Example 4 – Substitution right: Retail space	3.3
Example 5 – Multiple lease components: Separation criteria met	4.2
Example 6 – Multiple lease components: Land and building: Separation criteria not met	4.2
Example 7A – Classification of land and building: No separation	4.2
Example 7B – Classification of land and building: Separation required	4.2
Example 8 – Property taxes reimbursed by the occupier	4.4
Example 9 – Landlord allocation to lease and non-lease components based on the lease term	4.5
Example 10 – Landlord’s allocation: Variable payments allocated between all components	4.6
Example 11 – Allocation of property taxes	4.6
Example 12 – Impact of termination rights on enforceable period	5.3
Example 13 – Termination rights: No more than an insignificant penalty	5.5
Example 14 – Renewable lease: More than an insignificant penalty	5.5
Example 15 – No stated terms	5.5
Example 16 – Date of the change in the non-cancellable period	5.6
Example 17 – Landlord accounting: Percentage rent in a real estate	6.3
Example 18 – Landlord modifications to operating leases	7.2
Example 19 – Decrease in scope and consideration: Lease modification	7.3
Example 20 – Unamortised lease incentive: Lease modification	7.3
Example 21 – Termination/break of the lease not included in original contract	7.3

Title	Section
Example 22 – Deferral of lease payments not a lease modification	7.4
Example 23 – Modification that is a separate lease	7.5
Example 24 – Modification that is not a separate lease and lease would have been classified as an operating lease	7.5
Example 25 – Sub-lease classified as a finance lease with reference to the right-of-use asset in the head lease	8
Example 26 – Buyer-landlord accounting for a sale-and-leaseback transaction when transfer is a sale	9
Example 27 – Buyer-landlord accounting for a sale-and-leaseback transaction when transfer is not a sale	9


Keeping in touch

Follow 'KPMG IFRS' on LinkedIn or visit home.kpmg/ifrs for the latest news.


Whether you are new to IFRS Standards or a current user, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists.




IFRS Today
Blogs, podcasts and videos



News



IFRS app



KPMG IFRS on LinkedIn




Toolkit


Insights into IFRS®
Helping you apply IFRS Standards to real transactions and arrangements




Guides to financial statements
Illustrative disclosures and checklists




Newly effective standards web tool




IFRS compared to US GAAP



Q&A: Fair Value Measurement

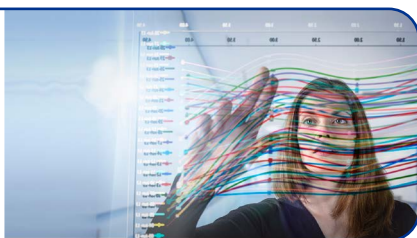


COVID-19 financial reporting resource centre



Handbooks

Earnings per share



Leases



Revenue



Share-based payments



Other in-depth analysis

Business combinations and consolidation



Combined and/or carve-out financial statements



Banks



Financial instruments



Forthcoming requirements and future developments

Better communication in financial reporting



IBOR reform



Insurance contracts



Sustainability reporting



For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG Accounting Research Online. This web-based subscription service is a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 30-day trial, go to aro.kpmg.com and register today.

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

This edition considers the requirements of IFRS 16 *Leases* published by the Board in January 2016 and amended in May 2020.

The text of this publication refers to IFRS 16 and to selected other current standards in issue at 30 November 2020.

Further analysis and interpretation will be needed for a company to consider the impact of IFRS 16 in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change. Accordingly, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

Acknowledgements

We would like to acknowledge the efforts of the following current and former members of the KPMG International Standards Group, who were the principal authors of this publication: Anushree Agrawal, Sashank Gopalswani, Ed Haygarth, Sylvie Leger, Mostafa Mouit, Brian O'Donovan and Sinead Slattery.

We would also like to thank the members of the KPMG global IFRS leases topic team for their contribution:

Kimber Bascom (leader)	US
Archana Bhutani	India
Judit Boros	Hungary
Yen San Chan	Singapore
Úna Curtis	Ireland
Jake Green	UK
Scott Muir	US
Brian O'Donovan (deputy leader)	UK
Emmanuel Paret	France
Marcio Rost	Brazil
Volker Specht	Germany
Patricia Stebbens	Australia
Mag Stewart	Canada
Alwyn Van Der Lith	South Africa
Beth Zhang	China

home.kpmg/ifrs

Publication name: *Real estate leases – The landlord perspective*

Publication number: 135807

Publication date: December 2020

© 2020 KPMG IFRG Limited, a UK company, limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

KPMG International Standards Group is part of KPMG IFRG Limited.

KPMG refers to the global organization or to one or more of the member firms of KPMG International Limited ("KPMG International"), each of which is a separate legal entity. KPMG International Limited is a private English company limited by guarantee and does not provide services to clients. For more detail about our structure please visit <https://home.kpmg/xx/en/home/misc/governance.html>

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

This publication contains copyright © material and trademarks of the IFRS® Foundation. All rights reserved. Reproduced by KPMG IFRG Limited with the permission of the IFRS Foundation. Reproduction and use rights are strictly limited. For more information about the IFRS Foundation and rights to use its material please visit www.ifrs.org.

Disclaimer: To the extent permitted by applicable law the Board and the IFRS Foundation expressly disclaims all liability howsoever arising from this publication or any translation thereof whether in contract, tort or otherwise (including, but not limited to, liability for any negligent act or omission) to any person in respect of any claims or losses of any nature including direct, indirect, incidental or consequential loss, punitive damages, penalties or costs.

Information contained in this publication does not constitute advice and should not be substituted for the services of an appropriately qualified professional.

'IFRS®', 'IASB®', 'IFRIC®', 'IFRS for SMEs®', 'IAS®' and 'SIC®' are registered Trade Marks of the IFRS Foundation and are used by KPMG IFRG Limited under licence subject to the terms and conditions contained therein. Please contact the IFRS Foundation for details of countries where its Trade Marks are in use and/or have been registered.