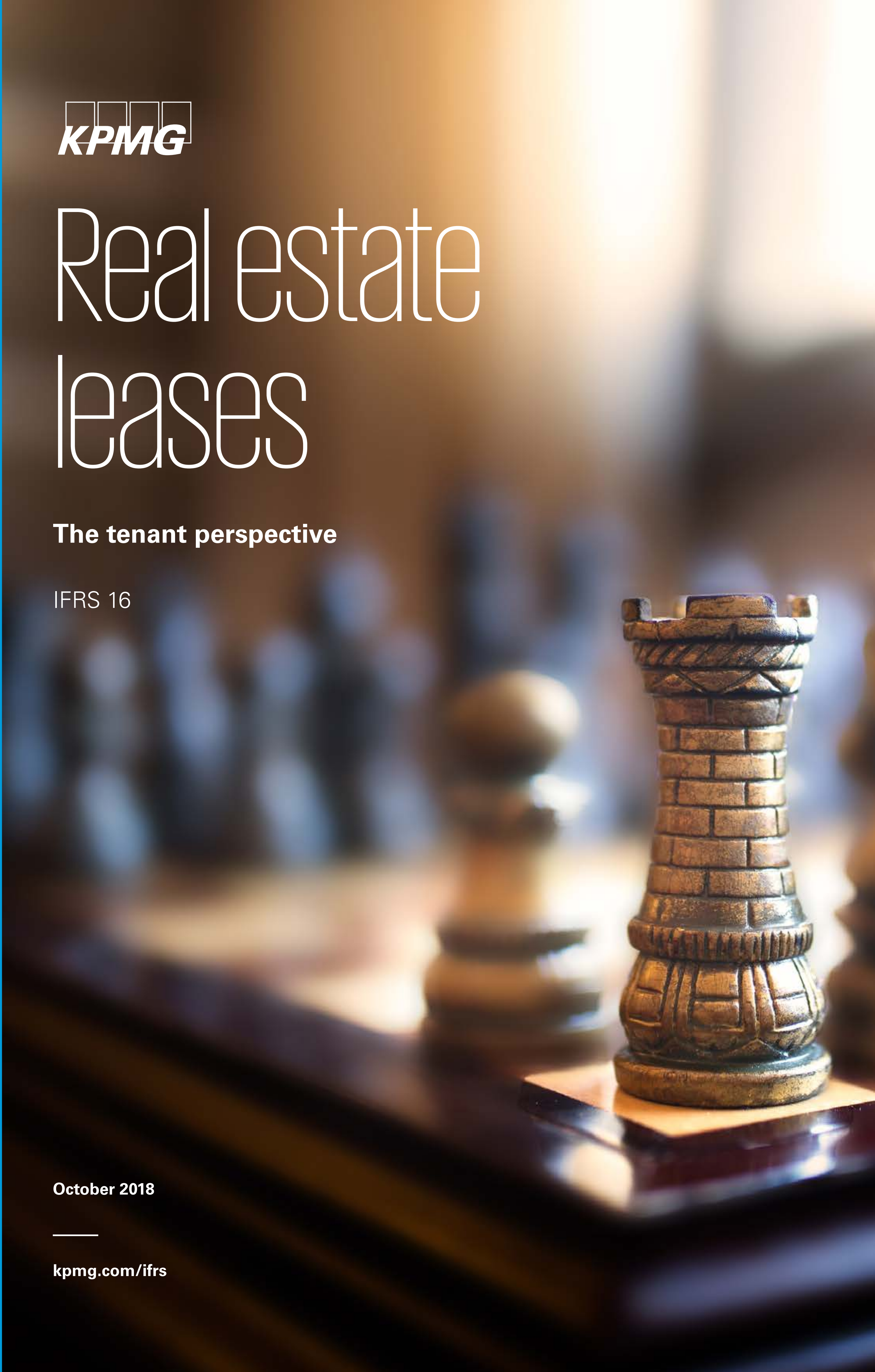

KPMG

Real estate leases

The tenant perspective

IFRS 16

October 2018

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The tenant perspective

Real estate leases will be at the heart of many IFRS 16 implementation projects. They are the 'big-ticket' leases that almost every business has, from retailers to banks to media companies.

Real estate leases pose many practical accounting challenges for tenants – the underlying asset has a high value, lease terms can be long, discount rates can be complex to determine, the leases often contain multiple options and rent adjustment mechanisms, and the contracts can contain lease and non-lease components.

On top of these challenges, tenants will find that the new standard significantly changes how they account for their real estate leases, impacting many key financial ratios.

A successful implementation project will therefore require a good working understanding of the new standard, and of the contracts themselves.

This publication covers key areas of the standard that are particularly relevant to tenants 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 landlord's perspective is coming soon. More in-depth guidance on particularly complex areas of the new standard, such as discount rates and transition, is available at kpmg.com/ifrs16.

In the meantime, we hope this publication will help you apply the new standard to your real estate leases.

Kimber Bascom
Ramon Jubels
Sylvie Leger
Brian O'Donovan
KPMG's global IFRS leases leadership team
KPMG International Standards Group

1 At a glance

The new standard significantly changes how a tenant accounts for its real estate leases, impacting many key ratios.

1.1 Key impacts – Financial ratios

Under the new standard, a tenant brings its real estate leases on-balance sheet, including those previously classified as operating leases under IAS 17 *Leases.* The only exception will be real estate leases that qualify for the short-term recognition exemption.

Many financial ratios will be impacted by the adoption of the new standard, with many very sensitive to inputs such as the discount rates used.

To illustrate, a tenant with an IAS 17 operating lease with regular, fixed lease payments will experience the following impacts on its key financial ratios when applying the new standard.

Ratio	Impact of bringing an operating lease with fixed rents on-balance sheet	
Gearing/leverage	↑	Higher, due to recognition of lease liabilities for the first time
Asset turnover	↓	Lower, because right-of-use assets will be recognised for the first time and therefore total assets will be higher
Current ratio	↓	Lower, because the current portion of the lease liability will be higher
Operating profit/ earnings before interest and tax (EBIT)	↑	Higher, because depreciation will be lower than the lease expense recognised under IAS 17
Earnings before interest, tax, depreciation and amortisation (EBITDA)	↑	Higher, due to the elimination of rent expense. Lease payments will be reflected as depreciation expense and interest expense
Interest cover	↓	Lower, because the increase in EBIT will be proportionally much lower than the increase in interest expense

1.2 Key considerations

Identifying all lease agreements and extracting lease data. Tenants will now recognise most leases on-balance sheet. This may require a substantial effort to identify all leases with payments that should be included in the lease liability, and whether they need to be subsequently reassessed for changes in lease payments.

New estimates and judgements. The new standard introduces new estimates and judgements that affect the measurement of lease liabilities. A tenant determines the liability at the commencement date and may be required to revise it – e.g. the assessment of whether an option is reasonably certain to be exercised (or not exercised). This will require ongoing monitoring and increase financial statement volatility.

Balance sheet volatility. The new standard introduces financial statement volatility to gross assets and liabilities for tenants, because of the requirement to reassess certain key estimates and judgements at each reporting date. This may impact a tenant's ability to accurately predict and forecast results and will require ongoing monitoring.

Changes in contract terms and business practices. To minimise the impact of the new standard, some tenants may wish to reconsider certain contract terms and business practices – e.g. changes in the structuring or pricing of a lease agreement, including the type of variability of lease payments and the inclusion of options in the contract. The new standard is therefore likely to affect departments beyond financial reporting – including treasury, tax, legal, procurement, real estate, budgeting, sales, internal audit and IT.

New systems and processes. Systems and process changes may be required to capture the data necessary to comply with the new requirements. New calculations and review processes will be needed to measure the lease liability at commencement and to subsequently identify when a lease needs to be reassessed and remeasured to reflect changes in lease payments.

Transition considerations. A key early decision is how to make the transition to the new standard. The extent of information required by tenants in 2019 will depend on the transition approach chosen – e.g. under a modified retrospective approach, if the lessee elects to measure the right-of-use asset at an amount equal to the lease liability, then historical information is not needed because liabilities for operating leases are measured based on remaining lease payments, and finance leases remeasured at the carrying amount of the lease liability under IAS 17.

Careful communication with stakeholders. Investors and other stakeholders will want to understand the new standard's impact on the business. Areas of interest may include the effect on financial results, the costs of implementation and any proposed changes to business practices.

Sufficient documentation. The judgements, assumptions and estimates applied in determining how to measure the lease liability at the commencement date, as well as on reassessment, will need to be documented.

2 Lease definition

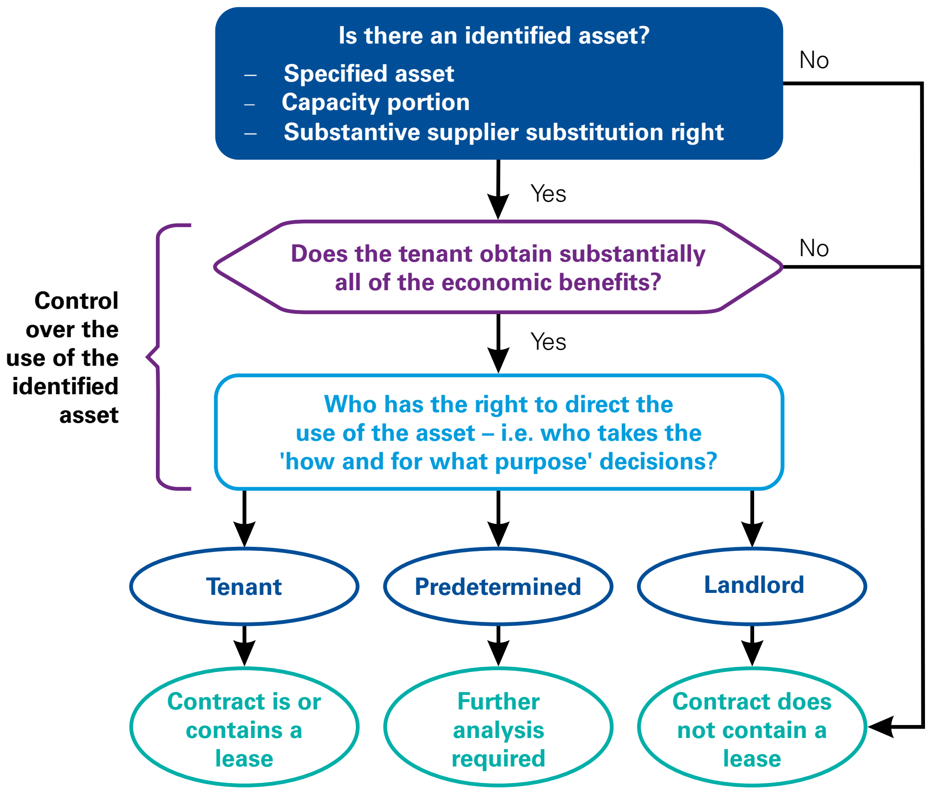
Identifying a lease of real estate is usually straightforward – but some scenarios will require judgement.

2.1 Overview

IFRS 16.A, B9

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. If a contract contains a lease, then it will generally be on-balance sheet for the lessee.

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



2.2 Applying the definition model 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.

Reference	Consideration	Criteria usually met in real estate arrangements?	
IFRS 16.B13, BC111	**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.
IFRS 16.B20	**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.
IFRS 16.B14–B19, BC112–BC115	**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.
IFRS 16.B21–B23	**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.
IFRS 16.B24–B30	**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. 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. For example, the 'how and for what purpose' decisions for a property used to house a factory, or a kitchen in a football stadium, may require closer analysis.

IFRS 16.A

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

IFRS 16.B14–B15

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

What if the tenant has the right to use the property 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). V 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 out to a different retailer, which sells equipment for winter sports.

In this situation, the period of use consists of 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 part of the definition of a lease 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.

2.3 Typical real estate arrangements

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

Example 1 – Lease of office space

Lessee M leases two floors of an office building from Lessor W.

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).

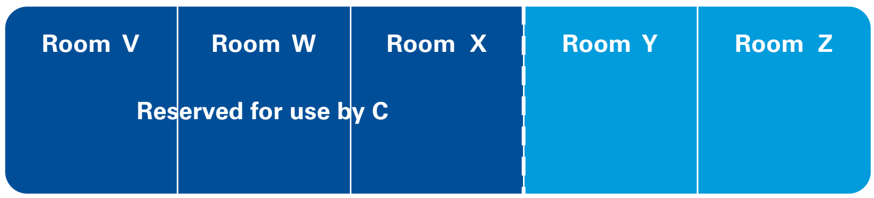
In this scenario, there is a lease. This is because:

- 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

Customer C enters into an arrangement with Supplier S 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:

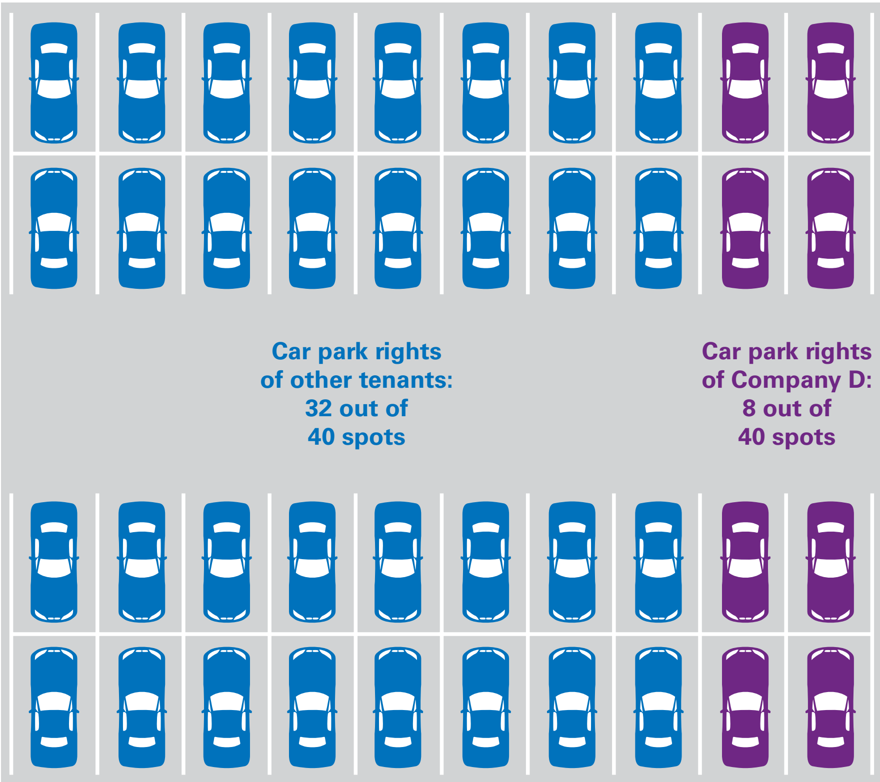
- the rooms are explicitly specified in the contract;
- the rooms are physically distinct from the other storage locations within the warehouse; and
- S has no substitution rights.

To complete its assessment of whether there is a lease, C then considers whether it obtains substantially all of the economic benefits from the use of Rooms V, W and X, and who has the right to direct the use of them.

Example 3 – Capacity portion is not an identified asset

Company D occupies one floor of an office building, which it leases from Landlord E. 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 a 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



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

However, in the case of the car park there is not an 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 meets the substantially all criterion.

By contrast, if D entered into an arrangement with E for 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, D then considers whether it obtains substantially all of the economic benefits from the use of the eight car spaces, and who has the right to direct the use of them.

Example 4 – Substitution right: Retail space

Company P owns a large shopping centre. Customer M enters into a contract 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.

IFRS 16.B16

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 unlikely to occur.

Is there a lease when you buy a leasehold property?

Long-term leases of land (sometimes known as 'ground leases') and/or buildings are common in many jurisdictions.

They are often referred to as 'sales' of leasehold property (land and building, or land only) and are set for long periods of time – e.g. 99 or 999 years. The difference between purchasing a property and purchasing a leasehold property is as follows.

– In an outright sale of a property, the buyer becomes the legal owner of the building and the land.
– In a 'sale' of a leasehold property, the buyer becomes the tenant. Once the leasehold period runs out, ownership of the entire property will revert back to the property owner. Subject to some restrictions, the tenant can sell its interest in the leasehold during the leasehold period.

Depending on the jurisdiction, the tenant may obtain the right to use the real estate in exchange for:

– lease payments paid throughout the leasehold period; or
– a single up-front lease payment.

Although in some cases such long-term leases may be economically similar to the purchase of land, leasehold arrangements will generally meet the definition of a lease under the new standard.

2.4 Recognition exemptions

IFRS 16.5–8

In general, as a practical expedient, a lessee can elect not to apply the lessee accounting model to:

Short-term leases

≤ 12 months

Leases of low-value items

≤ USD 5,000 for example

IFRS 16.B34

IFRS 16.B3–B8

Recognition exemption	Applicable for real estate arrangements?	
Short-term	✔	Generally, only in the following circumstances: – the lease term is 12 months or less; – on transition, the remaining lease term is 12 months or less; or – both the tenant and the landlord can terminate the lease within 12 months without permission from the other party and with no significant penalty. The consideration of 'penalty' may require significant judgement (see 5.1.1 and Example 12). If elected, a tenant applies this exemption by class of underlying asset.
Low value	✘	No. Real estate is not typically of low value when it is new.

See our Lease definition publication for more guidance on identifying whether a contract contains a lease.

3 Separating components of a contract

Many real estate leases contain several lease and non-lease components. Tenants need to know how to identify and account for them.

3.1 Overview

IFRS 16.12, 15, BC135(b)

In practice, 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, provision of utilities etc.

The new standard generally requires a tenant to separate the lease and non-lease components of a contract.

However, as a practical expedient a tenant can elect, by class of underlying asset, not to separate lease components from any associated non-lease components. A tenant that makes this election accounts for the lease component and associated non-lease component as a single lease component.

Judgement may be needed when determining which lease component each non-lease component is associated with, and there may be scenarios in which a non-lease component needs to be allocated between multiple lease components.

Step 1 – Identify the component(s)

IFRS 16.B32–B33

A tenant 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.

Fees for activities or costs that transfer goods or services to the tenant – e.g. maintenance, cleaning and utilities – are separate non-lease components.

Charges for administrative tasks or other costs associated with the lease that do not transfer a good or service to the tenant do not give rise to a separate component. However, they are part of the total consideration that the tenant allocates to the identified components.

Right to use an office building	Cleaning and maintenance services	Property taxes and insurance
Lease component	Non-lease components	Not a component

Step 2 – Account for the component(s)

IFRS 16.13–14, 16, BC137

Tenants allocate the consideration in the contract to the identified components based on the relative stand-alone prices of the lease components and the aggregate of the non-lease components, and account for non-lease components in accordance with the applicable accounting standards.

Tenants determine the relative stand-alone prices of lease and non-lease components based on the price that a landlord would charge a company for a similar component separately.

If an observable stand-alone price is not readily available, then the tenant estimates the stand-alone price of the components by maximising the use of observable information. Some tenants may find it useful to request this information from their landlord.

3.2 Typical components in real estate contracts

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

Example 5 – Multiple lease components: Land and building

IFRS 16.B32

Company T leases an entire office building from Company Q for 25 years. There are no non-lease components in the contract.

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 concludes that there is only one lease component in the contract because:

- it 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.

In this scenario, T recognises a single lease liability with a corresponding right-of-use asset.

However, if the perimeter of the lease 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 another component for the adjacent land.

IFRS 16.47(a)(i)

In this modified scenario, T would recognise a single lease liability, discounted using a single discount rate. In its statement of financial position, T could either present:

- its right-of-use assets separately from other assets; or
- the right-of-use asset for this lease as two separate components: within the 'land' and 'building' line items.

Example 6 – Non-lease component: Common area maintenance

Lessee L enters into a three-year lease of an apartment. The apartment is in a multi-tenant building that includes shared facilities – e.g. a swimming pool and garden.

In addition to the monthly lease payments, the contract includes an additional fee of 2,000 per quarter for the upkeep of the communal areas, maintenance and security – i.e. common area maintenance (CAM). This fee does not cover costs for non-routine and 'major' maintenance, which are billed to tenants separately.

At commencement, the timing and extent of the landlord's performance of CAM is unknown (e.g. because it's difficult to predict how many repairs will be needed). However, the landlord has committed to keep the building and common areas well maintained.

IFRS 16.IE4

L determines that the CAM is a separate non-lease component because it transfers a good or service to L other than the right to use the apartment. That is, L receives a service that it would otherwise have to pay for separately (e.g. if its plumbing required repairs).

IFRS 16.15–16

To account for the fixed quarterly charge for the CAM, L can either:

- separate it from the lease payments, exclude it from the lease liability and expense it as it is incurred; or
- apply the practical expedient and include it in the lease liability.

Example 7 – Applying the practical expedient to combine lease and non-lease components

Lessee B enters into a five-year lease of an office building. The lease payments are 10,000 per year and the contract includes an additional water charge calculated as 0.005 per litre consumed.

IFRS 16.15, 38(b)

Payments are due at the end of the year. B elects to apply the practical expedient to combine lease and non-lease components.

At the commencement date, B measures the lease liability as the present value of the fixed lease payments (i.e. five annual payments of 10,000). Although B has elected to apply the practical expedient to combine non-lease components (i.e. water charges) with the lease component, B excludes the non-lease component from its lease liability because they are variable payments that depend on usage. That is, the nature of the costs does not become fixed just because B has elected not to separate them from the fixed lease payments. B recognises the payments for water – *as a variable lease payment* – in profit or loss when they are incurred.

In contrast, if B does not elect to apply the practical expedient to combine lease and non-lease components, then it recognises the payments for water – *as an operating expense* – in profit or loss when they are incurred.

What are the consequences of applying the practical expedient?

Applying the practical expedient for tenants not to separate non-lease components from lease components has the potential to reduce cost and complexity in some cases. However, tenants will also need to consider the accounting consequences of applying it.

Some tenants may find the balance sheet consequences unattractive. Using this practical expedient may result in recognition by the tenant of a liability for the service component of the contract, which would otherwise remain off-balance sheet until the landlord performs.

At the same time, using the practical expedient will impact the presentation in the statement of profit or loss, with consequential impacts on key ratios. For example, if the CAM is accounted for as a non-lease component, then the tenant will typically recognise the CAM as an operating expense as it is incurred. However, if the CAM is fixed or variable depending on an index or rate and the tenant includes it in the lease payments, then it will not be an operating expense; instead, the entity will in effect recognise additional depreciation of the right-of-use asset and interest expense. In this example, applying the practical expedient increases reported EBITDA.

The practical expedient is an accounting policy choice, to be applied consistently by class of underlying asset. That is, a tenant cannot apply the practical expedient only to leases of office buildings for which it does not have readily available information about non-lease components. The tenant has to apply – or not apply – the practical expedient to all of its leases of office buildings.

3.3 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 for tenants to determine how to account for taxes levied on their 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?

Property owner	Occupier
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 tenant should account for the property taxes as part of the total consideration that is allocated to the separately identified components of the contract. *IFRS 16.B33* If property taxes are determined as a percentage of an 'assessed value' of the property, then reimbursements thereof are typically variable payments that *do not* depend on an index or rate (see 6.3.1).	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 *Levies* (similar to value-added taxes – see Section 6.4).

What if the owner and occupier are jointly liable for property tax?

In some jurisdictions, the owner and occupier 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 owner but, in the event of non-payment, there are legal mechanisms in place that allow the tax authority to demand payment from the occupier.

When both parties are jointly liable, we believe that the tenant should account for the property taxes in the same way as it would if it were solely liable for them – i.e. under IFRIC 21. This is because they are considered to be a tax that is levied on the tenant and are therefore not a lease payment.

Example 8 – Property taxes reimbursed by the occupier

IFRS 16.B33

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

IFRS 16.15

B does not apply the practical expedient to combine lease and non-lease components.

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 lessor for property taxes.

To determine how to account for the property tax, B considers the following.

- Annual lease payments of 100,000 are fixed.
- 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 tax 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, B includes the property tax (i.e. 10,000, calculated as 0.2% of 5 million) in the consideration that it allocates to the lease and non-lease components identified in the contract.

Because the taxes are variable payments that *don't* depending on an index or rate, the portion allocated to the lease component is excluded from the lease liability.

4 Discount rates

Real estate leases will often be the largest that a lessee needs to bring onto its balance sheet, and the impact of the new standard will be very sensitive to inputs such as the discount rate.

4.1 Overview

IFRS 16.26

A tenant discounts the lease payments using the interest rate implicit in the lease if this can be readily determined. Otherwise, the tenant uses its incremental borrowing rate.

The rate implicit in the lease, if readily determinable or **The lessee's incremental borrowing rate**

IFRS 16.A

To determine the rate implicit in the lease, a tenant needs to have information about the lease payments and:

- the unguaranteed residual value;
- the fair value of the underlying asset; and
- any initial direct costs to the landlord.

Due to a lack of information, a tenant will typically be unable to determine the interest rate implicit in the lease – and therefore will use its incremental borrowing rate.

Does a tenant need to determine a discount rate for every lease?

Generally, yes – the tenant needs a discount rate for each lease to which it applies the new lessee accounting model. The tenant uses the discount rate to calculate the present value of the future lease payments.

The only exceptions are as follows.

- If the lease is fully prepaid, such that there are no future lease payments to discount, then the tenant will not need a discount rate. This may be the case in some real estate leases in which the tenant obtains the right to use the real estate in exchange for a single up-front lease payment.

IFRS 16.38(b)

– If the payments made to the landlord are all variable and depend on sales or usage, then the tenant will not need a discount rate. Instead, the tenant will recognise the variable lease payments as an expense as they are incurred. This may be the case for some leases of real estate in the retail sector, in which lease payments depend on the sales of the tenant.

IFRS 16.5

– The tenant will not need a discount rate for leases to which it applies the short-term recognition exemption. In these cases, the tenant generally recognises lease expense on a straight-line basis, similar to current operating lease accounting.

IFRS 16.B1

In addition, a tenant may use a portfolio approach and determine a single discount rate for a portfolio of its property leases with similar characteristics. This is permitted if the tenant expects that this approach would not differ materially from applying the standard to individual leases.

4.2 Incremental borrowing rates for property

IFRS 16.BC162

Depending on the nature of the underlying asset and the terms and conditions of the lease, a tenant may be able to refer to a rate that is readily observable as an input when determining its incremental borrowing rate for a lease – e.g. a property yield when determining the discount rate to apply to property leases. A tenant adjusts these observable rates as needed to determine its incremental borrowing rate as defined in the new standard.

In practice, a tenant may find that the number and complexity of adjustments make it difficult for them to use property yields as an input to determine the incremental borrowing rate.

By its nature, property generally has significant residual value at the end of the lease. Property values usually increase over time and it is common in some jurisdictions for lease terms to be long – e.g. 99- or 999-year leases. These characteristics make it difficult for property lessees to determine an appropriate discount rate.

How should a tenant adjust an observable rate to derive an incremental borrowing rate?

IFRS 16.BC162

For leases of property, a property yield can be used as an *input* when determining the incremental borrowing rate for property leases.

Property yields reflect the annual return expected on a property. They may be quoted before or after expenses (gross or net yield) and are a function of numerous factors, including but not limited to:

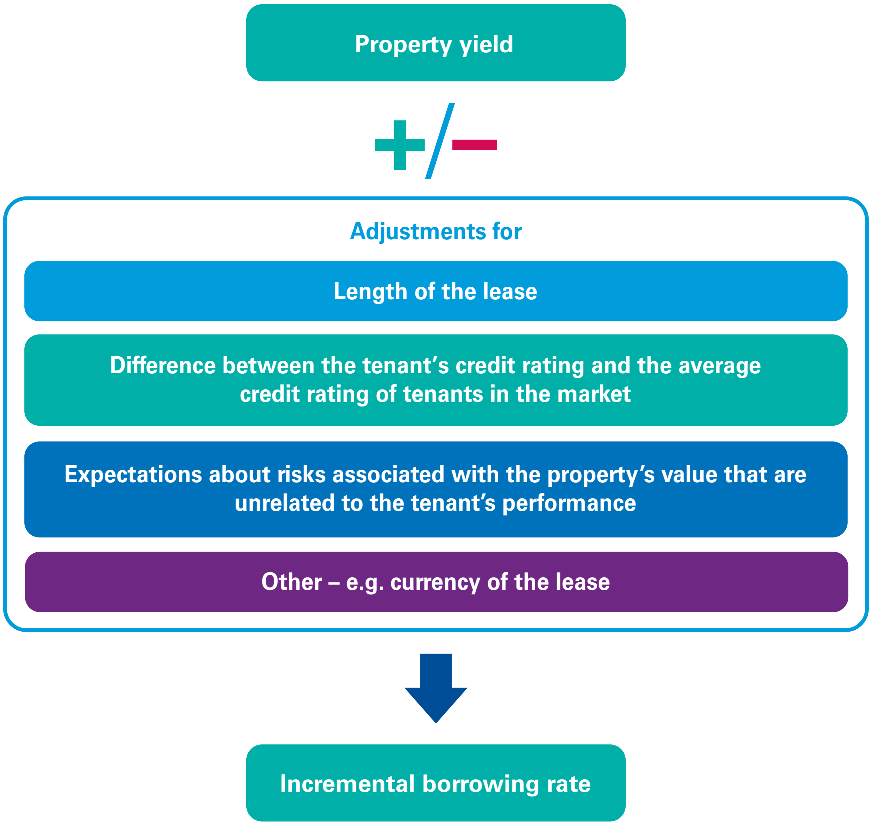
– the market rental rates for the type of property;

– expectations about growth (e.g. a low property yield is often associated with higher rental growth expectations);

– expectations about renovation costs; and

– expectations about the risks associated with the property's value.

These factors indicate that property yields are specific to a particular property. However, property yields do not consider company-specific features that would affect the tenant's incremental borrowing rate – e.g. the length of the lease, the tenant's credit rating etc. Therefore, adjustments to the property yield will be required to determine the tenant's incremental borrowing rate.



As an alternative, it might also be acceptable for a tenant to use its general borrowing rate as an input in determining its incremental borrowing rate. This rate is company-specific (e.g. it includes the tenant's credit rating) but does not consider the features specific to the leased property (e.g. lease term). Therefore, adjustments will be required to determine the tenant's incremental borrowing rate – e.g. adjustments for the lease term, security of an item with the underlying nature of the leased asset, expectations of residual value risk etc.

Will an incremental borrowing rate based on a property yield be higher?

No. In some jurisdictions, property yields are generally higher than borrowing rates and some lessees might prefer to use a property yield as the incremental borrowing rate because this would result in a lower lease liability.

However, if a property yield is used as an input in determining the incremental borrowing rate, then the lessee will need to adjust it as needed (see above) to ensure that the resulting incremental borrowing rate complies with the definition in the new standard. Regardless of whether a property yield is used as an input in determining the lessee's incremental borrowing rate, the incremental borrowing rate cannot exceed the rate that is required by the new standard.

4.3 Loan-to-value restrictions

The definition of incremental borrowing rate indicates that it is the rate that a lessee would have to pay to borrow the funds necessary to obtain an asset of a similar value to the right-of-use asset.

This is similar to a company borrowing funds collateralised or secured by an asset.

In practice, lenders may only provide partial funding for the acquisition of big-ticket assets – e.g. aircraft, ships or buildings. It appears that the incremental borrowing rate should be calculated using a 'blended' or 'weighted' rate at which the lessee would raise finance for 100 percent of the cost of an underlying asset.

Example 9 – Determining the lessee's incremental borrowing rate for big-ticket leases with an LTV ratio

Company B enters into a lease of an entire building. If B were to buy the building, a loan-to-value (LTV) ratio of 80% would apply (i.e. the lender would provide funding for only 80% of the value of the building) and B would finance the remaining 20% of the value by equity.

In this case, B excludes the 20% equity financing from the calculation of the incremental borrowing rate because it does not reflect a rate at which B would have to *borrow* the funds necessary to obtain the asset. Instead, B considers other sources of debt finance for the remaining 20% (e.g. bank loans, overdrafts etc). We believe that B should then determine a blended or weighted rate as follows: (80% × rate for secured borrowing) + (20% × rate for general borrowings).

B should then adjust this rate for other factors (as appropriate) – e.g. the lease term compared with the loan duration, the security's age and quality, and the lessee's credit rating.

Example 10 – Determining the lessee's incremental borrowing rate for big-ticket leases with 100% finance at a premium rate

Modifying Example 9, if Company B were to buy the building then the lender would offer to finance 100% of the cost of a building, but at a premium rate.

B determines its incremental borrowing rate by considering how it would arrange its borrowings in practice. We believe that in this case the incremental borrowing rate would be the lower of:

- the blended or weighted rate described in Example 9: i.e. (80% × rate for secured borrowing) + (20% × rate for general borrowings); and
- the premium rate that a lender would charge if it financed 100% of the purchase of a building.

B should then adjust this rate for other factors (as appropriate) – e.g. the lease term compared with the loan duration, the building's location and condition, and the lessee's credit rating.

See our Leases discount rates publication for more guidance on how to determine the correct discount rate.

5 Lease term

Determining the lease term is a key judgement, requiring careful consideration of options and the facts and circumstances surrounding each lease.

5.1 Overview

5.1.1 Initial assessment

IFRS 16.18, B35

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

– optional renewable periods if the tenant is reasonably certain to extend; and

– periods after an optional termination date if the tenant is reasonably certain not to terminate early.

IFRS 16.B34

A lease is no longer enforceable when the tenant and the landlord each have the right to terminate the lease without permission from the other party and without a significant penalty.

IFRS 16.B37

IFRS 16.B35

When determining the lease term, tenants consider all relevant facts and circumstances that create an economic incentive to exercise options to renew or forfeit options to terminate early. Termination options held only by the landlord are not considered when determining the lease term.

Examples of relevant facts and circumstances

Contractual/market	Asset
– 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	– Nature of item (specialised) – Location – Availability of suitable alternatives – Existence of significant leasehold improvements

Has ‘lease term’ changed under the new standard?

Generally, no. IAS 17 already requires tenants to determine the lease term. However, the significance of this estimate increases under the new standard, because it determines which lease payments are included in the measurement of the lease liability. The new standard also introduces a requirement for tenants to reassess the lease term in certain situations (see 5.1.2), which tenants will need to monitor.

IAS 17.4, IFRS 16.B34–B41

The key threshold (‘reasonably certain’) is the same as under IAS 17 but the new standard provides significantly more guidance on how to apply it – e.g. on identifying economic incentives and when a tenant reassesses the lease term.

5.1.2 Reassessment

IFRS 16.20–21, B41

After the commencement date, in certain circumstances, a tenant reassesses whether it is reasonably certain to exercise an option to extend the lease or not to terminate it early.

A tenant does this only when there has been a significant event or a significant change in circumstances that:

– is within its control; and

– affects whether it is reasonably certain to exercise those options.

The requirement to reassess lease term introduces balance sheet volatility. This may require changes to systems and processes – to enable tenants to identify when a lease needs to be reassessed and remeasured to reflect changes in the lease term.

5.2 Initial assessment of lease term – Common considerations

IFRS 16.18

At commencement, a tenant determines the lease term.

IFRS 16.A, B36

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

The following examples show common considerations for tenants when making their initial assessment of the lease term.

Example 11 – Determining the start of the lease term

IFRS 16.B34

Retailer D leases a shop for 10 years.

The shop could be opened immediately but before moving in, D spends four months installing leasehold improvements so that its design and branding conform with D's other stores. D determines that the leasehold improvements are eligible to be recognised as an item of property, plant and equipment.

Under the lease agreement, D is not required to pay rent until it physically moves into the shop. D can access the shop from 1 January 2020, and plans to open the store from 1 May 2020.

Lease term

IFRS 16.A, B36

The lease term starts when the underlying asset is made available for use. The rent-free period and date of occupation are not relevant. Accordingly, the commencement date of the lease is 1 January 2020.

Depreciation of right-of-use asset

IFRS 16.31–32

D starts depreciating the right-of-use asset from 1 January 2020.

IAS 16.16(b), Insights 3.2.30.80

In our view, depreciation of the right-of-use asset during the fit-out period in this scenario is not directly attributable to bringing the leasehold improvements to the location and condition necessary for their intended use. Accordingly, depreciation during the fit-out period is not capitalised as a part of the leasehold improvements.

Example 12 – Short non-cancellable period, after which the tenant and landlord can both terminate with no more than an insignificant penalty

IFRS 16.B34

Lessee L enters into a five-year lease of a warehouse.

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

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

It appears that the definition of 'penalty' should be applied broadly, and includes economic disincentives to exercise a termination option. To assess whether there are any economic disincentives that may create a 'penalty', L considers the following.

- 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.

Based on the facts and circumstances, L determines that it can terminate the lease without penalty after one year. Assuming that M can also terminate with no more than an insignificant penalty after one year, the lease term consists of the one-year non-cancellable period because there are no enforceable rights and obligations beyond this point.

Example 13 – Lease term when arrangement includes non-consecutive periods of use

Retailer Q sells Christmas decorations. Q enters into a three-year agreement to lease a retail store during the months of October, November and December. Q uses the same store location each year (i.e. there is an identified asset).

The lease payments are 1,000 for each month that Q uses the store.

Lease term

The lease term is nine months – i.e. the sum of the non-consecutive periods of use. Q can choose to apply the short-term recognition exemption to this lease if it has elected to apply the exemption to the same class of underlying asset.

Subsequent accounting

It appears that if Q does not apply the recognition exemption for short-term leases, then it should depreciate the right-of-use asset on a straight-line basis over the periods of use. It should not recognise any depreciation when the store is not used (i.e. during January–September).

IFRS 16.29–32, IAS 16.55

However, we believe that interest is accumulated on the outstanding lease liability over the whole period covered by the contract (i.e. three years).

5.3 Subsequent reassessment of lease term – Common considerations

A tenant revises the lease term for any reassessment of whether it is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease early – e.g. a subsequent installation of significant leasehold improvements may provide a strong incentive for the tenant to exercise an option to renew, which it had previously determined that it was not reasonably certain to do.

IFRS 16.21

A tenant also revises the lease term if there is a change in the non-cancellable period. For example, a tenant determined at commencement that the lease term was the non-cancellable period of five years, considering that it was not reasonably certain to 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 landlord, then it revises the lease term to six years to reflect the new non-cancellable period.

Using a revised discount rate, a tenant remeasures its lease liability when there is a change in the lease term and, generally, makes a corresponding adjustment to the right-of-use asset.

Example 14 – Leasehold improvements and lease term

Retailer W leases a shop from Landlord L.

The lease has a non-cancellable term of five years, and W can renew the lease for a further five years – i.e. the lease has a potential maximum term of 10 years.

Initial assessment at commencement

At lease commencement, W assesses that it is not reasonably certain to exercise the renewal option and therefore determines that the lease term is five years.

Subsequent reassessment of certainty that option will be exercised

During Year 3, W undergoes significant rebranding – changing its logo, colour scheme, target market etc. At this time, W installs significant leasehold improvements. These include a store fascia, shelving and other branded material. Based on its experience at other stores, W believes that these materials have a useful life of 10 years once they are installed, but cannot be repurposed to other stores because they would be damaged in being removed.

IFRS 16.B37(b)

W notes that the leasehold improvements are evidence that it has an economic incentive to renew the lease. W updates its overall assessment and notes that it is now reasonably certain to extend the lease.

Accordingly, W reassesses the total lease term to 10 years – i.e. a remaining lease term of seven years – remeasuring the lease liability using a revised discount rate. W adjusts the remeasurement of the lease liability to the right-of-use asset.

Example 15 – Lessee termination option: Assessing if reasonably certain not to be exercised

Lessee B enters into a 10-year lease of a floor of an office building.

There is no renewal option, but B has the option to terminate the lease early after Year 5 with a penalty equal to three months' rent of 25,000.

The annual lease payments are fixed at 100,000 per annum.

At the commencement date, the building is brand new and is technologically advanced compared with other office buildings in the surrounding business area, and the lease payments are consistent with the market rental rate.

Initial assessment at commencement

At the commencement date, B concludes that it is reasonably certain not to exercise the option to terminate the lease early, and therefore excludes the termination penalty from its lease liability and determines the lease term as 10 years.

Subsequent reassessment of certainty that option will be exercised

During Year 4, B sells a significant component of its business and reduces its headcount by 50%.

At the end of Year 4, similar office buildings in the area that meet B's needs for a smaller workforce are available for lease from Year 6 for annual payments of 55,000. B estimates that the cost to move its workforce would be 40,000.

IFRS 16.20–21

B concludes that the change in circumstance is significant, is within its control and affects whether it is still reasonably certain not to exercise the termination option.

To evaluate whether it is still reasonably certain that it will not terminate the lease early, B compares the future cash outflows as follows.

Year	Existing lease ('000)	New lease ('000)
6	100	120*
7	100	55
8	100	55
9	100	55
10	100	55
Total	**500**	**340**

* *Determined as annual lease (55) + penalty (25) + moving costs (40) = 120.*

B makes an overall assessment of whether it now has an economic incentive to terminate the lease early, including considering the cost saving of moving to a smaller office space.

Because the cost saving of moving to a smaller office space far exceeds the penalty for early termination, at the end of Year 4, B concludes that it is no longer reasonably certain not to exercise the option to terminate early at the end of Year 5. For simplicity, this example ignores the time value of money, but in practice B would consider it when making this assessment.

B includes the termination penalty (25,000) in its lease payments and determines that the remaining lease term has been reduced to one year.

B remeasures its lease liability using a revised discount rate and adjusts the right-of-use asset.

What's the impact of having to reassess the lease term?

IFRS 16.20–21

The requirement to reassess the lease term on the occurrence of a significant event or significant change in circumstance in the tenant's control is an important change from IAS 17. It is no longer possible for companies to compute a lease amortisation schedule at lease commencement and roll that schedule forward at each reporting date. Instead, companies need to reassess key judgements and consider the need to remeasure lease balances each time they report.

Remeasurements during the lease term provide more up-to-date information to users of financial statements. However, they also introduce new volatility in reported assets and liabilities, which may impact the ability to accurately predict and forecast future financial performance. Additional resources will be focused on lease accounting not only at lease commencement, but also at each reporting date.

Significant judgement is likely to be needed in determining whether there is a change in relevant factors or a change in the lessee's economic incentive to exercise or not to exercise renewal or termination options, and companies may need to develop indicators for identifying triggers for reassessment to ensure consistent application.

A tenant's reassessment of key judgements may, in some cases, have a significant impact on the lease amounts recognised in the statement of financial position and the statement of profit or loss and other comprehensive income.

6 Lease payments

Identifying the relevant payments to include in the lease liability is key to determining the impact on a tenant's balance sheet.

6.1 Overview

IFRS 16.26

At the commencement date, a tenant measures the lease liability as the present value of lease payments that have not been paid at that date. In a simple lease that includes only fixed lease payments, this can be a simple calculation.

Lease liability = **Present value of lease rentals** + **Present value of expected payments at end of lease**

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 incentive receivable (see Section 8.4);
- variable lease payments (see Section 6.3);
- payments for terminating the lease early (see Chapter 5); and
- payments for non-lease components – e.g. maintenance or utilities (see Chapter 3).

At commencement, a tenant identifies the payments to be included in its lease liability and right-of-use asset (see Chapter 7).

6.2 Fixed and in-substance fixed payments

IFRS 16.27(a)

Fixed and in-substance fixed payments are always included in a tenant's lease liability. '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)

If a lease payment is initially variable but subsequently becomes fixed, then it is treated as an in-substance fixed payment when the underlying variability is resolved. Using an unchanged discount rate, a tenant remeasures the lease liability to include the payment from that point onwards.

Example 16 – Minimum lease payment with no commercial substance

IFRS 16.B42(b)

Company R, an established retailer, leases space for a store in a mature retail development from Company Q. Under the terms of the lease, R is required to operate the store during normal working hours. R is not permitted to leave the store vacant or to sub-let it.

The contract states that the annual rentals payable by R will be:

– 100 if R makes no sales at the store; or

– 1 million if R makes any sales at the store during the term of the lease.

R concludes that the lease contains in-substance fixed lease payments of 1 million per annum. R notes that this amount is not a variable payment that depends on sales. This is because there is no realistic possibility that R will make no sales at the store.

Example 17 – Fixed uplifts intended to reflect inflation

Lessee B enters into a five-year lease of a retail store. The lease payments are 50,000 per annum, paid at the end of each year.

The rent is increased by 5% in each subsequent year. This increase is designed to compensate the landlord for expected changes in the consumer price index (CPI), because average annual inflation over the previous three years has been 5%.

B determines that the rents are fixed; they do not depend on the future value of the CPI. At lease commencement, B includes in the lease liability the annual lease payments that increase by the fixed factor of 5% – 50,000, 52,500, 55,125 etc.

There are no future changes in lease payments that require B to remeasure the lease liability.

Example 18 – Variable payments that have a fixed minimum

Lessee X enters into a 10-year lease of retail space. Lease payments are made in advance at the beginning of each year.

The first lease payment is 50,000 and subsequent lease payments increase annually by the *higher* of the increase in CPI for the preceding 12 months and 5%.

The lease liability is only remeasured when the annual increase in CPI exceeds 5%.

The CPI is 100 at lease commencement and 107 at the end of Year 1 – i.e. inflation is 7% during the first year.

At commencement date

Although the lease payments are structured to be variable, the contract includes an in-substance fixed payment – because the lease payments have a minimum fixed uplift of 5% per year that X cannot avoid. The variability in the lease payment exists only in how much the actual payment will exceed that minimum amount by.

At commencement, X makes payment for the first year and determines that the contract includes an in-substance fixed minimum (with a fixed escalation of 5% per annum). X includes the present value of the remaining nine payments assuming an annual increase of 5% each year in its lease liability – i.e. 52,500, 55,125, 57,881 etc – and measures the lease liability and right-of-use asset.

Subsequent remeasurement at beginning of Year 2

At the beginning of Year 2, X adjusts the remaining lease payments based on the higher of the increase in CPI (7%) and 5%. Accordingly, X increases the lease payments to 53,500 (50,000 x 107 / 100).

The payment determined for Year 2 (53,500) becomes the new base payment. To remeasure the lease liability at the beginning of Year 2, the new base payment is increased by 5% (the minimum annual increase) for the remainder of the lease.

X remeasures the lease liability and right-of-use asset using an unchanged discount rate.

Example 19 – Variable lease payments that establish a 'minimum' over time

IFRS 16.B42(a)(ii)

Retailer X enters into a 10-year lease of a store. The annual lease payments are calculated as follows.

- Years 1–4: variable, calculated as 5% of revenue for the period.
- Year 5 onwards: still calculated as 5% of revenue for the period, but with a minimum amount equal to the average of lease payments in the first four years.

As revenue is recorded in Year 1, the variability of the minimum lease payments starts to be resolved. The minimum lease payments for Year 5 and onwards are built up gradually over the first four years, as illustrated below.

	Year 1 ('000)	Year 2 ('000)	Year 3 ('000)	Year 4 ('000)
Revenue	200	100	-	300
Rent (5% of revenue)	10	5	-	15
Cumulative rent payments (A)	10	15	15	30
Cumulative average rent (A / 4 years)	2.5	3.75	3.75	7.5
Final average for four years				**7.5**

IFRS 16.B42(a)(ii)

Accordingly, X does not wait until all lease payments for Years 1–4 are known before it starts to recognise a lease liability.

At the end of Year 1, X measures its lease liability and right-of-use asset as the present value of annual lease payments of 2,500 for the last six years of the lease.

Subsequent to Year 1, X remeasures its lease liability for further increases in the minimum lease payments, using an unchanged discount rate. For example, at the end of Year 2, X remeasures the lease liability to reflect minimum annual payments of 3,750 for the last six years of the lease.

6.3 Variable lease payments

6.3.1 Payments that depend on an index or rate

IFRS 16.27(b)

Variable lease payments that depend on an index or rate are initially included in the lease liability using the index or rate as at the commencement date.

IFRS 16.28

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

IFRS 16.36(c), 39

After the commencement date, tenants remeasure the lease liability to reflect changes to the lease payments arising from changes in the index or rate, using an unchanged discount rate.

Example 20 – Payments that depend on an index (CPI)

IFRS 16.27–28, 39, 42(b), 43, IE6

Company Y rents an office building. The lease term is five years and the initial annual rental payment is 2.5 million. Payments are made at the end of each year. The rent will be reviewed every year and increased by the change in the CPI. The discount rate is 5%.

Initial measurement of the lease liability

To measure the lease liability at commencement, Y assumes an annual rental of 2.5 million in each of the five years. At commencement, Y measures its lease liability as 10.8 million.

Subsequent reassessment of lease liability

During Year 1, the CPI increases from 100 to 105 (i.e. the rate of inflation over the preceding 12 months is 5%).

Because there is a change in the future lease payments resulting from a change in the CPI, which is used to determine those lease payments, Y needs to remeasure the lease liability.

At the end of Year 1, Y calculates the lease payment for Year 2 as 2.625 million (2.5 million x (105 / 100)).

Accordingly, Y remeasures the lease liability assuming an annual rental of 2.6 million for the remaining four years. Using an unchanged discount rate, Y remeasures the lease liability to 9.3 million.

Y adjusts the subsequent remeasurement of the lease liability to the right-of-use asset.

What if lease payments depend on property valuations 'based on market' – are these payments that depend on an index or rate?

IFRS 16.27(b), 28

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 often includes 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'.

For example, we believe that in the fact pattern described above (i.e. the assessed value is determined by the authorities, updated on a regular basis and includes sufficient inputs that mean it represents a 'market' rent/value of the property), 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 preparers 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'.

Are property taxes variable lease payments that depend on an index or rate?

No. It appears that in the context of property taxes accounted for under the new standard (see Section 3.3), neither the tax rate nor the assessed property value as determined by the tax authority typically represent an index or rate.

This is because in many cases, although the property taxes are expressed as a percentage of an assessed value – i.e. as a 'rate' – they are in essence a mechanism through which the authorities collect an amount of tax determined by budgetary requirements. Typically, the authorities retain the general legislative power to vary the amount of tax and the collection arrangements. For example, the assessed values may not necessarily be based on market rates, the authorities may not keep the assessed values up to date, and even when the assessed values approximate market values the authorities may be able to change the percentage applied to the assessed value.

Property taxes are not a separate component because they do not transfer a good or service to the tenant, but they are considered to be part of the total consideration that is allocated to the components identified in a contract (see Section 3.1).

Accordingly, property taxes are variable payments that do not depend on a rate, which are not a separate component of a contract.

What if negotiations for market rent reviews take a long time to agree?

IFRS 16.A

Sometimes, lease payments are renegotiated during the lease term. This may occur because:

- the tenant is experiencing financial difficulty and seeks a rent reduction (see Section 8.3); or
- the lease payments are being updated to reflect market rental rates, as agreed in the lease contract.

In practice, periodic market rent reviews can take a long time to agree, sometimes due to the subjective nature of the valuation.

In some cases where negotiations take a significant period of time, the tenant may continue to pay rent at the original amount with a 'catch-up adjustment' made when the new rent is agreed.

IFRS 16.42(b)

It appears that an acceptable approach is for a tenant to remeasure the lease liability when the new rent is agreed – i.e. when there has actually been a change in the cash flows under the lease.

6.3.2 Payments that depend on sales or usage

IFRS 16.BC168–BC169

Variable lease payments that depend on sales or usage of the underlying asset are excluded from the lease liability. Instead, these payments are recognised in profit or loss in the period in which they are incurred.

Example 21 – Variable payments that depend on sales

Company X leases a store. The annual lease payments amount to 1% of the store's revenues. There is no minimum payment.

Because the lease contains only variable lease payments that do not depend on an index or rate, and there is no unavoidable payment, X measures the lease liability at the commencement of the lease as zero.

Example 22 – Variable payments that are not directly proportional to sales

Company X leases a space for a new store. Historically, X's stores generate an average of 900,000 in revenue per month.

The monthly lease payments for the new store are determined with reference to staggered sales targets as follows.

- Monthly revenue up to 600,000: 0.
- Monthly revenue 600,001–1 million: 20,000.
- Monthly revenue 1,000,001–2 million: 25,000.
- Monthly revenue >2 million: 30,000.

For example, in the following scenarios, the lease payments are as follows.

Monthly revenue	Lease payments
500,000	-
800,000	20,000
2.1 million	30,000
5 million	30,000

IFRS 16.B42, BC164

X considers the following in evaluating whether the variable lease payments are in-substance fixed.

- Genuine variability in the lease payments exists.
- It is realistic that the lease payments may differ each month.
- The payments are structured as variable payments, with no mechanism to become fixed at a later date.
- If revenues fell below 600,000, then no lease payment would be required.

X concludes that even though the lease payments are not directly proportional to sales (i.e. not determined as a percentage of sales), the lease payments are still variable (i.e. there is no in-substance fixed minimum) and depend on sales. The existence of a historical average or similar benchmark also does not create a fixed minimum. Accordingly, X excludes the monthly lease payments from its measurement of the lease liability and measures the lease liability at the commencement of the lease as zero.

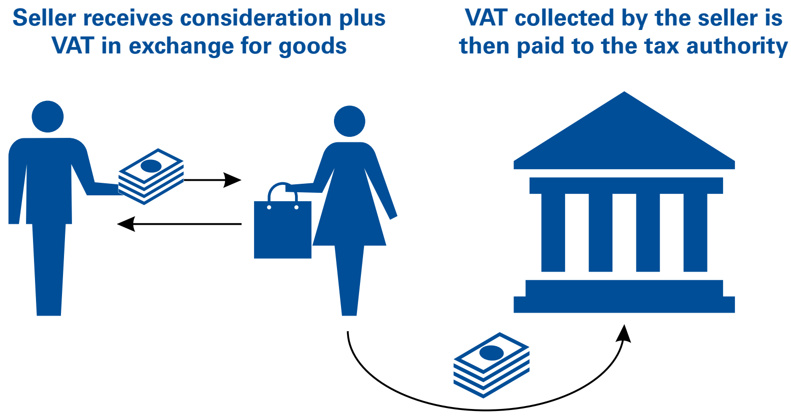
6.4 Value-added tax

In many jurisdictions a value-added tax (VAT), also known as 'goods and services tax' (GST), is charged on goods and services at the point of sale. This may include leases.

Generally, VAT operates as follows.

- Each country has its own VAT system and taxes are usually applied to goods or services consumed in the country.

- A seller charges VAT to the buyer, collects the VAT and then pays it to the government.
- Where the buyer is not the end user, but the good or service is purchased as a cost to its business, the VAT that it has paid is 'recoverable' and can be deducted from the amounts that it remits to the government.
- In some circumstances, the buyer cannot recover the VAT paid, either because the goods or services do not qualify or because of the buyer's status. For example, in some countries banks and insurers are not eligible for VAT refunds. In this case, the VAT is (partially or fully) irrecoverable.



It appears that when VAT is a tax that is levied on the lessee and collected by the lessor, who is acting as an agent for the tax authority, the VAT is not a lease payment or a non-lease component. This is because the payment is not made in exchange for the right to use an underlying asset, a good or a service to the lessee.

Instead, we believe that a lessee should account for this VAT under IFRIC 21, even if it elects not to separate lease and non-lease components. This means that a lessee should identify the obligating event for the VAT payment under applicable laws and regulations. For example, if the obligating event is the issue of each periodic invoice by the lessor, then the lessee should recognise a liability for each VAT payment on each invoice date, not at lease commencement. The obligating event for VAT is assessed according to the requirements of applicable legislation in each case.

See our Lease payments publication for more guidance on which payments are included in the lease liability.

7 The right-of-use asset

In addition to the amount of the lease liability, tenants will need to consider whether there are other costs to be included in the right-of-use asset.

7.1 Initial measurement

IFRS 16.23–24

At the commencement date, a tenant measures the right-of-use asset at a cost that includes the following.

Lease liability

+

Initial direct costs

+

Prepaid lease payments

+

Estimated costs to dismantle, remove or restore, measured in accordance with IAS 37

−

Lease incentives received

=

Right-of-use asset

IFRS 16.A

A tenant's 'initial direct costs' are the incremental costs of obtaining a lease that would not otherwise have been incurred.

Typical initial direct costs of a tenant	
Include ✔	**Exclude** ✘
– Commissions – Legal fees* – Costs of negotiating lease terms and conditions* – Costs of arranging collateral – Payments made to existing tenants to obtain the lease * If they are contingent on origination of the lease	– General overheads – Costs of investment appraisals, feasibility studies, due diligence, etc that are incurred regardless of whether the lease is entered into

'Lease incentives' are payments made by a landlord to its tenant associated with a lease, or a landlord's reimbursement or assumption of a tenant's lease costs.

7.2 Subsequent measurement

7.2.1 Cost model

IFRS 16.29, 34–35

Generally, a tenant measures the right-of-use asset at cost less accumulated depreciation and accumulated impairment losses, unless it applies one of the alternative measurement models:

– revaluation model for property, plant and equipment (PPE) (see 7.2.2); or

– fair value model for investment property (see 7.2.3).

Does impairment testing replace the test for onerous leases?

Yes – in effect, the impairment test replaces the current IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requirement to assess whether an operating lease is onerous. Because a lessee now recognises a lease liability for its obligation to make lease payments, there is no additional provision to recognise. Instead, the lessee assesses the right-of-use asset for impairment.

Impairment testing may increase the financial reporting burden for lessees. Operating leases are currently assessed to determine whether they have become onerous, but not tested for impairment. Applying the impairment test requirements may be more complex, particularly for right-of-use assets that are not part of a larger cash-generating unit.

7.2.2 Revaluation model for PPE

IFRS 16.35

If the right-of-use assets relate to a class of property to which the tenant applies the revaluation model in IAS 16 *Property, Plant and Equipment*, then it may elect to apply the model to all of the right-of-use assets that relate to that class of property.

7.2.3 Fair value model for investment property

IFRS 16.34, 48, IAS 40.2

A tenant applies IAS 40 *Investment Property* to account for the right-of-use asset if the underlying property would otherwise meet the definition of investment property. For example, a tenant may choose to sub-lease a vacant leased property if it would earn favourable rental income.

IFRS 16.34, 56, IAS 40.30

Under IAS 40, an entity chooses as its accounting policy either the fair value model or the cost model for measuring its investment property. The entity applies its chosen policy consistently to its owned and leased investment property – i.e. the entity cannot choose different policies for owned and leased investment property.

This will be discussed in more detail in our forthcoming publication *Real estate leases – The landlord perspective.*

7.3 Restoration costs

IFRS 16.24(d), 25

A tenant recognises restoration costs as a part of the right-of-use asset when it incurs the obligation for them. Depending on the facts and circumstances, this may be either at the commencement date or as a consequence of having used the underlying asset during a particular period. The obligation for such costs is measured under IAS 37.

Routine wear and tear that occurs during the course of the lease may increase the amount of the tenant's hand-back obligation but typically does not give rise to an asset and so is expensed as it is incurred.

The tenant applies IAS 2 *Inventories* if the leased property is used to produce inventories in the period.

Example 23 – Estimated costs to remove leasehold improvements

Lessee B is a retailer of high-end clothing. B enters into a five-year lease of a retail space that includes an outdoor courtyard.

The lease payments are 10,000 per annum, paid at the end of each year. B's incremental borrowing rate is 5%.

IAS 37.14

Under the lease agreement, B is required to restore the property to its original condition (e.g. removing any leasehold improvements etc) at the end of the lease.

At commencement of the lease

At commencement, B fits out the store by knocking down a wall and installing display shelves, lighting fixtures and a staircase. At this time, B's suppliers estimate that it will cost 5,000 to remove the fit-outs and rebuild the wall, to restore the property to its original condition at the end of the lease. The nominal risk-free rate is 4%.

IFRS 16.24(d), 25

Accordingly, B records the following at commencement.

– A lease liability of 43,295 (measured at the present value of five annual payments of 10,000, using B's incremental borrowing rate).
– A provision for restoration costs of 4,110 (measured as the estimated restoration costs of 5,000 at the end of Year 5, discounted using a risk-free rate).
– A total of 47,405 (43,295 + 4,110) as an asset at lease commencement.

At the end of Year 1

IAS 37.14

Due to ongoing wear and tear, B estimates that it will cost 1,000 to replace the carpet at the end of the lease. Accordingly, B recognises a provision and a corresponding expense for the replacement cost when the damage occurs.

Due to the nature of the wear and tear (continuous use of carpet), B expects this to be proportionate to its use of the property. Discounted using the risk-free rate, B recognises an expense and provision of 171.

At the beginning of Year 2

IFRS 16.25

B renovates the courtyard and builds a water feature to improve the appearance of the space. The builder estimates that it will cost 500 to remove the feature. Discounted using a risk-free rate, B records an additional provision of 427 for restoration costs to remove the water feature and capitalises it on the balance sheet.

8 Lease modifications

There are many different types of lease modifications. This chapter discuss the four most common modifications for real estate.

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:

- increasing the scope of the lease by adding the right to use one or more underlying assets;
- increasing the scope of the lease by extending 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. Adjusting the lease payments (cash flows) by contractual rent adjustment mechanisms, and reassessing whether a lessee is reasonably certain to exercise (or not exercise) an option included in the original contract, are *not* lease modifications.

8.1 Increase in leased space – Adding a floor

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

IFRS 16.44–46

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

In this case, the tenant:

- 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 16.44, Ex15

Example 24 – Adding a floor to an office lease with a corresponding increase in consideration

Lessee Z entered into a lease contract with Lessor L to lease one floor in an office building for 10 years. Z's business has since expanded and Z now requires additional office space.

At the beginning of Year 7, Z and L amend the contract to grant Z the right to use an additional floor of office space in the same building for four 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, costs for undertaking credit checks etc.

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.

Z 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.

Z does not modify the accounting for the original office space lease.

8.2 Increase in lease term

IFRS 16.45–46

Another common type of modification of a real estate lease is that the term of the lease is extended – i.e. the tenant agrees to stay in the same space for a period that is longer than the maximum term of the original agreement.

Extending the contractual term of a lease agreement is different from reassessing whether a tenant will exercise a renewal option that is included in the original agreement; for reassessment of the lease term, see 5.1.2.

A tenant accounts for a modification that is an increase in the lease term as follows:

- allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components;
- determine the new lease term;

– remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and

– make a corresponding adjustment to the right-of-use asset.

A tenant performs the above at the effective date of the modification – i.e. when the modification is agreed, not on expiry of the original lease term.

Example 25 – Increase in lease term

IFRS 16.45–46, A, Ex16

Lessee X enters into a 20-year lease of a factory in an industrial area with Lessor Y. There are no renewal or termination options. X does not provide any residual value guarantee. There are no initial direct costs, lease incentives or other payments between X and Y.

The annual lease payments are 150,000 payable in arrears and the incremental borrowing rate at commencement of the lease is 5% (assume that the interest rate implicit in the lease cannot be readily determined). Therefore, X initially recognises the lease liability and right-of-use asset at 1,869,332.

At the end of Year 17 (i.e. three years before expiry of the lease), Y approaches X indicating that other parties are interested in leasing the factory. X is well established in the industrial area and there is continued demand for its products. Therefore, X wants to extend the lease term. X and Y enter into negotiations and at the end of Year 18 they agree to extend the lease term by an additional 10 years – i.e. the lease term will be 30 years in total. The annual lease payments remain unchanged. There are no initial direct costs, lease incentives or other payments between X and Y as a result of the modification.

Because there were no renewal options in the original lease, this is not a reassessment of the lease term. This is a lease modification that increases the lease term only – i.e. it does not grant X the right to use an additional underlying asset. Therefore, it cannot be accounted for as a separate lease.

The effective date of the modification is the end of Year 18. At this date, the lease liability is 278,912, the right-of-use asset is 186,933 and X's incremental borrowing rate is 8% (assume that the interest rate implicit in the lease cannot be readily determined).

X remeasures the lease liability to 1,130,412 based on:

– annual lease payments payable in arrears of 150,000;

– a remaining lease term of 12 years (two years remaining on the original lease term plus the 10-year extension); and

– a revised incremental borrowing rate of 8%.

X recognises the difference between the carrying amount of the lease liability before the modification (278,912) and the carrying amount of the modified lease liability (1,130,412) of 851,500 as an adjustment to the right-of-use asset.

How does an increase in the lease term impact a restoration obligation included in the right-of-use asset?

IFRS 16.24(d), 25, IAS 37.36, 59, IFRIC 1.4–5, 8

At the commencement date, a tenant measures the right-of-use asset at cost and includes an estimate of costs to be incurred in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the conditions required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.

The obligation for these costs is recognised and measured in accordance with IAS 37.

Insights 3.12.150.10–20, IFRIC 1

Under IAS 37, provisions are reviewed at each reporting date and adjusted to reflect the current best estimate. Changes to the best estimate of the settlement amount may result from changes in the amount or timing of the outflows or changes in discount rates.

A lease modification may result in a change to a tenant's obligations to restore the underlying asset at the end of the lease. This may be the case if, for example, the modification changes the scope of the lease by adding or terminating the right to use one or more underlying assets or changing the lease term.

In this case, the tenant recognises a change to the provision for restoration costs due to the change in scope or lease term in the right-of-use asset and depreciates it prospectively over the remaining useful life of the right-of-use asset.

8.3 Reduction in rent

IFRS 16.45–46

Another common type of modification of a real estate lease is a change in the contractual lease payments. For example, a tenant that is suffering trading or liquidity difficulties may ask the landlord to reduce the rent.

A tenant accounts for a lease modification that is a change in consideration only as follows:

– allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components;

– determine the lease term;

– remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and

– make a corresponding adjustment to the right-of-use asset.

IFRS 16.45, A

A tenant performs the above at the effective date of the modification – i.e. when the modification is agreed, not when the adjusted lease payments are paid.

Example 26 – Reduction in rent (consideration)

IFRS 16.45–46, A, Ex19

Lessee X enters into a 20-year lease of office space with Lessor Y.

The annual lease payments are 150,000 payable in arrears and X's incremental borrowing rate at commencement of the lease is 5% (assume that the interest rate implicit in the lease cannot be readily determined). X does not provide any residual value guarantee. There are no initial direct costs, lease incentives or other payments between X and Y. Therefore, X initially recognises the lease liability and right-of-use asset at 1,869,332 each.

At the end of Year 10, X and Y agree to reduce the lease payments to 100,000 payable in arrears.

The change in consideration was not part of the original terms and conditions of the lease and is therefore a lease modification. The modification does not grant X an additional right of use and therefore cannot be accounted for as a separate lease.

The effective date of the modification is the end of Year 10. At this date, the lease liability is 1,158,260, the right-of-use asset is 934,666 and X's incremental borrowing rate is 6% (assume that the interest rate implicit in the lease cannot be readily determined).

X remeasures the lease liability at 736,009 based on:

– annual lease payments payable in arrears of 100,000;

– a remaining lease term of 10 years; and

– a revised incremental borrowing rate of 6%.

X recognises the difference between the carrying amount of the lease liability before the modification (1,158,260) and the carrying amount of the modified lease liability (736,009) of 422,251 as an adjustment to the right-of-use asset.

Reduction of the consideration can also take the form of a rental rebate.

Example 27 – Rental rebates

Retailer J leases a store in a shopping mall from Lessor K under a six-year agreement. The annual lease payments are 120,000 payable in arrears (i.e. a monthly payment of 10,000).

Due to a slow-down in the market in Year 3 following the holiday period, K agrees to give J a rental rebate for a period of three months starting at the beginning of Year 4 – i.e. the lease payments for Year 4 are reduced to 90,000 and then return to 120,000 per annum. This was not included in the original agreement.

The rental rebate represents a reduction in the lease payments that was not included in the original agreement. Therefore, it is a lease modification.

8.4 Compensation for inconvenience

Sometimes, a landlord will compensate its tenant for disturbance or inconvenience caused during the lease term, such as the following.

- A burst water pipe in an office building: the landlord compensates its tenant for the inconvenience of relocating its staff while the pipes and surrounding water damage are fixed.
- Construction or renovation in the common area of a shopping centre: the landlord compensates its tenant for loss of income because the work affects customer access to the shop, negatively impacting its trade.

IFRS 16.A

If compensation for inconvenience is included in the original lease agreement, or is in effect part of the lease agreement because it is required by the relevant laws and regulations, then the payment is accounted for as part of the original lease. Because this is not a lease modification, the discount rate remains unchanged.

IFRS 16.A, 45–46

By contrast, if the compensation for inconvenience is not included in the original lease agreement but is added as part of a new lease contract – perhaps because the lease is due to expire and the landlord wants to incentivise the tenant to renew – then the payment is accounted for as a lease modification that is not accounted for as a separate lease (see Section 8.3 and Example 26).

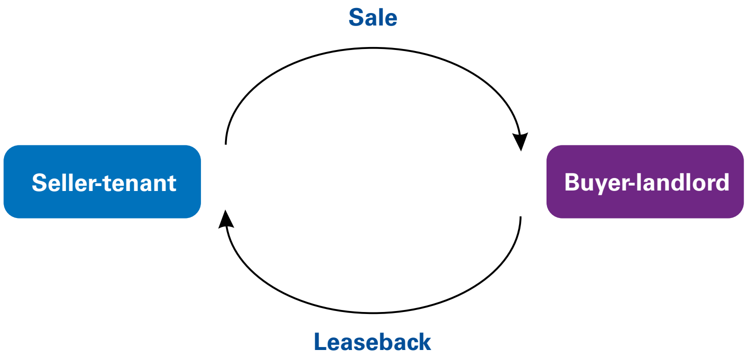
See our Lease modifications publication for more guidance on accounting for changes to lease contracts.

9 Sale-and-leaseback

The new standard changes the accounting for sale-and-leaseback transactions – effectively eliminating them as a potential source of off-balance sheet financing for seller-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 *Revenue from Contracts with Customers* to determine whether a sale has taken place. This assessment determines the accounting by both the seller-tenant and the buyer-landlord, as follows.

	Tenant (seller)
Transfer to buyer-landlord is a sale	– 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	– Continue to recognise the underlying asset – Recognise a financial liability under IFRS 9 *Financial Instruments* for any amount received from the buyer-landlord

* Adjustments are required if the sale is not at fair value or lease payments are off-market.

IFRS 16.IE11

Example 28 – Sale-and-leaseback transaction when transfer is a sale

Company C sells an office building to Company D for cash of 2,000,000. Immediately before the transaction, the building is carried at a cost of 1,000,000. At the same time, C enters into a contract with D for the right to use the building for 18 years with annual payments of 120,000 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 on the date of sale is 1,800,000. Because the consideration for the sale of the office building is not at fair value, C makes adjustments to recognise the transaction at fair value. C recognises the amount of the excess sale price of 200,000 (2,000,000 - 1,800,000) as additional financing provided by D to C. The incremental borrowing rate of the lessee is 4.5% per annum.

The present value of the annual payments is 1,459,200, of which 200,000 relates to the additional financing and 1,259,200 relates to the lease.

C recognises the transaction as follows.

- C measures the right-of-use asset retained through the leaseback of the office building as a proportion of its previous carrying amount, which is 699,556 (1,259,200 / 1,800,000 x 1,000,000).
- C recognises only the portion of the gain on sale that relates to the rights transferred to D, which is 240,356. The total gain on sale of the building amounts to 800,000 (1,800,000 - 1,000,000), of which:
  - 559,644 (1,259,200 / 1,800,000 x 800,000) relates to the right to use the office building retained by C; and
  - 240,356 ((1,800,000 - 1,259,200) / (1,800,000 x 800,000)) relates to the rights transferred to D.
- At the commencement date, C makes the following entries.

	Debit	Credit
Cash	2,000,000	
Right-of-use asset	699,556	
Building		1,000,000
Financial liability		1,459,200
Gain on sale-and-leaseback		240,356
To recognise sale-and-leaseback of building		

Does the new standard kill sale-and-leaseback as an off-balance sheet financing proposition?

Accounting for sale-and-leaseback transactions is – and remains – a complex area. However, one thing remains clear: the new standard largely eliminates sale-and-leaseback transactions as a potential source of off-balance sheet finance. Under the new standard, a seller-tenant always recognises a sale-and-leaseback transaction on-balance sheet unless the leaseback is short or the underlying asset is of low value.

The new standard introduces guidance on off-market terms that helps companies to identify when a transaction is deemed to be off-market, and clarifies the appropriate accounting treatment when the terms are above-market or below-market. A company has to maximise the use of observable prices and information to determine which measure is the most appropriate to use when assessing whether terms are off-market. This may require significant judgement, especially when the underlying asset is specialised.

10 Transition considerations

Although transition is a complex area for all leases, certain features of real estate leases may require additional attention.

10.1 Data extraction challenges

Real estate leases typically run for longer terms than other leases – often for terms of 10 or 20 years – and long-term ground leases (see Section 2.3) can run for 99 or even 999 years.

Such long lease terms will present tenants with data extraction challenges. Depending on the transition approach chosen, tenants may need to gather extensive historical data as at lease commencement and as at each date on which they would have had to recalculate the lease assets and liabilities on a reassessment or modification of the lease. Some example data requirements are as follows.

Examples of historical data that will be gathered

Retrospective method

- Changes to lease payments, including changes in related items such as rates and indices
- Changes to the discount rate
- Lease modifications – i.e. changes to the scope and consideration for a lease
- Changes to the lease term, including whether the tenant was reasonably certain to exercise a renewal option, or not exercise a termination option
- Amortisation and impairment of the right-of-use asset

Modified retrospective method – applying hindsight

- Changes to lease payments, including changes in related items such as rates and indices
- Lease modifications – i.e. changes to the scope and consideration for a lease

10.2 Key transition decisions for tenants

The new standard presents tenants with a host of different transition options and practical expedients. Many of the options and expedients can be elected independently of each other, and some on a lease-by-lease basis. Some big decisions for tenants are outlined below.

10.2.1 Grandfathering the lease definition

IFRS 16.C3

On transition to the new standard, a tenant can choose whether to apply a practical expedient to 'grandfather' its previous assessment of which existing contracts are, or contain, leases.

A tenant that chooses to take advantage of the practical expedient:

- applies the new standard to leases previously identified under IAS 17 and IFRIC 4 *Determining whether an Arrangement contains a Lease*;
- does not apply the new standard to contracts previously identified as not containing leases under IAS 17 and IFRIC 4; and
- applies the new standard's definition of a lease to assess whether contracts entered into or modified after the date of initial application of the new standard are, or contain, leases.

Due to the nature of real estate, whether an arrangement contains a lease will usually be obvious – and this assessment will not generally change under the new standard (see Section 2.2). Therefore, deciding whether to apply this practical expedient is not likely to be a focus area for tenants. Election of this practical expedient is applied consistently to all contracts (i.e. as a lessee and a lessor).

10.2.2 Retrospective vs modified retrospective

IFRS 16.C5

A key decision for tenants will be whether to apply the new standard retrospectively or using a modified retrospective approach. Once the decision is made, a tenant applies this election consistently to all of its leases.

Due to the costs and complexities of applying the retrospective approach, most tenants will probably prefer to follow a modified retrospective approach and produce other pro forma financial information to communicate comparable trend data to stakeholders.

10.2.3 Modified retrospective – Measuring the right-of-use asset

IFRS 16.C8

A lessee is permitted to choose, on a lease-by-lease basis, how to measure the right-of-use asset using one of two methods:

- *Option 1:* as if the new standard had always been applied (but using the incremental borrowing rate at the date of initial application); or
- *Option 2:* at an amount equal to the lease liability (subject to certain adjustments).

What's the impact of choosing one method over the other?

IFRS 16.C7

Due to the nature of real estate leases, they will probably be the largest that a lessee needs to bring onto its balance sheet.

If on transition a lessee elects to measure its right-of-use assets as if the new standard had always applied, then for a lease previously classified as an operating lease this will result in a decrease in net assets. This is because the carrying amount of the right-of-use asset depreciates quicker than the lease liability amortises.

Which method a tenant chooses to measure its right-of-use asset may depend on its objectives. A tenant may consider the impact of each method as follows.

Option 1 – As if the new standard had always been applied	Option 2 – At an amount equal to the lease liability
A tenant whose performance is assessed by its net profit may prefer to measure its right-of-use assets using Option 1. This is because, under this method, a tenant recognises a smaller right-of-use asset on the date of initial application, and consequently records lower depreciation charges in the remaining years of the lease.	Conversely, a tenant that is more focused on its net asset position may prefer to measure its right-of-use assets using Option 2. This may be due to debt covenant restrictions or other performance metrics that are focused on the balance sheet rather than profit or loss.

10.2.4 Modified retrospective – Which practical expedient to use

IFRS 16.C10

When applying a modified retrospective approach to leases previously classified as operating leases, a tenant may use one or more of the practical expedients on:

- discount rates: a tenant may use a single discount rate for a portfolio of similar leases;
- impairment and onerous leases: see below;
- leases with a short remaining term: a tenant may elect not to recognise a right-of-use asset and lease liability for leases that end within 12 months or less of the date of initial application;
- initial direct costs: a tenant may exclude initial direct costs from the measurement of right-of-use assets at the date of initial application; and
- hindsight: see below.

Onerous leases under IAS 17

IFRS 16.C10(b)

If this practical expedient is elected, then a tenant can rely on a previous assessment of whether leases were onerous under IAS 37 immediately before the date of initial application as an alternative to performing an impairment review under IAS 36 *Impairment of Assets*. A tenant can apply this practical expedient on a lease-by-lease basis.

It appears that it is acceptable to apply this expedient to any lease classified as an operating lease under IAS 17 – not only those for which a tenant has previously recognised a provision.

Example 29 – Onerous leases on transition

Retailer X leases 100 stores classified as operating leases under IAS 17.

In 2018, X has vacated and intends to sub-let 20 stores, 12 of which have been assessed as onerous leases.

X can apply the practical expedient to all 100 leases.

Hindsight

IFRS 16.C10(e), BC287

It appears that a tenant may apply hindsight only in areas for which the standard would otherwise require the tenant to reconstruct historical judgements and estimates – e.g. to its previous assessments of whether it was reasonably certain to exercise an extension option, in determining the lease term.

In contrast, we believe that the use of hindsight is not permitted for other areas in which the historical accounting would have been based on factual information, not estimates – e.g. changes to variable lease payments as the result of changes in a consumer price index.

When will this practical expedient be relevant?

Companies may find this practical expedient of limited benefit in practice.

Similar to the other practical expedients, it is only available when a company follows a modified retrospective approach. A key benefit of a modified retrospective approach is that a company can transition its operating leases using information as at the date of initial application.

Indeed, if a company elects a modified retrospective approach and measures its right-of-use assets using Option 2 (see 10.2.1), then it is required to use only current information.

However, if a company measures its right-of-use assets retrospectively using Option 1 (see 10.2.1), then this expedient will simplify the calculation of the right-of-use asset and the documentation of that calculation. This is because, except where there has been a previous lease modification, a company can use its current assessment of the lease term, rather than reconstructing its initial assessment of the lease term and subsequent changes thereto.

10.3 Sale-and-leaseback on transition

IFRS 16.C16

A company does not reassess sale-and-leaseback transactions entered into before the date of initial application to determine whether a sale occurred in accordance with IFRS 15 *Revenue from Contracts with Customers*.

IFRS 16.C17

For a sale-and-leaseback transaction accounted for as a sale and finance lease under IAS 17, the seller-lessee:

- accounts for the leaseback in the same way as for any finance lease that exists at the date of initial application; and
- continues to amortise any gain on the sale over the lease term.

IFRS 16.C18

For a sale-and-leaseback transaction accounted for as a sale and operating lease under IAS 17, the seller-lessee:

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

Example 30 – Sale and operating leaseback on transition

In 2004, Company R sold its head office building to Company P and leased the building back for 20 years. R has an option to repurchase the building for its market value.

In assessing the classification of the leaseback under IAS 17, R noted that the exercise price of the repurchase option was at market value and therefore P retained the risk (reward) of any change in the market value of the building. R also noted that there were no other indicators that the leaseback was a finance lease. R therefore accounted for this transaction as a sale and operating leaseback – i.e. R derecognised the building and recognised the rentals payable to P as an expense on a straight-line basis over the term of the leaseback.

On 1 January 2019:

- R's leaseback of its head office building has a remaining term of five years; and
- the present value of the lease payments, discounted at R's incremental borrowing rate at 1 January 2019, is 500.

IFRS 16.99, 103, 15.B66

R notes that its option to purchase the building means that the transaction does not meet the criteria to be recognised as a sale under IFRS 15. That is, if R entered into the transaction on these terms after the adoption of the new standard, then it would account for it as a financing under IFRS 9, not as a sale-and-leaseback. However, because the transaction was in place at the date of initial application of IFRS 16, R continues to account for it as a sale-and-leaseback.

R elects to adopt the new standard using a modified retrospective approach, to measure the right-of-use asset using Option 2 (see 10.2.3) and to apply the practical expedient not to recognise initial direct costs.

IFRS 16.C18

On 1 January 2019, R recognises a right-of-use asset of 500 and a lease liability of 500.

What is the main transition relief for sale-and-leasebacks?

There are two significant reliefs for existing sale-and-leasebacks on transition.

First, a company does not assess whether an existing sale-and-leaseback qualifies for sale-and-leaseback accounting on transition. That is, a company does not assess whether the sale leg would meet the criteria to be recognised as a sale under IFRS 15. This is an important relief because it eliminates the possibility that the company might be required to account for an existing sale-and-leaseback as financing in the scope of IFRS 9 *Financial Instruments*. This relief applies to seller-tenants and to buyer-landlords.

Second, a seller-tenant does not apply the partial gain recognition approach to sale-and-leaseback transactions entered into before the date of initial application. This will simplify transition for companies that have many such transactions at the date of initial application.

In other respects, the transition requirements for the leaseback leg of a sale-and-leaseback transaction are consistent with the general transition requirements for all leases. As a result, an existing sale-and-leaseback will generally come on-balance sheet for the seller-tenant, through application of the new lease accounting model to the leaseback. The only exceptions will be leasebacks to which the recognition exemptions apply.

See our Transition options publication for more guidance to help tenants determine which option is best.

Appendix I – IFRS 16 at a glance

Topic	Key facts
Lease definition	– New lease definition with an increased focus on control over the use of the underlying asset
Lessee accounting model	– Single lease accounting model – No lease classification test – Most leases on-balance sheet: - lessee recognises a right-of-use asset and lease liability - treated as the purchase of an asset on a financed basis
Lessor accounting model	– Dual lease accounting model for lessors – Lease classification test based on IAS 17 *Leases* 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	– Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under the new standard 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	– Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 *Revenue from Contracts with Customers* is also adopted – Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

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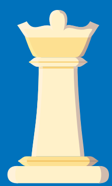

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Further analysis and interpretation will be needed for a company to consider the impact of IFRS 16 in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations 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.

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Kimber Bascom (leader)	US
Zola Beseti	South Africa
Archana Bhutani	India
Judit Boros	Hungary
Yen San Chan	Singapore
Úna Curtis	Ireland
Ramon Jubels	Brazil
Wolfgang Laubach	Germany
Sylvie Leger	Canada
Andrew Marshall	UK
Brian O'Donovan (deputy leader)	UK
Emmanuel Paret	France
Julie Santoro	US
Patricia Stebbens	Australia
Mag Stewart	Canada
Beth Zhang	China

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