



Lease Definition

The new on-/off-balance sheet test

IFRS

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A key judgement

Assessing whether an arrangement is, or contains, a lease will be one of the biggest practical issues when applying IFRS 16 *Leases*. Lease definition is the new test that determines whether an arrangement is on- or off-balance sheet for a customer.

In many cases, the assessment will be straightforward, and a transaction that is a lease today will be a lease under the new standard. A key focus will be completing and documenting the assessment.

In other cases, the assessment will be more complex, and the conclusion on whether an arrangement is, or contains, a lease may change. This could affect common transactions such as power purchase agreements, IT outsourcing agreements and transport agreements, where the focus of the analysis will often be on whether the customer 'controls' the use of an identified asset.

As companies prepare to adopt the new standard in 2019, a key decision will be whether to apply the practical expedient to grandfather the lease definition on transition. This is a balancing act. Although the practical expedient offers considerable cost relief, it may result in continued lease accounting for contracts that are not leases under IFRS 16.

Either way, companies should not underestimate the task ahead. It may take a substantial effort to identify all lease agreements and extract all relevant lease data.

This publication provides an analysis of the key elements of the lease definition and the related transition provisions. We hope it will help you identify your leases as you prepare to adopt IFRS 16.

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1

At a glance

Applying the lease definition is a key area of judgement and one of the biggest practice issues.

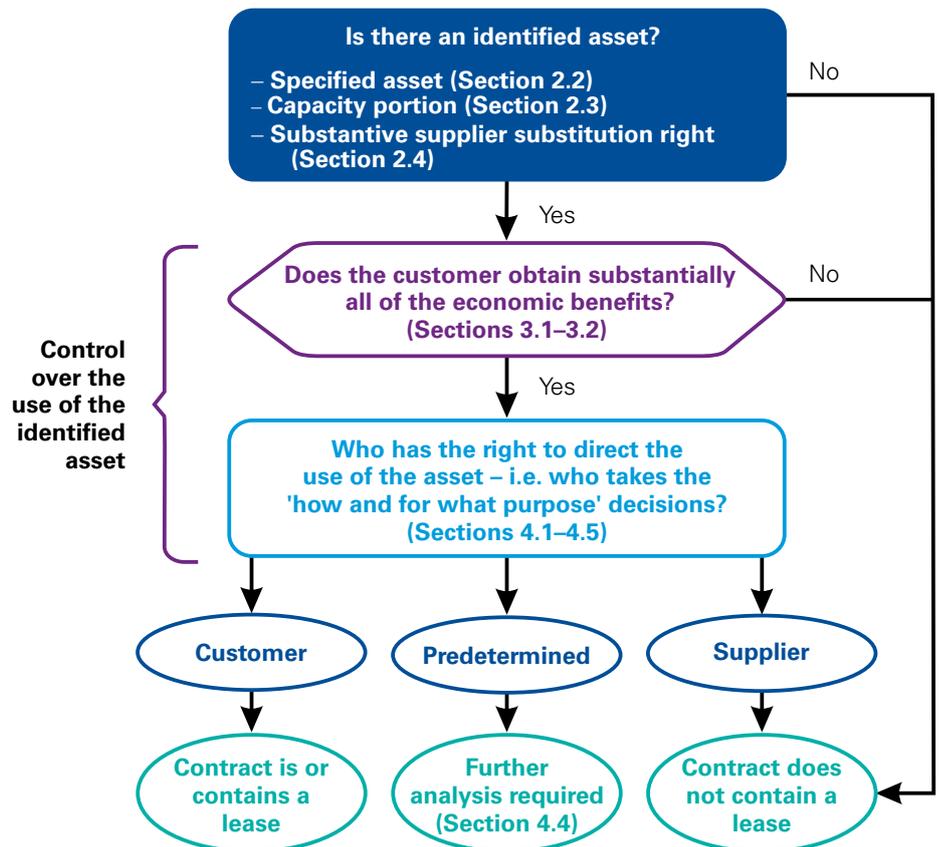
1.1

IFRS 16.A, B9

Key facts

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.



IFRS 16.9, 11

Both customer and supplier need to make this assessment at inception of a contract and will revisit it only if the terms and conditions of the contract change.¹

IFRS 16.5

A lessee can elect not to apply the lease accounting model to short-term leases and leases of low-value items – see Section 6.2.

IFRS 16.C3

On transition to IFRS 16, a company can elect either to apply the new lease definition to existing contracts, or to grandfather the assessment of which existing contracts are leases and to apply the new lease definition only to contracts that are entered into or changed after transition – see Section 7.1.

1. As the customer and supplier are subject to the same assessment, we also refer to them interchangeably as 'company'.

1.2

Key impacts

There will be an increased focus on the assessment of whether a transaction is a lease. Lessees will now recognise most leases on-balance sheet. In effect, lease definition replaces lease classification as the key on-/off-balance sheet test.

All lease agreements need to be identified and lease data extracted. Lessees will now recognise most leases on-balance sheet. This may require a substantial effort to identify all lease agreements and extract all relevant lease data necessary to apply the standard.

There may be changes in which transactions are identified as leases. In its impact assessment, the IASB noted that it had identified examples of transactions currently accounted for as leases that will not be leases under the new standard. There could also be additional leases – see Appendix 2. However, the conclusion on whether a transaction is a lease will be unchanged in many cases.

New estimates and judgements. The new standard introduces new estimates and judgemental thresholds that affect the identification of lease transactions.

- Determining whether a supplier's substitution rights are substantive, which is key to assessing whether an identified asset exists – see Chapter 2.
- Identifying the economic benefits and evaluating whether the customer has the right to obtain substantially all of them throughout the period of use, which is not always straightforward – see Chapter 3.
- Differentiating a lessee from a customer in a typical supply or service contract by identifying who has the right to direct the use of the identified asset throughout the period of use – see Chapter 4.

Deciding whether to grandfather the lease definition on transition is a key implementation decision. The scope and timing of a company's IFRS 16 implementation project could be fundamentally different depending on whether it applies this practical expedient. Applying the practical expedient reduces costs but may also decrease comparability – see Chapter 7.

The recognition exemptions provide additional relief for lessees. Lessees can reduce the impact of the new standard – on transition and subsequently – by applying the optional practical expedients for short-term leases and leases of low-value items. However, this may reduce comparability if the effect is material.

New systems and processes. Systems and process changes may be required to capture and assess the data necessary to comply with the new requirements, including creating an inventory of all leases on transition.

Sufficient documentation. In many cases the decision on whether there is a lease will be unchanged. However, this does not remove the need to prepare sufficient documentation when retrospectively applying the new lease definition.

Changes in contract terms and business practices. To minimise the impact of the new standard, some companies may wish to reconsider certain contract terms and business practices. 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.

2

Identified asset

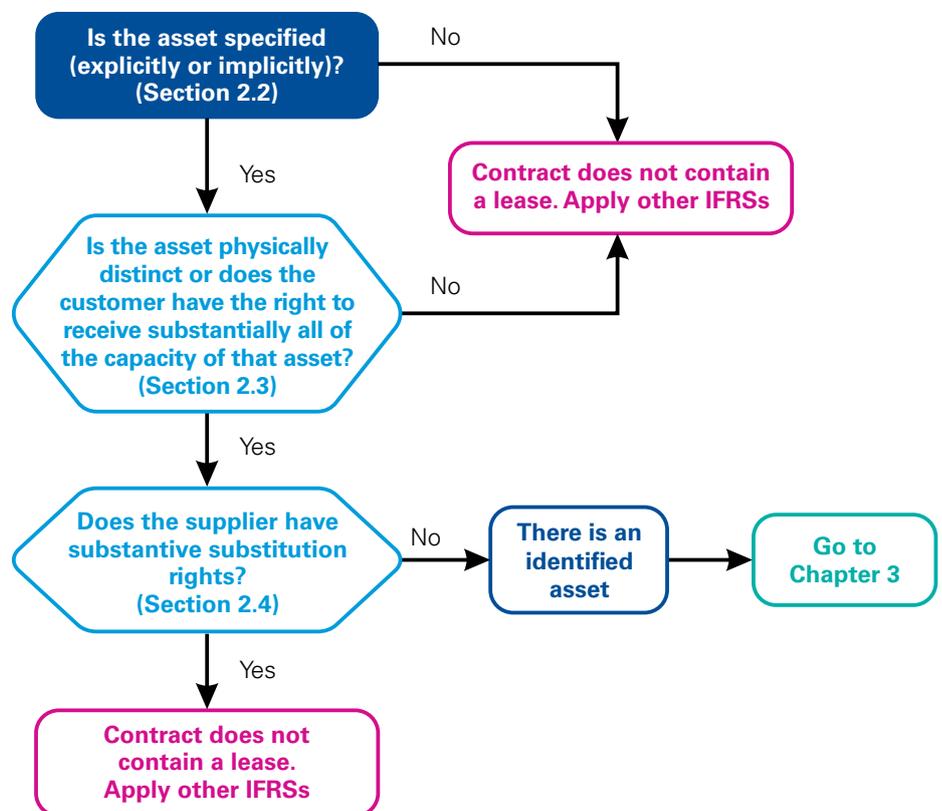
Determining whether a supplier's substitution rights are substantive is key to assessing whether an identified asset exists.

2.1

IFRS 16.B13–B20

Overview

For a lease to exist, there has to be an identified asset, determined as follows.



2.2

IFRS 16.B13, BC111

Specified asset

In many cases, the asset that is the subject of the lease will be explicitly specified in a contract (e.g. by a serial number or a specified floor of a building). However, an identified asset can be one that is implicitly specified when it is made available for use by the customer.



What does 'implicitly specified' mean?

An asset is implicitly specified if the facts and circumstances indicate that the supplier can fulfil its obligations only by using a specific asset.

This may be the case if the supplier has only one asset that can fulfil the contract. For example, a power plant may be an implicitly specified asset in a power purchase contract if the customer's facility is in a remote location with no access to the grid, such that the supplier cannot buy the required energy in the market or generate it from alternative power plants.

In other cases, an asset may be implicitly specified if the supplier owns a number of assets with the required functionality, but only one of those assets can realistically be supplied to the customer within the contracted timeframe – i.e. the supplier does not have a substantive right to substitute an alternative asset to fulfil the contract – see Section 2.4. For example, a supplier may own a fleet of vessels but only one vessel that is in the required geographic area and is not already being used by other customers.



Does the asset need to be specified at contract inception?

No. The key test is whether the asset is specified at the time when it is made available to the customer.

In many cases, the contract will specify the asset at inception. For example, a contract to use real estate will typically specify the relevant floor of the building at the time when the contract is signed.

However, an asset may be specified only at a later date. For example, a supplier may enter into a binding contract to supply a drilling rig to a customer to explore a specific offshore oilfield in six months. At the date of signing the contract, the supplier has five drilling rigs of a similar specification that could be used to fulfil the contract. All five of the drilling rigs are at a similar distance from the offshore oilfield. However, once a given drilling rig is transported to the offshore oilfield, only that drilling rig can be used to fulfil the contract. In this case, although the contract does not initially specify the drilling rig that will be used to fulfil the contract, it is clear at contract inception that the contract *will* depend on the use of a specific drilling rig. The individual drilling rig is specified when it is made available to the customer.

IFRS 16.B13, BC111

2.3

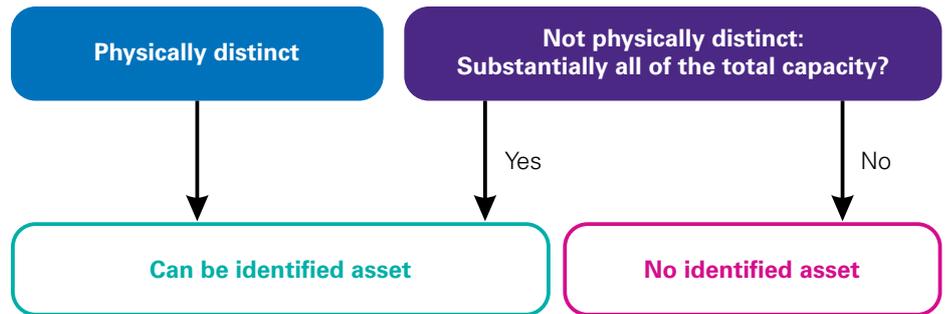
IFRS 16.B20

Capacity portions

In many cases, the asset subject to the contract will be the entire underlying asset and therefore easy to identify (e.g. a building or a piece of equipment). However, a portion of an asset's capacity can be an identified asset if:

- it is physically distinct (e.g. a floor of a building, a specified strand of a fibre-optic cable or a distinct segment of a pipeline); or

- it is not physically distinct, but the customer has the right to receive substantially all of the capacity of the asset (e.g. a capacity portion of a fibre-optic cable that is not physically distinct but represents substantially all of the capacity of the cable).



IFRS 16.BC116

The IASB concluded that a customer is unlikely to have the right to control the use of a capacity portion of a larger asset if that portion is not physically distinct (e.g. if it is a 20 percent capacity portion of a pipeline). This is because decisions about its use are typically made at the larger asset level. Consequently, the IASB concluded that widening the definition to include capacity portions of a larger asset would increase complexity for little benefit. Companies would be forced to consider all contracts for goods or services in which a customer obtains some capacity from an asset as possible leases, only to then (possibly) conclude that they are not leases as the customer does not have the relevant decision-making rights about the asset's use and does not have the right to obtain substantially all of the economic benefits.

Example 1 – Storage tank: Capacity portion is not an identified asset

Customer D enters into an arrangement with Supplier E for the right to store its gas in a specified storage tank that has no separate compartments. At inception of the contract, D has storage rights that permit it to use up to 60% of the capacity of the storage tank throughout the term of the contract. E can use the other 40% of the storage tank as it sees fit.

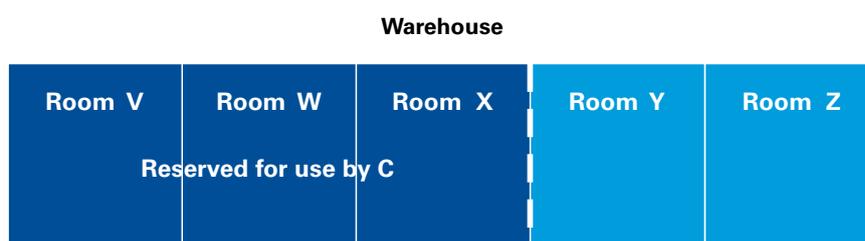
E has no substitution rights. However, the arrangement allows E to store gas from other customers in the same storage tank.

Storage tank	
Storage rights of Customer D 60%	Storage rights of other customers 40%

In this scenario, there is not an identified asset. This is because D only has rights to 60% of the storage tank's capacity and that capacity portion neither is physically distinct from the remainder of the tank nor meets the substantially all criterion.

**Example 2 – Warehouse: 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.



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.

**Is this approach to capacity portions new?**

Yes. In developing IFRIC 4 *Determining whether an Arrangement contains a Lease*, the IFRS Interpretations Committee decided not to address capacity portions. Therefore, the impact will depend on the previous accounting policy that a company applied for portions under IFRIC 4 – see Appendix 2.

**Does 'substantially all' of the capacity of an asset mean 90 percent?**

Not necessarily. The new standard does not define 'substantially all' in the context of the definition of a lease.

IFRS 16, like IAS 17 *Leases*, uses the same phrase in one of the criteria used by the lessor to determine lease classification: whether the present value of the lease payments (including the residual value guaranteed by the lessee or a third party) equals or exceeds substantially all of the fair value of the asset. US GAAP allows the use of a threshold of 90 percent for 'substantially all'. In our view, although the 90 percent threshold may provide a useful reference point, it does not represent a bright-line or automatic cut-off point under IFRS.

For the purpose of applying the lease definition, a company should develop an interpretation of 'substantially all' and apply it on a consistent basis.



How do you determine the asset's capacity?

In some situations, there is a difference between an asset's nominal capacity and the capacity expected to be used by customers.

For example, Customer O enters into a 30-year contract with Supplier B to transport gas through a pipeline. B builds and operates a new pipeline to transport O's gas. O decides the quantities of gas to be sent in the pipeline. B anticipates that O will need additional capacity in the future and decides to build the pipeline with excess capacity – i.e. at commencement date, O uses only 70 percent of the pipeline's nominal capacity. The pipeline is located in a remote area where the probability is remote that another customer would use the excess capacity.

Determining an asset's capacity for testing whether the customer has the right to receive substantially all of the capacity of the asset may involve judgement and requires consideration of all facts and circumstances – e.g. considering the reason for the unused excess capacity. In this example, the test should be performed based on the capacity expected to be used by O and other parties – i.e. 70 percent. This is consistent with assessing whether the customer has a right to obtain substantially all of the economic benefits from using the asset throughout the period of use – see Chapter 3. Consequently, in this example O uses all of the expected capacity and therefore the pipeline qualifies as an identified asset.



Should a customer's 'right of first refusal' over capacity be considered when assessing whether a portion represents 'substantially all' of the capacity of an asset?

Generally, yes.

In some contracts, a supplier commits to making all of the capacity of an asset available to a customer but may sell unused capacity to third parties, if the customer agrees. In these cases, the customer has the right to use substantially all of the capacity of the asset such that there is an identified asset.

For example, Customer O enters into a 10-year contract with Supplier B for 70 percent of the capacity of a gas pipeline. O decides the quantities of gas to be sent in the pipeline. B operates and maintains the pipeline. O pays a fixed capacity charge per month and a variable amount for each quantity of gas transported. O has the right of first refusal on the additional 30 percent of the capacity.

In this situation, O is entitled to substantially all of the capacity of the pipeline, given that it uses 70 percent of the capacity and has the right of first refusal for the other 30 percent. Therefore, the pipeline is an identified asset.

However, a 'right of first refusal' would not be considered when the right is not substantive. For example, in the case above, if the amount that O would be required to pay to use the additional 30 percent of capacity was so high that there was no realistic commercial possibility that O would ever purchase that additional capacity, then the pipeline would not be an identified asset.

2.4

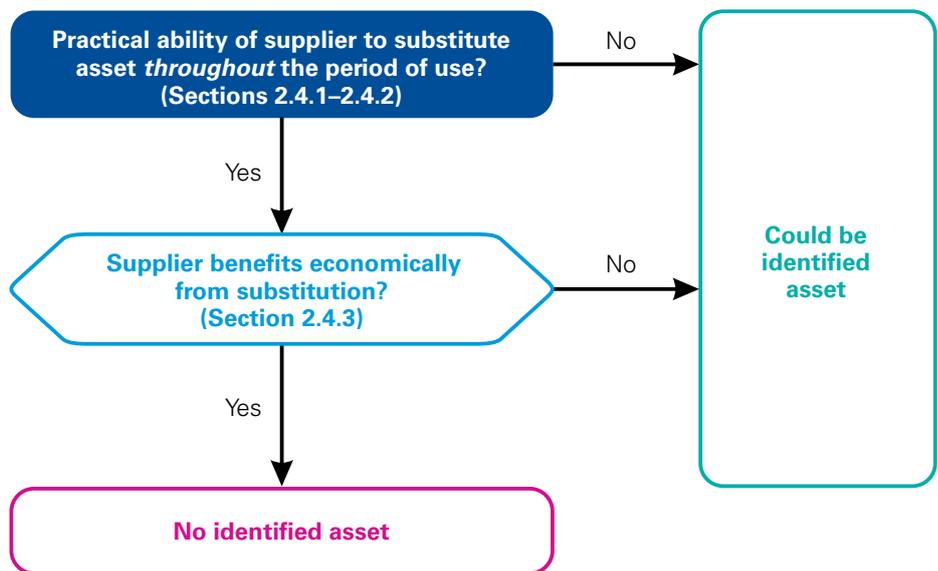
IFRS 16.B14–B19

Substantive supplier substitution rights

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

A supplier's substitution right is 'substantive' if the supplier:

- has the practical ability to substitute the asset throughout the period of use; and
- would benefit economically from exercising its right to substitute the asset.



IFRS 16.B16

A company assesses whether substitution rights are substantive at inception of the contract. At that time, the company considers all of the facts and circumstances, but not future events that are unlikely to occur. For example, it excludes the following future events:

- an agreement by a future customer to pay an above-market rate for use of the asset;
- the introduction of new technology that is not substantially developed at inception of the contract;
- a substantial difference between the customer's use of the asset, or the performance of the asset, and the use or performance considered likely at inception of the contract; or
- a substantial difference between the market price of the asset during the period of use and the market price considered likely at inception of the contract.

IFRS 16.B18

A supplier's right or obligation to substitute the asset for repairs and maintenance, because the asset is not working properly – i.e. a 'warranty-type' obligation – or because a technical upgrade becomes available, is not a substantive substitution right.

IFRS 16.B17, BC113

**Why does the definition focus on 'substantive' substitution rights?**

Substitution rights are likely to be a key area of focus in applying the lease definition. This is because some element of substitution is often permitted in leases of fleets of vehicles, or portfolios of photocopiers and similar equipment. However, if the underlying asset is with the customer, then the costs of substitution will probably exceed the benefits, such that the substitution rights are not substantive.

The assessment of substitution rights is aligned with the overall approach of assessing whether the supplier or customer controls the use of the underlying asset. The presence of a *substantive* substitution right indicates that the supplier (and not the customer) controls the use of the underlying asset, such that there is no lease.

The focus on substitution rights that are 'substantive' also reflects concerns that companies may seek to structure arrangements to avoid lease accounting by including substitution rights in contracts – e.g. substitution rights that the supplier has no practical ability to exercise.

As a result, there is an 'anti-avoidance' flavour to some of the guidance on substitution rights. In most cases, demonstrating that a substitution right is substantive will be a high hurdle.

IFRS 16.B19

**What should a customer do if it cannot assess whether a substitution right is substantive?**

If a customer does not have sufficient information to assess whether a substitution right is substantive, then the customer should assume that it is *not* substantive.

Many of the factors that influence whether a substitution right is substantive are specific to the supplier – e.g. whether the supplier has access to alternative assets, the costs involved in substitution etc. The customer may not have access to this information.

The IASB believes that often when a substitution right is substantive, this will be clear to the customer. In other cases, the IASB does not expect the customer to exert undue effort in making the assessment.

2.4.1

IFRS 16.B14(a)

Practical ability to substitute

A supplier has the practical ability to substitute alternative assets when the customer cannot prevent it from substituting the asset and the supplier has alternative assets either readily available or available within a reasonable period of time.



Example 3 – Rail cars: Practical ability to substitute

Customer L enters into a five-year contract with a freight carrier (Supplier M) to transport a specified quantity of goods. M uses rail cars of a particular specification that are stored at its premises and has a large pool of similar rail cars that can be used to fulfil the requirements of the contract.

In this case, because the rail cars are stored at M's premises, it has a large pool of similar rail cars and substitution costs are minimal, M has the practical ability to substitute the assets – i.e. the rail cars are not implicitly specified.

2.4.2

IFRS 16.A

IFRS 16.B15

Period of use

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

A supplier does not have the practical ability to substitute the asset throughout the period of use (and therefore there is no substantive substitution right) if, for example:

- the substitution right applies only to a part of the period of use or on or after a specific date (Example 4, Scenarios 1 and 2); or
- the substitution right applies only on the occurrence of a particular event (Example 4, Scenario 3).



Example 4 – Motor vehicle: Supplier's substitution right does not apply throughout the period of use

Scenario 1

Customer S enters into a contract with Supplier T for the right to use a motor vehicle for five years. T has the right to substitute the asset at any time after three years from the commencement of the contract (i.e. no substitution right for the first three years).

Because the supplier's substitution right does not apply throughout the period of use, it is not substantive.

Scenario 2

The contract is the same as above except that it gives T the right to substitute the identified asset on a single date, three years into the lease, but not at any other time.

The substitution right is not substantive because it does not apply throughout the period of use.

Scenario 3

The contract is as above but T has a right to substitute on the occurrence of a particular event.

The substitution right is not substantive because it does not apply throughout the period of use but only on the occurrence of a particular event.

IFRS 16.B14–B15



What if the customer has the right to use the underlying asset for 'non-consecutive periods'?

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

For example, Football Team V has the exclusive right to use a specific stadium for the months of September to May each year (during V's playing season); the contract runs for 10 years. From June to August, the owner of the stadium holds concerts and other events in the stadium.

In this situation, the period of use consists of 90 non-consecutive months. This is because V can use the stadium for nine months each year over the 10-year contract. The use of the same stadium by the owner 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 prevents companies from avoiding 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.



If the supplier can exercise a substitution right on or after a given date, then does the lease end on this date?

No, the lease does not end on the date on, or from which, the supplier can exercise a substitution right. Rather, the lease term is determined in the usual way and may extend beyond this date.

For example, in Scenarios 1 and 2 in Example 4 above, assuming that the other elements of the lease definition are met, at the commencement date it should not be assumed that the lease ends after three years. In the absence of additional information, the lease term, as assessed at contract inception, would be five years – i.e. the period for which the customer (lessee) has the right to use the asset.

2.4.3

IFRS 16.B14(b)

IFRS 16.B17

Economic benefits from substitution

A supplier would benefit economically from the exercise of its right to substitute the asset when the economic benefits associated with substituting the asset are expected to exceed the related costs.

The costs associated with substitution are generally higher if the asset is not located at the supplier's premises – i.e. when it is at the customer's premises or elsewhere. In this situation, the costs are more likely to exceed the benefits associated with substituting the asset.



Example 5 – Copier: Supplier substitution right: Evaluation of economic benefits

Customer C enters into a three-year lease of a multi-function copier/printer. The contract provides C with the right to determine how to use the machine during the three-year term (subject to the limitations of its design and capabilities).

Supplier S is required to provide an equivalent machine if the one originally delivered ceases to operate properly. S may also substitute an equivalent machine at any time during the period of use at its expense and without C's approval.

S has other equivalent machines readily available. However, it is not likely that S would earn more rental income by substituting an equivalent machine for the original machine. S would incur costs both to transport and install an equivalent machine at C's location, and to remove and transport the original machine to storage or to another customer's location.

In this example, S's substitution right is not substantive because the economic benefits from substituting the original machine for an equivalent machine would not exceed the costs of the substitution. Therefore, there is an identified asset.



Example 6 – Rail cars: Substitution right is substantive

Continuing Example 3, Supplier M has the practical ability to substitute the rail cars that are stored at its premises when they are not being used to transport goods. Costs associated with substituting the rail cars are minimal for M.

Relevant experience demonstrates that:

- M benefits economically from being able to deploy alternative assets as necessary to fulfil customer needs; and
- the conditions that make substitution economically beneficial (e.g. the nature and mix of different customer needs for M's assets) are likely to continue throughout the period of use.

As M has the practical ability to substitute the rail cars and their substitution is economically beneficial throughout the period of use, M's substitution rights are substantive and the arrangement does not contain a lease.



Example 7 – Lighting as a service: No practical ability to substitute and no economic benefits

Customer L enters into an eight-year contract with Supplier K that requires K to install specific lighting equipment at L's stores. The equipment is designed and selected by K, subject to L's approval. K has an option to upgrade the equipment for future technological advancements and an obligation to replace any damaged or defective equipment. However, the equipment is large and costly to transport and install, so it is not economically feasible or practicable for K to substitute alternative assets once the equipment is installed (i.e. the costs of substitution would exceed the benefits).

Fulfilment of the arrangement is dependent on the use of identified assets and the substitution rights are not substantive.



Example 8 – Vessels: Alternative scenarios involving substitution rights

The following three scenarios relate to a contract to use a vessel for five years:

- Ship owner S has a substitution right and many identical vessels (Scenario 1);
- Ship owner S has a substitution right and the vessel is significantly customised (Scenario 2); and
- Customer C is unable to determine whether Ship owner S's substitution rights are substantive (Scenario 3).

Scenario 1

Customer C enters into a five-year contract with Ship owner S to provide a vessel. The crew is managed and paid by S. S may substitute the vessel without C's consent throughout the term of the contract. The following facts are also relevant.

- S has many identical vessels that are maintained in a close and accessible location and S could easily substitute another vessel for the one specified in the contract at a nominal cost.
- S would benefit economically from substituting the vessel because substitution allows it to make the most effective use of its vessel portfolio to meet regularly changing circumstances, which are likely to continue throughout the period of use.

In this scenario, the vessel is not an identified asset because S's substitution right is substantive. Accordingly, the contract does not contain a lease.

Scenario 2

Changing the facts of Scenario 1, although S has the right to substitute the vessel without C's consent throughout the period of use, there are no other similarly customised vessels in S's portfolio or readily available from other suppliers.

In this scenario, the substitution right is not substantive because a similarly customised vessel is not readily available – i.e. S does not have the practical ability to substitute the vessel.

Note

In Scenario 2, even if S could customise an alternative vessel in its portfolio within a reasonable period of time, the cost of customising and providing a similar alternative vessel would probably exceed the economic benefits that would be realised from substitution – i.e. although S would not obtain additional payments from C for the substitution, S would incur potentially significant costs to customise an alternative vessel for C's needs. In this case, S's substitution right would still not be substantive because it would not benefit economically from the exercise of its substitution right.

Scenario 3

Changing the facts of Scenario 2, C is unable to determine whether the substitution right is substantive. In particular, C is unable to determine whether a similarly customised vessel is readily available, or whether the economic benefits that would result from substitution would exceed the expected costs of making the substitution.

In this scenario, C presumes that the substitution right is not substantive, and therefore that there is an identified asset.



How do you evaluate whether the supplier would benefit economically from exercising its substitution rights?

Judgement will be required to evaluate when the economic benefits associated with substituting the asset are expected to exceed the costs associated with doing so.

Examples of factors to consider include:

- the availability of other assets to fulfil the contract;
- the alternative use of the asset and additional benefits for the supplier;
- the costs that would be incurred to substitute the asset (e.g. costs of relocation, disruption of activity during a period of time); and
- the feasibility of substituting the asset (because of size, remote location etc).

Because the analysis is performed from the supplier's perspective, it is more difficult for the customer to determine whether the supplier's substitution right is substantive. As noted in Example 8, Scenario 3, if a customer cannot readily determine whether a supplier has a substantive substitution right, then the customer should presume that any substitution right is not substantive.

IFRS 16.B19, BC115



Does a clause permitting a landlord to relocate a tenant at any time represent a substantive substitution right?

Generally, no. Some real estate leases permit the landlord to relocate the tenant to alternative premises at any time – the landlord may use this right, for example, to move an existing tenant to another floor in an office building to accommodate a new tenant, or to relocate a tenant in a retail park to another site in the park to manage footfall.

A key question in such cases is whether the landlord would benefit economically from the substitution, based on the facts and circumstances at inception.

Future events that, at inception of the contract, are not considered likely to occur are excluded from the evaluation of whether the supplier's substitution right is substantive. An example of such a future event included in the new standard is a future customer offering to pay an above-market rent.

IFRS 16.B14(b)

IFRS 16.B16(a)

IFRS 16.IE2.Ex2

The IASB provides an example of an airport operator that can move tenants around at any time and at minimal costs. In situations such as this, the supplier may benefit economically from substitution and its substitution right may be substantive.



Does a clause permitting a landlord to relocate a tenant if market rents increase or another tenant offers to pay a higher rent represent a substantive substitution right?

IFRS 16.B15

No. Some real estate leases permit the landlord to relocate the tenant to alternative premises under certain circumstances. Substitution rights that can be exercised only on occurrence of a specified event – e.g. if market rents increase or another tenant offers to pay a higher rent – are not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

3

Economic benefits

Identifying the economic benefits from using the asset and evaluating whether the customer has the right to obtain substantially all of them throughout the period of use are not always straightforward.

3.1

Economic benefits from using the asset

IFRS 16.B21

The economic benefits from using an asset include its primary output, by-products and other economic benefits from using the asset that could be realised from a commercial transaction with a third party (e.g. sub-leasing the asset).

IFRS 16.B22

These economic benefits need to be in the defined scope of a lessee's right to use an asset – e.g. if a contract limits the use of a vehicle to only one particular territory during the period of use, then a company considers only the economic benefits from use of the vehicle within that territory, and not beyond.



Example 9 – Motor vehicle: Lease of a vehicle with maximum mileage permitted

IFRS 16.B22

Company C leases a motor vehicle that it can drive only up to a maximum of 100,000 miles during the three-year period. When assessing whether it has the right to obtain substantially all of the economic benefits from use of the vehicle, C considers only the economic benefits for the permitted mileage.



Example 10 – Solar farm: Primary products and by-products

IFRS 16.IE2.Ex9

Utility Company C enters into a 20-year contract with Power Company D to purchase all of the electricity produced by a new solar farm. D owns the solar farm and will receive tax credits relating to the construction and ownership of the solar farm, and C will receive renewable energy credits that accrue from use of the solar farm.

C has the right to obtain substantially all of the economic benefits from the use of the solar farm over the 20-year period because it obtains:

- the electricity produced by the farm over the lease term – i.e. the primary product from use of the asset; and
- the renewable energy credits – i.e. the by-product from use of the asset.

Although D receives economic benefits from the solar farm in the form of tax credits, these economic benefits relate to the *ownership* of the solar farm. The tax credits do not relate to the *use* of the solar farm and therefore are not considered in this assessment.

IFRS 16.BC118

**Are tax credits and similar items 'economic benefits' for the purposes of applying the lease definition?**

It depends on whether the benefits arise from ownership or use of the asset.

A lease conveys a right to *use* the underlying asset. Accordingly, the IASB concluded that the benefits derived from ownership of the asset (e.g. income tax credits) are excluded when considering whether a customer has the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use.

Conversely, benefits such as renewable energy credits received from use of the asset are more akin to a by-product and so will be included in the analysis of economic benefits.

The new standard is more specific in this area than current guidance and has the potential to reduce diversity in assessing whether an arrangement contains a lease. However, given the variety of arrangements seen in practice, and the complex structures sometimes used to allocate specific forms of benefits to different parties, judgemental issues may still remain in practice.

3.2

'Substantially all'

Evaluating whether a customer has the right to obtain substantially all of the economic benefits from use of an asset throughout the period of use is straightforward in many situations, generally because the customer in a lease frequently has exclusive use of the asset.

However, in some situations a contract may provide a party other than the customer the right to more than a minor amount of the economic benefits from use of the same asset. In evaluating whether the customer has the right to obtain substantially all of the economic benefits from use of an asset, a company considers the complete population of economic benefits that can be derived from the asset in the scope of the customer's right to use.

IFRS 16.B21

**Example 11 – Office: Sub-letting**

Customer C enters into a contract to use an office. Because C does not need all of the space covered by the contract, it sub-lets 25%. C receives substantially all of the economic benefits through its own use and sub-letting (other benefits).

IFRS 16.B22

**Example 12 – Business jet: Sharing of the economic benefits**

Customer G enters into a two-year contract to use a business jet. G shares access and use of the business jet with another party. Both parties have the right to use the jet at any point in time, subject to a certain number of hours per month and the other party not using it at the same time. G does not receive substantially all of the economic benefits because it shares the use of the asset with another party.

**Does 'substantially all' mean 90 percent?**

Not necessarily – see the discussion of the 'substantially all' threshold in Section 2.3.

**Can a customer obtain substantially all of the benefits from use even if lease payments are variable?**

Yes. The existence of variable lease payments derived from the use of an asset – e.g. a percentage of sales from use of a retail space – does not prevent a customer from having the right to obtain substantially all of the economic benefits from use of the asset. In these cases, although the customer passes on certain benefits to the supplier, the customer receives substantially all of the gross benefits.

For example, Customer D enters into a contract to use a retail store. The rent payments include a fixed amount per month plus 20 percent of the retail revenue generated from the store. D receives substantially all of the economic benefits: the gross proceeds accrue to D. Sharing a part of the revenues generated from the store (or, generally, usage-based rentals) does not prevent a contract from being a lease.

The new standard is explicit on this point, to reduce the risk that companies seek to avoid lease accounting by introducing variable payments into an arrangement that would otherwise be a lease.

**Does the significance of the lease payments affect the conclusion on whether a lease exists?**

Generally not. The economic benefits that a customer derives from use of the asset (e.g. the cash flows from selling products in a leased retail store) are generally separate from its lease payments. The significance of the lease payments, fixed or variable, for the right to use the asset, compared with the economic benefits to be derived from the use of that asset (e.g. high-rent locations), generally should not affect the conclusion about whether a lease exists.

IFRS 16.B23



What if the supplier absorbs all of the variability in net operating profits and receives most of the economic benefits from use of the asset?

Profit-sharing arrangements generally do not prevent the customer from obtaining all of the economic benefits from use of an identified asset throughout the period of its use. However, when the customer obtains a fixed rate of return and the supplier receives or absorbs all of the variability in net operating profits, it is not clear whether a contract contains a lease, particularly if the supplier also receives most of the economic benefits from use of the asset.

For example, a supplier may receive most of the cash flows from use of the asset in a business such as a casino, hotel operation or investment property. In this situation, careful consideration should be given to the substance of the contract, including the nature of the arrangement between the parties, when determining whether the customer has the right to obtain substantially all of the economic benefits from use of the identified asset. Customer and supplier should assess whether the nature of the arrangement is such that the customer is, in effect, an agent of the supplier, rather than the principal in the operation that is using the asset. If the customer is an agent of the supplier, then there is no lease between the supplier and customer.

4 Right to direct the use

It is the right to direct the use of an identified asset that differentiates a lessee from a customer in a typical supply or service contract.

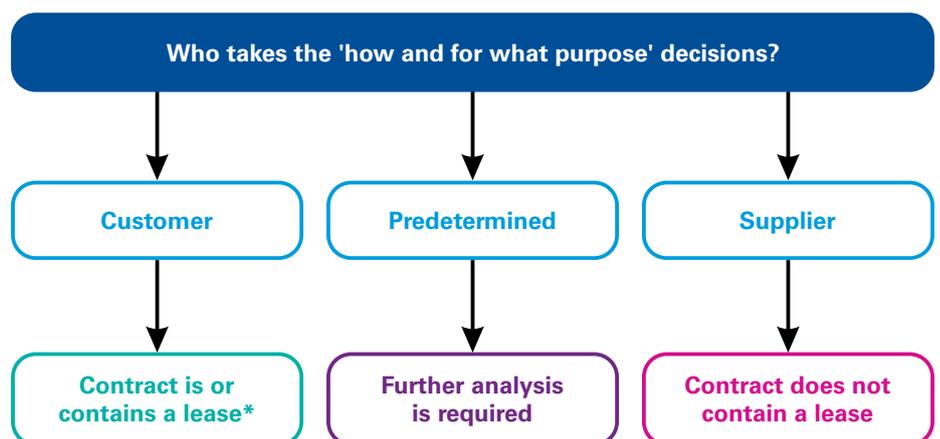
4.1

IFRS 16.B24

Overview

A customer has the right to direct the use of an identified asset in either of the following situations:

- the customer has the right to direct how and for what purpose the asset is used throughout the period of use – see Section 4.3; or
- the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use – see Section 4.4.



* If other criteria are met.



How are decision-making rights evaluated?

The new standard effectively requires a three-fold classification of decision-making rights into how and for what purpose decisions, operating decisions and protective rights. These categories feature in the analysis in different ways.

- **How and for what purpose (or relevant) decisions:** Unless they are predetermined, the allocation of these decisions to the supplier or customer determines whether the arrangement contains a lease – see Sections 4.2–4.3.
- **Operating decisions:** These are ignored, unless the how and for what purpose decisions are predetermined, in which case there is a lease if the customer makes the operating decisions and the other criteria are met – see Section 4.4.
- **Protective rights:** These typically define the scope of the customer’s right to use an asset but do not, in isolation, preclude a conclusion that there is a lease. However, when protective rights are too restrictive for the customer to have any substantive decision-making authority over the use of the asset, this could indicate that the how and for what purpose decisions are predetermined – see Section 4.5.

It follows that assessing the categories into which decisions fall is likely to be a key area of judgement in practice. The first step is to identify what the how and for what purpose decisions are – see Section 4.2.

4.2

IFRS 16.B24–B27, B30

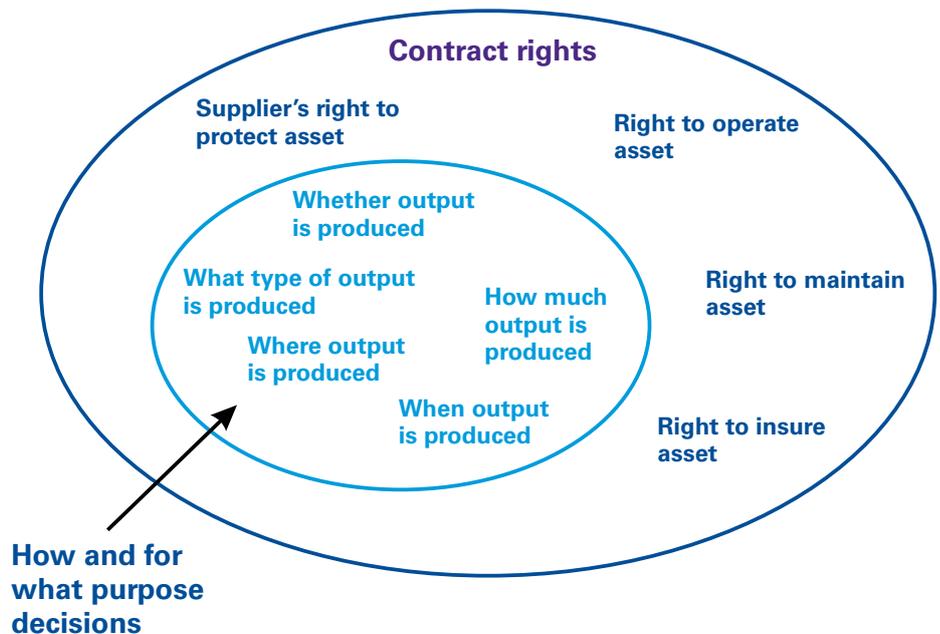
How and for what purpose decisions

A company considers the decision-making rights that are most *relevant* to changing how and for what purpose the asset is used – ‘relevant’ in the sense that they affect the economic benefits derived from use.

Examples of relevant decisions that, depending on the circumstances, grant the right to change how and for what purpose the asset is used include the following.

- **What:** rights to change the type of output that is produced by the asset (e.g. deciding whether to use a shipping container to transport goods or for storage).
- **When:** rights to change when the output is produced (e.g. deciding when a power plant will be used).
- **Where:** rights to change where the output is produced (e.g. deciding on the destination of a truck or a ship).
- **Whether and how much:** rights to change whether the output is produced, and the quantity of that output (e.g. deciding whether to produce energy from a power plant and how much energy).

Examples of decision-making rights that do *not* grant the right to change how and for what purpose the asset is used include rights to operate an asset or rights to maintain an asset.



Is a decision to take output that has already been produced a how and for what purpose decision?

No. The right to take output that has already been produced only determines what happens to that output, not whether and how much output is produced in the first place.

For example, Customer M enters into a 20-year contract with Supplier S, a solar developer, to install, operate and maintain a solar plant on M's facility. The solar plant has been designed by S to fulfil M's energy demand. M has the right to purchase any energy produced and S has the obligation to sell the energy to M whenever M wants to purchase it. Energy that is not purchased by M is sold into the grid – i.e. M has no obligation to purchase energy.

In this example, M's decision as to whether to purchase the electricity from the solar plant affects only to whom the existing output is directed (to M or the grid); M's decision does not affect when, where, whether or how much energy is produced. Therefore, it is not a how and for what purpose decision.

It is possible that all of the relevant decisions about how and for what purpose the asset is used are predetermined – see Example 17 in Section 4.4.

4.3

IFRS 16.A, B25, B29

Determining who takes the how and for what purpose decisions

A customer has the right to direct how and for what purpose the asset is used if, in the scope of its rights of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use (see Section 4.2).

In assessing whether a customer has the right to direct the use of an asset, a company considers only the rights to make decisions about the asset's use during the period of use. Decisions that are predetermined before the period of use – i.e. commencement date – are not considered.

The new standard defines the period of use as “The total period of time that an asset is used to fulfil a contract with a customer (including any non-consecutive periods of time)” – see 2.4.2.



Example 13 – Cargo ship: Customer takes the how and for what purpose decisions

IFRS 16.IE2.Ex6

Customer T enters into a five-year contract with Supplier U, a ship owner, for the use of an identified ship. T decides whether and what cargo will be transported, and when and to which ports the ship will sail throughout the period of use, subject to restrictions specified in the contract. These restrictions prevent T from sailing the ship into waters at a high risk of piracy or carrying explosive materials as cargo. U operates and maintains the ship, and is responsible for safe passage.

T has the right to direct the use of the ship. The contractual restrictions are protective rights that protect U's investment in the ship and its personnel – see Section 4.5. In the scope of its right of use, T determines how and for what purpose the ship is used throughout the five-year period because it decides whether, where and when the ship sails, as well as deciding the cargo that it will transport. T has the right to change these decisions throughout the period of use.



Example 14 – Lighting: Customer takes the how and for what purpose decisions

Customer L enters into an eight-year contract with Supplier K that requires K to install specific lighting equipment in L's stores. The equipment is designed and selected by K, subject to L's approval. To optimise its usage, K provides services under which it monitors the equipment remotely and performs maintenance on the equipment as needed. However, L specifies the hours of operation and the level of brightness, which impact the amount of consideration that it pays, which is based on usage.

In this example, L directs the use of the assets because it directs how and for what purpose the assets are used by specifying:

- the hours of operation (when, whether and how much output is produced); and
- the level of brightness (how much output is produced),

and can direct K to change these specifications within a reasonable variance.

**Example 15 – Drilling rig: Customer takes the how and for what purpose decisions**

Customer O enters into a three-year contract with Supplier S to drill six wells in a defined area. The drilling rig to be used by S is explicitly specified in the contract; S has no substitution rights. S is responsible for manning the rig, maintenance and safety. Compensation is based on a daily operation rate. In the case of bad weather or adverse conditions, S can suspend the work. Without S's consent, O cannot change the allocation of the rig – i.e. O cannot sub-lease the rig or change the defined area on its own.

O can make the following decisions:

- select the targets to be drilled and zones to be tested;
- set the exact timing of the well drilling; and
- stop the drilling, even if the initial expected depth was not reached.

In this example, O can change the how and for what purpose decisions related to the drilling rig throughout the period of use and therefore directs the use of the rig. S's right to suspend work in the case of bad weather or adverse conditions is a protective right. This is discussed further in Section 4.5.

**How is an arrangement analysed when the customer and the supplier each take some of the how and for what purpose decisions?**

The customer does not have to take all of the how and for what purpose decisions in order to have a lease – they can be split between the parties. Judgement is required to assess the individual significance of the different how and for what purpose decisions – i.e. their impact on the economic benefits.

If some decisions have greater significance than others, then the party that takes the more significant decisions generally directs the right to use the asset.

For example, Retailer T enters into a contract with Landlord L to use a specific retail unit for a five-year period. The unit is part of a larger retail space with many retail units. The contract requires T to use the unit to operate its well-known store brand to sell its goods during the hours when the larger retail space is open. L can make reasonable changes to the opening hours of the larger retail space. T decides on the mix of goods sold from the unit, their pricing and the quantity of inventory held.

In this example, there are a number of how and for what purpose decisions that are not predetermined. L can make reasonable changes to the opening hours. However, by deciding the mix of goods, their pricing and available quantities, T makes the decisions that will have a more significant impact on the economic benefits derived from the unit. Therefore, it is T that directs the right to use the unit.

IFRS 16.IE2.Ex4

4.4

IFRS 16.B24, B28–B29, BC121–BC122

How and for what purpose decisions are predetermined

The decisions about how and for what purpose the asset is used can be predetermined in a number of ways. They could, for example, be agreed between the customer and the supplier in negotiating the contract, with neither party being able to change them after the commencement date, or they could, in effect, be predetermined by the design of the asset.

A customer has the right to direct the use of an identified asset when *all* relevant decisions are predetermined and either:

- the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
- the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose it will be used throughout the period of use.

In either of these two cases, the customer controls the rights of use that extend beyond the rights of a customer in a typical supply or service contract (i.e. the customer has rights that extend beyond solely ordering and receiving output from the asset). This is important because the ability to specify the output in a contract before the period of use is *not* sufficient to direct the use.

IFRS 16.BC121

The IASB noted that it would expect situations in which *all* how and for what purpose decisions are predetermined to be rare.



Example 16 – Cargo ship: Customer hires the captain

Customer T enters into a four-year contract with Supplier S, a shipping company, to transport cargo from Hartlepool to Hamburg. The ship to be used is explicitly specified in the contract and cannot be substituted. T's cargo will occupy substantially all of the capacity of the ship. The contract specifies the cargo to be transported and dates of pickup and delivery. T hires the captain; the rest of the crew is provided by S.

In this example, all of the decisions about how and for what purpose the asset is used are predetermined because the contract specifies when and where the ship sails, as well as the cargo to be transported. The ship was not designed by T, but T may operate the ship because the ship's captain is hired by T. Although the ship cannot be operated without the rest of the crew (which is provided by S), it is usually the captain who makes the (major) operational decisions and gives instructions. In this scenario, the presumption is that T operates the ship and consequently has the right to direct its use.

IFRS 16.IE2.Ex9A

 **Example 17 – Solar plant: Customer designed the asset**

Customer M enters into a 20-year contract with Energy Supplier S to install, operate and maintain a solar plant for M’s energy supply. M designed the solar plant before it was constructed – M hired experts in solar energy to assist in determining the location of the plant and the engineering of the equipment to be used. M has the exclusive right to receive and the obligation to take any energy produced.

In this example, the nature of the solar plant is such that all of the decisions about how and for what purpose the asset is used are predetermined because:

- the type of output (i.e. energy) and the production location are predetermined in the agreement; and
- when, whether and how much energy is produced is influenced by the sunlight and the design of the solar plant.

Because M designed the solar plant and thereby predetermined any decisions about how and for what purpose it is used, M is considered to have the right to direct the use. Although regular maintenance of the solar plant may increase the efficiency of the solar panels, it does not give the supplier the right to direct how and for what purpose the solar plant is used. In practice, solar panels may be one rare example where *all* how and for what purpose decisions are predetermined.

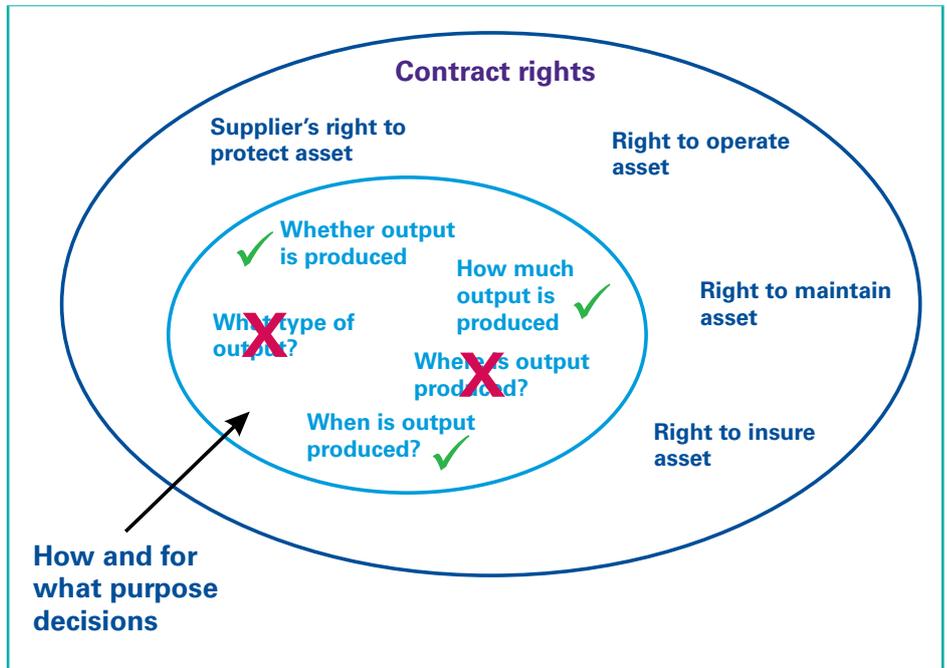
IFRS 16.B29

 **What happens if only some of the how and for what purpose decisions are predetermined?**

If some but not all of the relevant decisions about how and for what purpose the asset is used are predetermined, then the assessment includes only those relevant decisions that are not predetermined – see Section 4.3.

For example, Oil Producer O enters into a contract with Pipeline Operator P to obtain exclusive use of P’s oil pipeline for a period of 30 years. In this case, the decisions over *what* is transported (i.e. oil) and *where* it is transported (from the beginning to the end of the pipeline) are predetermined.

Therefore, the analysis will focus on determining whether the supplier or the customer has the right to make the relevant decisions that are not predetermined – i.e. whether, when and how much oil is transported through the pipeline.



Does the customer need relevant expertise in order to support a conclusion that the 'customer designed the asset'?

No. Example 17 illustrates the involvement of an external specialist by the customer in determining the location of the solar farm and the engineering of the equipment to be used.

In some cases, a customer's (or its specialist's) decision about the location of the asset and the engineering of the equipment could be sufficient to conclude that the customer designed specific aspects of the asset when the location is key for the asset's performance (e.g. for solar or wind farms). However, judgement applies and the individual facts and circumstances need to be considered.

4.5

IFRS 16.B30

Supplier's protective rights

A contract may include certain terms and conditions designed to protect the supplier's interest in the identified asset or other assets, to protect its personnel or to ensure the supplier's compliance with laws or regulations. Such protective rights typically define the scope of the customer's right to use an asset but do not, in isolation, prevent the customer from having the right to direct the use of the asset within that scope.

For example, a contract may:

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



Example 18 – Aircraft: Scope of right of use

Customer L enters into a two-year contract with Supplier M, an aircraft owner, for the use of an identified aircraft. The contract details the interior and exterior specifications for the aircraft. It also contains contractual and legal restrictions on where the aircraft can fly. Subject to these restrictions, L determines where and when the aircraft will fly, and which passengers and cargo will be transported on it. M is responsible for operating the aircraft, using its own crew.

The restrictions on where the aircraft can fly define the scope of L's right to use the aircraft. In the scope of its right of use, L determines how and for what purpose the aircraft is used throughout the two-year period of use because it decides whether, where and when the aircraft travels, as well as the passengers and cargo that it will transport. L has the right to change these decisions throughout the period of use.

The contractual and legal restrictions on where the aircraft can fly are protective rights and do not prevent L from having the right to direct the use of the aircraft.

IFRS 16.IE2.Ex7

5

Joint arrangements

Identifying the customer when a joint arrangement is involved is critical in determining whether there is a lease.

IFRS 16.B11, BC126, 11.20, 24

A joint arrangement (i.e. a joint venture or a joint operation) is considered to be the customer when the contract is either:

- entered into by the joint arrangement itself; or
- signed by one or more of the parties to the joint arrangement on behalf of the joint arrangement.

Provided that these requirements are met, the joint arrangement and not the individual parties to the joint arrangement is considered to be the customer when assessing whether the contract contains a lease. In this situation, it would not be appropriate to conclude that a contract does not contain a lease on the grounds that each of the parties to the joint arrangement either:

- obtains only a capacity portion that is not physically distinct;
- obtains only a portion of the economic benefits from use of the underlying asset; or
- does not unilaterally direct the use of the underlying asset.

When the joint arrangement is the customer, the contract contains a lease if the parties to the joint arrangement collectively have the right to control the use of an identified asset throughout the period of use through their joint control of the arrangement.

If there is a lease, then:

- in the case of a *joint operation*, each party to the joint operation accounts in its own financial statements for its share of the right-of-use asset and its share of the lease liability; and
- in the case of a *joint venture*, the right-of-use asset and the lease liability are recognised in the financial statements of the joint venture, but not in the financial statements of the partners to the joint venture.



Example 19 – Drilling rig: Contract signed by the joint operation

Joint Operation J is a separate vehicle with its own legal personality. J enters into a three-year contract with Supplier R, a service provider for the oil and gas industry, for the use of a drilling rig. The drilling rig is explicitly specified in the contract and R has no substitution rights. R is responsible for manning the rig, maintenance and safety. J makes all decisions about when and where to use the rig, as well as which geological targets to test.

In this example, J is the customer because J entered into the contract on its own. Moreover, the contract contains a lease because the drilling rig is an identified asset, J obtains substantially all of the economic benefits from the use of the drilling rig and J directs the right to use it.

Consequently, each of the parties to J recognises its share of the right-of-use asset and its share of the lease liability.



Example 20 – Drilling rig: Contract signed by the operator *on behalf* of the joint operation

IFRS 16.B11

Parties X, Y and Z set up a joint operation (K) as a separate vehicle with its own legal personality to explore a mineral interest. Each party to the joint operation contributes its undivided interest in that mineral interest (X: 40%; Y: 30%; Z: 30%) to K. X is appointed as the operator of K – i.e. X manages the day-to-day operations of K – while Y and Z are non-operators.

X, on behalf of K, enters into a two-year contract with Supplier R, a service provider for the oil and gas industry, for the use of a drilling rig. The drilling rig is explicitly specified in the contract and R has no substitution rights. R is responsible for manning the rig, maintenance and safety. In accordance with the joint operation agreement, X, Y and Z jointly make all decisions about when and where to use the rig, as well as which geological targets to test.

In this example, K is the customer to the contract, because X enters into the contract on behalf of K. Moreover, the contract contains a lease because:

- the drilling rig is an identified asset;
- X, Y and Z collectively obtain substantially all of the economic benefits from using the drilling rig (by using it to test K's mineral interest); and
- X, Y and Z jointly direct the use of the rig (i.e. they can collectively decide when, where and how to use the rig).

Therefore, K is the lessee in a lease with R. Consequently, X, Y and Z account in their own financial statements for their share of the right-of-use asset and their share of the lease liability.



Example 21 – Drilling rig: Contract signed by the operator

Parties X, Y and Z set up a joint operation (K) as a separate vehicle with its own legal personality to explore a mineral interest. Each party to the joint operation contributes its undivided interest in that mineral interest (X: 40%; Y: 30%; Z: 30%) to K. X is appointed as the operator of K – i.e. X manages the day-to-day operations of K – while Y and Z are non-operators.

X, in its own name as a principal, enters into a four-year contract with Supplier R, a service provider for the oil and gas industry, for the use of a drilling rig. The drilling rig is explicitly specified in the contract and R has no substitution rights. R is responsible for manning the rig, maintenance and safety. In accordance with the contract, X makes all decisions about when and where to use the rig, as well as which geological targets to test.

X is involved in a number of projects at various stages of development. X allocates the drilling rig to K for an initial two-year period and afterwards it is earmarked to another unrelated mineral interests' project in the same geographic region for the remaining two years of the contract.

In this example, X is the customer to the contract because X enters into the contract in its own name, as a principal, and not on behalf of K. Moreover, the contract contains a lease because:

- the drilling rig is an identified asset;
- X obtains substantially all of the economic benefits from using the drilling rig (by using it to test its mineral interests and obtaining reimbursements from Y and Z for their share of the costs); and
- X directs the right to use the rig (i.e. X can decide when, where and how to use the rig).

Therefore, X is the lessee in a lease with R. Consequently, X has the entire right-of-use asset and lease liability on its balance sheet.

In addition, X will need to determine whether it has entered into a sub-lease of the drilling rig with K, in which X would be the lessor and K the lessee. When determining whether there is such a sub-lease, K is assessed as the customer – i.e. X's share in the joint operation is included.

- If there is such a sub-lease, then X applies lessor accounting for the sub-lease. However, unlike when testing whether there is a sub-lease, lessor accounting for the sub-lease is restricted to Y's and Z's share in K because X cannot record a sub-lease to itself. Consistently, Y and Z account for their respective shares in the sub-lease between X and K.
- If there is no such sub-lease (e.g. because there is no collective control over the rig during the two-year period), then X (as receiver) and Y and Z (as payers) account for reimbursements related to the drilling rig as they would for other cost reimbursements.



When is a joint operator acting on behalf of the joint operation?

In practice, questions may arise about whether a joint operator enters a contract as a principal in its own name or on behalf of the joint operation. Judgement applies and the individual facts and circumstances – including the legal environment – should be considered.



Who is the customer if all parties to a joint operation sign the contract in their own names?

In some cases, all of the parties to a joint operation may sign *one* contract with a supplier, each in their own name and as principal. Alternatively, one party to a joint operation may sign on behalf of all other parties to the joint operation. These possibilities are not explicitly addressed in the new standard.

For example, four parties form a joint operation (JO) that has no separate legal personality to operate a gas field. Extracted gas is transported through a pipeline to a storage and processing facility. Whether, when and how much pipeline capacity is used is decided collectively by all joint operators through the decision to extract gas. The pipeline is owned and operated by an independent party (Supplier S). The four joint operators sign a 30-year contract with S to obtain exclusive use of the pipeline. This *one* contract is signed by each joint operator in its own name – i.e. not on behalf of JO.

Paragraph BC126 of the new standard uses the phrase ‘collectively have the right to control’. Therefore, if the joint operators enter the same contract collectively, then it appears that the accounting outcome is the same as if JO had entered into the contract itself.

Consequently, we believe that in this example JO is the customer to the contract. Effectively, the joint operators contribute their contractual rights for the use of the pipeline to the JO.

We believe that the same conclusion could be reached when the contract is instead signed by JO on behalf of its joint operators or by one joint operator on behalf of all the others.

These scenarios involve judgement and at this early stage of implementing the new standard, practice may evolve.

6

Scope and lessee exemptions

The recognition exemptions allow lessees to continue to hold certain leases off-balance sheet.

6.1

IFRS 16.3–4, IAS 38.6

Scope

Although some transactions meet the general definition of a lease, they are not accounted for as leases under the new standard because a specific scope exclusion applies.

The scope exclusions for lessees and lessors are not exactly the same. For example, although lessors apply the new standard to leases of biological assets that are in the scope of IAS 41 *Agriculture*, lessees do not.

Another difference in the scope exclusions for lessees and lessors is related to intangible assets. From the lessor's perspective, 'leases' of intangibles are generally not in the scope of the new standard. Lessees can (but are not required to) apply IFRS 16 to leases of intangible assets other than rights held under licensing agreements in the scope of IAS 38 *Intangible Assets* (e.g. motion picture films, video recordings, plays, manuscripts, patents and copyrights).

When do you apply the new standard?

	Lessees	Lessors
Leases to explore for or use minerals, oil, gas and other natural resources – i.e. leases of the mineral resource itself, not leases of assets used in exploration, development or production	✗	✗
Leases of biological assets in the scope of IAS 41	✗	✓
Service concession arrangements in the scope of IFRIC 12 <i>Service Concession Arrangements</i>	✗	✗
Licences of intellectual property granted in the scope of IFRS 15 <i>Revenue from Contracts with Customers</i>	N/A	✗
Rights held under licensing agreements in the scope of IAS 38	✗	N/A
Leases of other intangible assets	✓ (optional)	N/A

6.2

6.2.1

IFRS 16.5–8, A

Lessee exemptions

Overview

Even if a particular lease is in the scope of the new standard, a lessee may be able to simplify its accounting for that lease. A lessee can elect not to apply the lessee accounting model to:

- leases with a lease term of 12 months or less that do not contain a purchase option – i.e. short-term leases (see 6.2.2); and
- leases for which the underlying asset is of low value when it is new – even if the effect is material in aggregate (see 6.2.3).



Short-term leases

≤ 12 months



Leases of low-value items

≤ USD 5,000
for example

If a lessee elects to apply either of these recognition exemptions, then it recognises the related lease payments as an expense on either a straight-line basis over the lease term, or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.



What benefits do the recognition exemptions offer for lessees?

Applying the new definition is likely to be one of the biggest practice issues under the new standard. However, the recognition exemptions reduce compliance costs for lessees. The exemptions permit a lessee to account for qualifying leases in the same manner as existing operating leases under IAS 17 and to disclose only the income statement expense relating to these leases (and, in some cases, its lease commitments for short-term leases).



Why might a lessee decide not to apply the exemptions?

Lessees may find advantages in not applying the exemptions. For example:

- they may prefer to recognise and measure all leases on a consistent basis;
- they may prefer to avoid the systems and documentation consequences of having to identify which leases do and do not qualify for the exemptions, and of applying two lease accounting models; and/or
- they may prefer to present the lease expense as interest and depreciation, and record the lease assets and liabilities. This could lead to presentation of higher alternative earnings figures – e.g. EBITDA.



Do the recognition exemptions apply to lessors?

No. However, many of the affected short-term leases will be operating leases from the lessor's perspective. Therefore, lessors will usually get the same result as if the exemption were applied.

6.2.2

IFRS 16.A

Short-term leases

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

The 'lease term' is determined in a manner consistent with that for all other leases. Consequently, the short-term lease exemption may be applied to renewable and cancellable leases (e.g. month-to-month, evergreen leases) if the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months.

IFRS 16.6–8

Although short-term leases are in the scope of the new standard, a simplified form of accounting is permitted. A lessee can elect, by *class of underlying asset*, not to apply the recognition requirements of IFRS 16 and, instead, recognise the lease payments as a lease expense on a straight-line basis, or other systematic basis if it is more representative of the pattern of the lessee's economic benefits, over the lease term, consistent with current IAS 17 operating lease accounting.

IFRS 16.8

A 'class of underlying asset' is a grouping of underlying assets of a similar nature and use in the lessee's operations. When electing the short-term lease exemption for a particular class of underlying asset, only underlying assets from leases that meet the definition of a short-term lease are considered.

IFRS 16.7

If a lessee elects to apply the short-term lease exemption and there are changes to the lease term – e.g. the lessee exercises an option that it had previously determined that it was not reasonably certain to exercise – or the lease is modified, then the lessee accounts for the lease as a new lease.

IFRS 16.53(c)

A lessee is required to disclose the lease expense for short-term leases to which it applies the recognition exemption. This expense need not include the expense relating to leases with a lease term of one month or less – e.g. short-term car rental.

IFRS 16.55, 60

If a lessee applies the short-term lease exemption to a class of underlying assets, then it discloses that fact. In addition, a lessee discloses for those short-term leases:

- the lease expense for the period; and
- its lease commitments at the reporting date. This disclosure is required only if the portfolio of its committed short-term leases at the reporting date is dissimilar to the portfolio for which the short-term lease expense for the period is disclosed. This provides greater transparency of a lessee's off-balance sheet liabilities in circumstances where the short-term lease cost does not reasonably reflect the lessee's short-term commitments.

IFRS 16.B34

**Example 22 – Manufacturing: Applying the short-term leases exemption**

Lessee L enters into a 10-year lease of a machine to be used in manufacturing parts for a plane. It expects the model of plane to remain popular with customers until it completes development and testing of an improved model. The cost to install the machine in L's manufacturing facility is not significant. L and Lessor M each have the right to terminate the lease without a penalty on each anniversary of the lease commencement date.

Although the contract is for 10 years, the non-cancellable period is one year because both L and M have a substantive termination right – both can terminate the lease without penalty – and the cost to install the machine in L's manufacturing facility is not significant. As a result, the lease term is one year and the lease qualifies for the short-term lease exemption.

IFRS 16.7, BC95

**Example 23 – Construction equipment: Lease modification or change in lease term****Assessment on lease commencement**

Lessee S enters into a contract with Lessor T to lease a piece of non-specialised equipment for 12 months for construction work at one of its factories. The contract includes two 12-month renewal options with no change in payments. The lease does not contain a purchase option.

At lease commencement, S determines that it is not reasonably certain to exercise the renewal options, considering all relevant economic factors. This is because S expects to complete its construction work within the first 12 months. S concludes that the lease term is 12 months.

Therefore, the lease qualifies for the short-term lease exemption because the lease term is no longer than 12 months and there is no purchase option in the contract. On entering into this lease, S elects to apply the short-term lease exemption to all short-term leases of assets within the same class of underlying asset.

In applying the short-term lease exemption, S recognises the lease payments as a lease cost on a straight-line basis over the lease term.

Short-term lease that no longer meets the definition after a modification or a change in the lease term

Continuing the same example, 10 months after entering into the lease, S expands the scope and duration of construction at its factory so that it now expects to have an ongoing need to use the equipment throughout the second year. Market prices have increased such that S has an economic incentive to extend the existing lease rather than enter into a new lease. S therefore gives binding notice that it will exercise its option to extend the lease for a further 12 months.

As there has been a change in the lease term, S accounts for a new lease. The new lease term is 14 months (two remaining months from the initial lease term plus 12 additional months), so it no longer meets the definition of a short-term lease. S recognises a right-of-use asset and a lease liability accordingly.

IFRS 16.B35

**Example 24 – Tractor: Leases with termination options****Scenario 1 – Termination option controlled by lessor**

Lessee E enters into a contract with Lessor R to lease a tractor. The lease is for 10 months and is automatically renewed for a further six months unless the lease is terminated by R.

Periods covered by an option to extend (or not to terminate) the lease when exercise of the option is controlled by the lessor are included in the lease term. Accordingly, the lease term is 16 months and the lease is not a short-term lease.

Scenario 2 – Termination option controlled by lessee

Assume the same facts as in Scenario 1, except that E can decide whether to terminate the lease after 10 months. At lease commencement, E is not reasonably certain to continue the lease beyond the 10-month non-cancellable term based on all relevant economic factors – i.e. E is not reasonably certain that it will not exercise the termination option.

The lease term is 10 months and the lease meets the definition of a short-term lease.

IFRS 16.7, BC95

**What happens if the lessee applies the short-term lease exemption and the circumstances change?**

If the lease term changes such that the *remaining* lease term extends to more than 12 months, or the contract is modified to include a lessee purchase option, then the lease no longer qualifies for the recognition exemption.

When this is the case, the lessee applies the requirements of the new standard, including the recognition and measurement requirements, as if the date of the change were the commencement date of the lease.

IFRS 16.7, BC95

**Does the exemption for short-term leases apply to cancellable leases?**

Yes. The short-term lease exemption may be applied to cancellable leases (e.g. month-to-month, evergreen leases etc) if at the commencement date the lessee is not reasonably certain to renew (or to continue, in the case of a termination option) the lease beyond 12 months. The lease term for evergreen leases is established in the same manner as for all other leases, which means considering whether the lessee is reasonably certain to exercise one or more available renewal options.

Determining whether a lessee is reasonably certain to exercise a renewal option in an evergreen lease may involve significant judgement. In general, the shorter the non-cancellable period of a lease, the greater the likelihood that the lessee is reasonably certain to exercise one or more lease term renewal options. This is because, in many cases, it may be cost-prohibitive to continually substitute leased assets. For example, if a lessee leases a piece of construction equipment on a weekly basis and expects to need a substantially similar piece of equipment for the duration of a four-month project, then there may be a compelling economic reason not to continually substitute that asset throughout the four-month period.



Does the exemption create significant structuring opportunities?

This remains to be seen. However, the IASB considered the risk that leases could be structured to meet the definition of a short-term lease. It concluded that this risk is mitigated by the economic consequences of a short-term lease for a lessor. There are often economic disincentives for a lessor to grant short-term leases, because lessors will take on more residual asset value risk, and therefore may require increased lease payments to mitigate that risk. Other lessors may refuse to take on that additional risk entirely or be unable to do so based on the terms of their financing arrangements to acquire the leased assets.

IFRS 16.BC94

6.2.3

IFRS 16.5(b), 8, B3–B8

IFRS 16.B5, B7, BC102

IFRS 16.53(d)

IFRS 16.B6, B8, BC98–BC104

Low-value items

A lessee is permitted not to apply the recognition and measurement requirements to leases of assets that, when they are new, are of low value. This exemption, unlike the short-term lease exemption, can be applied on a lease-by-lease basis.

The exemption permits a lessee to account for qualifying leases in the same manner as existing operating leases. However, if an underlying asset of low value is highly dependent on, or highly inter-related with, other underlying assets, then a lessee does not apply the recognition exemption to the lease of that individual asset as it is not a separate lease component. The exemption also does not apply to a head lease for an asset that is sub-leased or that is expected to be sub-leased.

When applying the exemption for low-value items, a lessee does not provide all disclosures applicable to other leases (e.g. a maturity analysis of the remaining lease payments). However, for each reporting period presented in the financial statements, it does disclose the expense relating to low-value assets for which it applies the exemption.

The IASB included the exemption on the basis that it would provide substantial cost relief for many lessees and, in particular, smaller entities. The IASB intended the exemption to apply to assets with a value of approximately USD 5,000 or less when they are new, such as small IT equipment (e.g. some laptops, desktops, tablets, mobile phones, individual printers) and some office furniture – i.e. ‘inexpensive’ assets. The exemption is not intended to capture underlying assets such as automobiles and most photocopiers.

The exemption applies without regard to materiality (individually or in aggregate) of the leases to the reporting entity. This exemption could have a significant effect on certain industries – e.g. a telemarketing firm that leases a large number of phones and low-value IT equipment. In turn, this may complicate the comparison of the financial statements of entities in such industries reporting under US GAAP and IFRS, given the FASB’s decision not to provide a similar exemption.

IFRS 16.IE3



Example 25 – Applying the low-value items exemption

Lessee B is in the pharmaceutical manufacturing and distribution industry and has the following leases.

Leases	Eligible for low-value item exemption?
Real estate: both office building and warehouse	No
Inexpensive office furniture	Yes
Company cars: both for sales personnel and senior management; of varying quality, specification and value	No
Trucks and vans used for delivery	No
Inexpensive IT equipment – e.g. laptops	Yes

The leases of office furniture and laptops qualify for the recognition exemption if the underlying assets, when they are new, are individually of low value. B applies the new standard’s recognition and measurement requirements to its leases of real estate, company cars, and trucks and vans.

IFRS 16.BC102

**Can the lessee always apply the low-value item exemption despite materiality?**

Yes. The IASB recognised that there is a risk that the aggregate value of leases captured by the exemption might be material in some cases. There is a concern that this would probably be the case for large assets made up of a number of individual leases of low-value assets (e.g. IT equipment made up of individually low-value component parts). However, this is mitigated by the fact that a lessee cannot apply the recognition exemption to the lease of an individual asset in either of the following scenarios:

- if the underlying asset is highly dependent on, or highly inter-related with, other assets; or
- if the lessee cannot benefit from that underlying asset on its own or together with other readily available resources, irrespective of the value of that underlying asset.

In these circumstances, the highly dependent or inter-related assets are combined when assessing whether the exemption applies.

IFRS 16.7.B7

**What happens if the exemption is applied and the underlying asset is subsequently sub-leased?**

If a lessee sub-leases, or expects to sub-lease, an asset, then the head lease does not qualify as a lease of a low-value item. When a lessee neither enters into a sub-lease immediately nor expects to do so later, it may elect to apply the exemption.

However, if the lessee initially elects to use the exemption – because it rightly expects not to sub-lease the asset – but subsequently enters into a sub-lease, then the lease would no longer qualify for the exemption. Although this is not explicitly addressed in the new standard, it appears that at the date of the change, the lessee should consider the lease to be a new lease. In these cases, the lessee also considers whether the reason for the change in intention provides evidence as to whether other leases of low-value items do or do not qualify for the exemption.

7

Transition

Deciding whether to grandfather the lease definition on transition is a balancing act.

7.1

IFRS 16.C3–C4

Election to grandfather the lease definition

On transition to the new standard, companies can choose whether to:

- apply the new definition of a lease to all of their contracts; or
- apply a practical expedient to grandfather their previous assessment of which existing contracts are, or contain, leases.

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

- applies the new standard to leases previously identified in accordance with IAS 17 and IFRIC 4;
- does not apply the new standard to contracts previously identified as not containing leases in accordance with IAS 17 and IFRIC 4; and
- applies the new standard's definition of a lease to assess whether contracts entered into (or changed) on or after the date of initial application of the new standard are, or contain, leases.

IFRS 16.C2

The 'date of initial application' is the beginning of the annual reporting period in which a company first applies the new standard. For example, if a company prepares financial statements for annual periods ending on 31 December and adopts IFRS 16 in 2019, then its date of initial application is 1 January 2019.



What are the main pros and cons of adopting this practical expedient?

The practical expedient to grandfather the definition of a lease on transition offers considerable relief. Without this relief, companies would be required to reassess all of their previous decisions about which existing contracts do and do not contain leases. The practical expedient is therefore likely to prove popular.

However, it will not be adopted by all companies. For example, a company that is a purchaser under a power purchase agreement (PPA) that is an operating lease under current requirements but not a lease under the new standard (see Appendix 2) may prefer to apply the new definition of a lease, rather than bring the PPA on-balance sheet.

Companies will want to evaluate carefully whether to apply the transition relief, balancing:

- the cost savings that would arise if they take the transition relief; against
- the potential impact of needing to apply the new lease accounting model to arrangements that would fall outside lease accounting under the new definition.

Other considerations will include the number, size and duration of such agreements – and the extent of inconsistency in accounting for agreements entered into before and after the date of initial application.



How significant are the costs of applying the new lease definition retrospectively?

For many companies, the costs could be high; this will depend on the facts and circumstances of the company.

A company will need to apply the new lease definition not only to contracts previously identified as leases, but also to all other purchase arrangements.

To mitigate the costs of applying the new lease definition retrospectively, a company could seek to develop a practical approach in which it groups similar contracts and focuses the most in-depth analysis on those groups of contracts that are more likely to be impacted by the differences in the lease definition between IAS 17 and the new standard. However, in a large, diversified group the time and costs required to conduct – and, crucially, document – the assessment could still be high.



How significant is the impact on comparability of using the practical expedient?

For many companies, the impact on comparability could be small; this will depend on the facts and circumstances of the company.

The impact will be small for companies that identify substantially the same transactions as being leases under the old and new definitions. Although lease definition was a key talking point as the new standard was developed, for many routine transactions, the same transactions are leases under the old and new definitions – e.g. many real estate and equipment leases.

Companies will see a higher impact on comparability if they have entered into arrangements that are operating leases under IAS 17 but do not meet the new definition of a lease – e.g. some PPAs. If the practical expedient is applied, then the arrangement will be on-balance sheet when transitioning to the new standard.



Can a company choose to apply the new definition of a lease only to certain classes of transaction on transition – e.g. to power purchase agreements?

No. Application of the practical expedient is an accounting policy choice, to be applied consistently to all contracts on transition. A company cannot elect to apply the new definition only to individual classes of underlying assets or when the company acts only in the capacity of lessee or lessor.

IFRS 16.11

**If an entity applies the practical expedient, then does this determine the assessment of the contract for the rest of its term?**

Not necessarily. The practical expedient applies to the identification of leases only on the date of initial application of the new standard. There is no exemption from the general requirement to reassess whether a contract is, or contains, a lease if the terms and conditions of the contract are subsequently modified.

IFRS 16.11

**Does the practical expedient permit an entity to grandfather errors or omissions in its previous assessment of which contracts are, or contain, leases?**

No. The practical expedient is not intended to be an amnesty.

During the course of the IFRS 16 implementation project, it is possible that some companies will identify errors or omissions in their previous assessment of which contracts are, or contain, leases. These should be corrected in the normal way under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

7.2

IFRS 16.C10

Practical expedient for leases with a short remaining term

When applying a modified retrospective approach to leases previously classified as operating leases, a lessee may account for leases with a lease term that ends within 12 months of the date of initial application as short-term leases.

This practical expedient can be applied independently of any other exemption permitted in the new standard, and is elected on a lease-by-lease basis.

**Example 26 – Motor vehicle: Lease with a remaining term of 12 months**

Lessee Q leases a vehicle for use in its business for an annual rental of 100. The lease commences on 1 January 2017. The lease includes a three-year non-cancellable period, renewable at Q's option for a further two years at the same rental. The useful life of the vehicle is 10 years.

In 2017, Q assesses that it is reasonably certain to exercise the renewal option and that the lease term is five years. Q notes that there are no indicators that the lease is a finance lease and so classifies it as an operating lease.

Q adopts the new standard using a modified retrospective approach with a date of initial application of 1 January 2019. At that date, Q assesses that it is no longer reasonably certain to exercise the renewal option – i.e. the remaining term of the lease is one year.

Q can choose to account for the lease in one of two ways in 2019, as follows.

- Q can apply the new standard's lessee model to the lease and recognise a right-of-use (ROU) asset and a lease liability. Under this approach, Q would measure the lease liability at 100, discounted at its incremental borrowing rate at 1 January 2019. It could then measure the ROU asset retrospectively, or at an amount equal to the lease liability. As a result, Q would recognise depreciation and interest expense in 2019.
- Q can use the practical expedient to account for the lease as a short-term lease. Under this approach, Q would not recognise an ROU asset or lease liability for this lease. Instead, Q would recognise lease expense of 100 in 2019, including this expense in its disclosure of total short-term lease expense.



Can a lessee apply this practical expedient on transition even if it does not plan to use the recognition exemption for short-term leases subsequently?

Yes. The use of this practical expedient is independent of the lessee's ongoing accounting policy for short-term leases after transition.

- The recognition exemption for short-term leases (see 6.2.2) is an accounting policy choice by class of underlying assets. As such, it is applied consistently to leases of underlying assets in the same class and from period to period.
- The practical expedient for leases with a remaining term of 12 months at the date of initial application can be elected on a lease-by-lease basis at that date.

As such, the practical expedient offers additional relief – and additional flexibility – on transition.

8

Next steps

8.1

Lease definition

8.1.1

Exemptions on transition

A key next step is to evaluate which of the optional exemptions you will apply on transition. This will include deciding the following.

- Whether to apply the practical expedient to grandfather the assessment of which transactions are, or contain, leases at the transition date – see Section 7.1.
- Whether to apply the recognition exemption for leases of low-value items and, if so, to which leases – see 6.2.3.
- Whether to apply the recognition exemption for short-term leases and, if so, to which leases – see 6.2.2.
- Whether to apply the practical expedient for other leases with a short remaining term on transition and, if so, to which leases – see Section 7.2.

These are all key decisions to be made on transition – will you spend the time and cost necessary to reassess your existing transactions and thereby exclude some existing transactions from lease accounting, or grandfather existing arrangements and apply the new definition only to new arrangements?

Crucially, the decision on whether to apply the practical expedient to grandfather lease definition on transition will impact the scope and nature of the work to be completed before transition.

8.1.2

Applying the new lease definition to existing contracts

If you choose *not* to apply the practical expedient to grandfather lease definition on transition, then you will need to apply the new lease definition to your existing contracts – i.e. to contracts that do and do not contain leases under IFRIC 4 and IAS 17.

For most companies, this is likely to be a major project. Although the absolute number of contracts for which you ultimately reach different conclusions on lease definition under the new standard and IFRIC 4/IAS 17 may be relatively small (see Appendix 2 for a summary of the differences), completing and documenting the assessment will involve significant work. Getting started is an immediate priority.

A practical approach to make the project manageable may include the following.

- Stratifying the main types of leasing (and potential leasing) contracts that the company enters into.
- Identifying the types of contracts for which it is relatively clear whether they do/do not contain leases.
- For contracts for which the evaluation is less clear, completing a full evaluation for a representative sample of contracts to identify key points of principle and judgements, and discussing the analysis with relevant experts (e.g. valuation

specialists etc) and the company's auditors. Examples of contracts that may require more detailed review might include:

- long-term supply agreements – e.g. those involving tooling arrangements;
 - outsourcing agreements – e.g. outsourcing of IT services; and
 - power purchase agreements.
- Preparing standard documentation to document these more detailed reviews.
 - Compiling a database of lease documentation required to extend these detailed reviews to the full population of contracts, considering the use of machine-reading software if it is appropriate.

8.1.3

Other considerations affecting all companies

Irrespective of whether a company applies the practical expedient to grandfather lease definition on transition, it should consider the following.

- Guidelines for procurement departments to consult with finance when negotiating the terms of material contracts that might contain leases, so that the accounting impact is understood before the contract is signed.
- New processes and systems to evaluate new contracts to assess whether they are leases, and to document the results of that evaluation.
- New processes and systems to identify and evaluate changes to contracts that may impact the assessment of whether they contain leases.
- Training for personnel involved in negotiating, assessing and processing (potential) leases.

In addition, ensuring that all leases have been identified and that the disclosures of operating lease commitments required under IAS 17 are complete and accurate, is a priority for all.

8.2

Transition considerations

A key early decision is how to transition to the new standard. For many companies, the choice of transition method and which practical expedients to apply will have a major impact on the cost of implementing the standard and the comparability of trend data in the years after transition. The transition option will have a significant impact on the extent of data gathering and the timing of system and process changes, and should be considered as soon as possible.

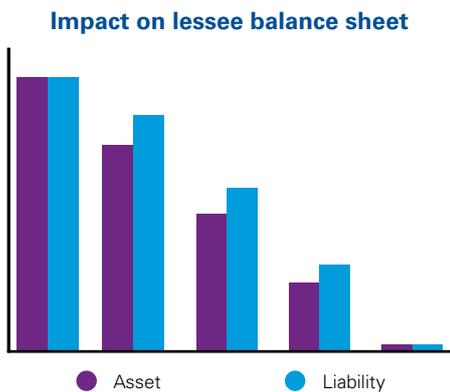
Our [Leases: Transition Options](#) provides additional guidance to help you transition to the new standard.

8.3

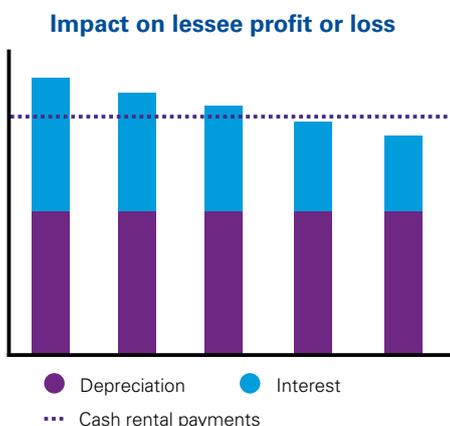
Pre-adoption disclosures

You will need to prepare for the pre-adoption disclosures. IAS 8 requires disclosures about standards that have been issued but are not yet effective. Several regulators have openly stated that this disclosure will be a focus area for the upcoming new standards. As the application date approaches, more detailed information is expected to be disclosed.

Appendix 1 – IFRS 16 Overview



Companies with operating leases will appear to be more asset-rich, but also more heavily indebted



Total lease expense will be front-loaded even when cash rentals are constant

Topic	Key fact
Lease definition	<ul style="list-style-type: none"> – New lease definition with an increased focus on control of the use of the underlying asset
Lessee accounting model	<ul style="list-style-type: none"> – Single lease accounting model – No lease classification test – Most leases on-balance sheet: <ul style="list-style-type: none"> - lessee recognises an ROU asset and lease liability - treated as the purchase of an asset on a financed basis
Lessor accounting model	<ul style="list-style-type: none"> – Dual lease accounting model for lessors – Lease classification test based on IAS 17 classification criteria – Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset – Operating lease accounting model based on IAS 17 operating lease accounting
Practical expedients and targeted reliefs	<ul style="list-style-type: none"> – Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under 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 – i.e. underlying assets with an approximate value of USD 5,000 or less when they are new – even if they are material in aggregate
Effective date	<ul style="list-style-type: none"> – Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 is also adopted – Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

Appendix 2 – IFRS 16 vs IFRIC 4

1

IFRS 16.A, IAS 17.4

IFRIC 4.4

Overview

The defined term 'lease' is the same in the new standard and IAS 17. However, the detailed guidance on how to identify whether a transaction is, or contains, a lease in IFRS 16 and IFRIC 4 is different in a number of respects.

Under IFRIC 4 an arrangement is, or contains, a lease if:

- fulfilment of the arrangement depends on the use of a specific asset; and
- the arrangement conveys a right to use the asset.

The detailed differences between IFRIC 4 and the new standard mean that some agreements that are currently treated as leases may no longer be leases under IFRS 16 – e.g. some PPAs. Conversely, there may be contracts that do not currently contain a lease, but may be captured by the new definition in IFRS 16.

2

Use of a specific asset

IFRIC 4's requirement that fulfilment of the arrangement is dependent on the use of a specific asset is broadly similar to the requirement in the new standard that there is an identified asset. However, there are two key differences.

Capacity portions

IFRIC 4.BC9–BC12

IFRIC 4 is essentially silent on whether a capacity portion of a larger asset can be a specific asset. In developing IFRIC 4, the IFRS Interpretations Committee decided not to address capacity portions. However, IFRIC 4 is applied when the underlying asset would represent a unit of account under IAS 16 *Property, Plant and Equipment* or IAS 38.

In contrast, the new standard is explicit that a capacity portion of a larger asset is an identified asset if it:

- is physically distinct; or
- represents substantially all of the capacity of the asset (see Section 2.3).

Whether this more specific guidance increases or decreases the number of transactions identified as leases under the new standard will depend on the facts and circumstances of the individual company. In particular, it will depend on the accounting policy that a company applied for capacity portions under IFRIC 4.

Substitution rights

IFRIC 4.7–8

IFRIC 4 states that an asset may be specified implicitly or explicitly. An asset is implicitly specified if it is not 'economically or practically feasible' for the supplier to substitute alternative assets.

The IFRS 16 guidance on substitution rights is more detailed. In particular, it states that an asset is specified implicitly unless a substitution right is ‘substantive’ – see Section 2.4. The extensive guidance on substitution rights includes the following.

- A substitution right is substantive only if the lessor would benefit economically from substitution, whereas IFRIC 4 requires only that substitution is ‘economically... feasible’.
- A substitution right is substantive only if the lessor has the practical ability to exercise that right throughout the period of use, whereas IFRIC 4 states only that the existence of a substitution right does not preclude the existence of a lease up to the date of substitution.

This suggests that demonstrating that an arrangement does not contain a lease due to the existence of a substitution right will be a higher hurdle under the new standard than under IFRIC 4.

3 Right to use the asset

IFRIC 4.9

Under IFRIC 4, an arrangement conveys the right to use an asset if any one of three specific criteria are met, as follows.

IFRIC 4 control criteria	Identifies a lease under IFRS 16?
The customer has the ability or right to operate the asset, including to direct how others operate the asset, while obtaining more than an insignificant amount of the output.	Not necessarily. Under the new standard, a more comprehensive analysis of control – including an assessment of who takes the how and for what purpose decisions – is required (see Chapter 4). IFRS 16 focuses only on who ‘operates’ the asset when the how and for what purpose decisions are predetermined. In addition, a lease exists only if the lessee obtains ‘substantially all’ of the economic benefits (see Chapter 3).
The customer has the ability or right to control physical access to the asset while obtaining more than an insignificant amount of the output.	Not necessarily. IFRS 16 places no emphasis on who controls physical access to the asset when assessing who directs the use of the asset (see Chapter 4). In addition, a lease exists only if the lessee obtains ‘substantially all’ of the economic benefits (see Chapter 3).
No other party takes more than an insignificant portion of the output and the unit price of the output is neither fixed nor at market.	Not necessarily. The first part of this criterion is similar to the ‘substantially all’ test in IFRS 16. However, the way in which the output is priced is not a relevant consideration when identifying a lease under IFRS 16.

In practice, the new standard’s increased focus on which party controls the use of the underlying asset during the period of use is likely to be the key difference between IFRIC 4 and IFRS 16. It is possible that a number of arrangements that are identified as being leases under IFRIC 4 will not be leases under the new standard, as the following example illustrates.



Example 27 – OEM plant: Comparing IFRS 16 and IFRIC 4

Customer B enters into a five-year contract with Manufacturer S to purchase components for a new hi-tech product.

S is an original equipment manufacturer (OEM), which manufactures for various customers and operates various plants within its legal structure. The production process is very complex and uses proprietary knowledge to manufacture the product.

The contract specifies that S needs to use Plant P to produce the components. Alternative plants cannot be used because B requires a special certification for its product and the components used.

S will operate the plant and charge a cost-plus price to B. The possibility that other parties may receive more than an insignificant amount of the output of Plant P is considered remote. B's only decision-making rights relate to deciding on the quantity of components to be delivered.

	IFRIC 4	IFRS 16
Contract?	Yes.	Yes.
Specific asset/ identified asset?	Yes – explicitly identified in the contract and cannot be changed due to certification requirements.	Yes – it is specified in the contract and there are no substantive substitution rights (the plant cannot be changed) and it is not a capacity portion (the contract allows the use of the whole asset).
Customer has right to use the asset?	Yes. <ul style="list-style-type: none"> – B takes all of the output, and the probability of third parties taking more than an insignificant amount of output is remote. – The price is neither fixed per unit nor a market price. 	No – the how and what purpose decisions are made by S because S decides when and how to operate the asset and operates the asset. B's only decision-making rights relate to deciding on the quantity of components to be delivered.

	IFRIC 4	IFRS 16
Customer obtains substantially all of the economic benefits?	N/A.	Yes – the probability of third parties taking more than an insignificant amount of output is remote and there are no by-products or other benefits.
Lease?	Yes – all elements are present.	No.

Although IFRIC 4 is used by all industries, those that are likely to be most affected by the changes include:

- energy;
- mining;
- oil and gas; and
- telecommunications.

The focus of their analysis under the new standard will be to determine whether the customer has the right to direct the use of the identified assets, which is subject to significant judgement in some cases.

Appendix 3 – IFRS 16 vs US GAAP

Despite small differences in the actual wording, IFRS and US GAAP use a converged definition of a lease but different exemptions apply for lessees.

1

Definition

The drafting on lease definition is largely converged. However, there are some small wording differences in the core material on the lease definition – e.g. regarding substantive substitution rights. The status of the examples also differs between IFRS and US GAAP.

The IASB and US FASB do not expect these differences in the standards to lead to significant differences in the transactions that are identified as being leases under IFRS and US GAAP.

2

Exemption for short-term leases for lessees

IFRS 16.A

Both IFRS and US GAAP include an exemption for short-term leases. The exemptions are broadly converged in that both focus on leases with a term (as determined in accordance with the standard) of 12 months or less. However, IFRS 16 states that if the lessee has an option to purchase the underlying asset, then the lease is not a short-term lease. In contrast, US GAAP excludes from the exemption only leases in which the lessee is reasonably certain to exercise a purchase option. This means that more leases will qualify for the exemption under US GAAP than under IFRS.

Changes in short-term leases

IFRS 16.7

Both IFRS 16 and US GAAP require lessees to re-evaluate whether a lease qualifies as a short-term lease if it is modified, or there is a change in the lease term.

However, US GAAP also states that a lease is no longer a short-term lease if it becomes reasonably certain that the lessee will exercise an option to purchase the underlying asset. This additional requirement is unnecessary under IFRS 16 because any lessee purchase option precludes short-term lease categorisation.

Renewal options

Under IFRS 16, a short-term lease is assessed as a new lease if the lease is modified or there is any change in the lease term (e.g. the lessee exercises an option not previously included in its determination of the lease term).

In contrast, under US GAAP a lease ceases to be a short-term lease only if the change in the lease term results in the period beyond the end of the previously determined lease term being more than 12 months. Therefore, under US GAAP if a lessee has a 12-month lease and exercises a 12-month renewal option 30 days before the end of the initial 12-month lease term, then the remaining lease term at the date of the option exercise is 13 months. However, the lease does still qualify as a short-term lease because the period beyond the end of the previously determined lease term is only 12 months.

This means that more leases that have been renewed will qualify for the exemption under US GAAP than under IFRS.

3

Exemption for leases of low-value assets under IFRS 16 for lessees

IFRS 16.5(b), B3–B8

Under IFRS 16, a lessee is permitted not to apply the recognition and measurement requirements to leases of assets that are of low value when they are new – see 6.2.3. Leases of low-value assets qualify for the recognition exemption regardless of whether they are material to the lessee.

There is no equivalent exemption under US GAAP. The FASB decided against a low-value asset exemption because current guidance on materiality permits a lessee to exclude leases that are immaterial to its financial statements. The FASB observed that a lessee may be able to adopt reasonable capitalisation thresholds below which lease assets and lease liabilities are not recognised.

This means that a company with a large number of low-value leases can elect not to recognise lease assets and liabilities for those leases under IFRS, but always needs to assess materiality in the aggregate under US GAAP.

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The text of this publication refers to IFRS 16 and to selected other current standards in issue at 1 April 2017.

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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