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Accounting for changes

Lease modifications are very common. For example, a lessee with a struggling business may seek to negotiate lower lease payments or terminate some leases early. Or a lessor may wish to end a lease early so that it can redevelop or redeploy the underlying asset.

Whatever the reason for the change, the resulting accounting can be complicated.

IFRS 16, the new leases standard, introduces detailed guidance on accounting for lease modifications. This is good news, providing clarity and consistency in an area where there has been little guidance – and much diversity – in the past.

A company adopting IFRS 16 using either a retrospective approach or a modified retrospective approach with the election to recreate the right-of-use asset from the commencement date will need to address historical lease modifications now, as part of its transition project. And all companies will need to prepare for lease modifications that will take place after transition – a key ‘day two’ aspect of the new world of lease accounting.

This publication contains practical guidance and examples showing how to account for the most common forms of lease modifications. We hope you will find it useful as you prepare to adopt the new standard in 2019.

Kimber Bascom
Ramon Jubels
Sylvie Leger
Brian O’Donovan
KPMG’s global IFRS leases leadership team
KPMG International Standards Group
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At a glance

1.1

Key facts

IFRS 16.A

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

- increasing the scope of the lease by adding the right to use one or more underlying assets (see Examples 1, 2, 7, 8 and 14);
- decreasing the scope of the lease by removing the right to use one or more underlying assets (see Example 3) or shortening the contractual lease term (see Examples 8, 9, 15 and 17);
- increasing the scope of the lease by extending the contractual lease term (see Examples 4, 7 and 16); and
- changing the consideration in the lease by increasing or decreasing the lease payments (see Examples 1, 2, 3, 5, 6, 7, 14, 15, 16 and 17).

Changes that result from renegotiations of the original contract are lease modifications. Adjusting the lease payments (cash flows) by contractual rent adjustment mechanisms, and reassessing whether a lessee is reasonably certain to exercise (or not exercise) an option included in the original contract, are not lease modifications.

Lessees modifications

IFRS 16.BC202

The new standard distinguishes between lease modifications that represent, in substance, the creation of a new lease that is separate from the original lease and those that represent, in substance, a change in the scope of, or consideration paid for, the existing lease (see Chapter 3). In a nutshell:

- separate lease: account for the new lease; make no adjustment to the initial lease; and
- not a separate lease: remeasure the initial lease.

IFRS 16.7

If a lessee applies the recognition exemption for short-term leases, then a lease modification will be considered a new lease.

Lessors modifications

Although the new standard introduces fewer changes for lessors, it does introduce requirements for lease modifications. There is separate guidance on lease modifications for finance leases and operating leases (see Chapter 4).

Effective date of a lease modification

Lease modifications are accounted for at the effective date of the lease modification. This is the date when both parties agree to the lease modification and is usually the date when the modified contract is signed. For modifications that are not accounted for as separate leases, the lease liability and right-of-use asset are remeasured at this date. Complex application issues arise if the modification is agreed on one date but the change in the right of use or consideration happens on a different date (see Chapter 5).
1.2 Key impacts

**Identifying all lease agreements and extracting lease data.** Lessees will now recognise most leases on-balance sheet. This may require a substantial effort to identify all leases with payments that should be included in the lease liability, and whether subsequent modifications result in accounting for a separate lease and/or remeasurement of the lease liability and the right-of-use asset.

**New estimates and judgements.** The new standard introduces new estimates and judgements that affect the measurement of lease liabilities. A lessee determines the liability at commencement and may be required to revise it – e.g. when the lease term is modified. This will require ongoing monitoring and increase financial statement volatility.

**Balance sheet volatility.** The new standard introduces financial statement volatility to assets and liabilities for lessees and lessors, due to the requirements to account for lease modifications. This may impact a company’s ability to accurately predict and forecast results and will require ongoing monitoring (see Chapters 3 and 4).

**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 – e.g. changes in the structuring or pricing of a lease agreement, including the inclusion of options in the contract to avoid subsequent lease modifications. The new standard is therefore likely to affect departments beyond financial reporting – including treasury, tax, legal, procurement, real estate, budgeting, sales, internal audit and IT.

**New systems and processes.** Companies should ensure that they have systems and processes enabling them to identify and measure completely and in a timely manner the commencement of new leases, and the modification, reassessment or impairment-triggering events of existing ones. This becomes even more important when leasing is decentralised and undertaken by non-accountants.

**Transition considerations.** A key early decision is which transition option to adopt. The extent of information required by lessees in 2019 will depend on the transition approach chosen – e.g. under a modified retrospective approach, if the lessee elects to measure the right-of-use asset at an amount equal to the lease liability, then no historical information about modifications before the date of initial application is needed. Under the retrospective approach, or if a lessee using the modified retrospective approach elects to recreate the right-of-use asset from the commencement date, modifications will need to be reconstructed.

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

**Sufficient documentation.** The judgements, assumptions and estimates applied in determining how to measure the lease liability at the commencement date, as well as when a modification occurs, will need to be documented.
Key concepts

Lease modifications come in many shapes and sizes – but a few key concepts are central to accounting for all of them.

2.1 What is a lease modification?


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

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

Changes that result from renegotiations and changes to the terms of the original contract are lease modifications.

2.2 Modifications are different from reassessments

IFRS 16.BC201

There is a difference between scenarios that result in the remeasurement of existing lease assets and lease liabilities due to:

- reassessment of estimates used in lease accounting; and
- lease modifications.

After the commencement date, lease reassessments take place, for example, when there are changes in the lease payments (cash flows) based on contractual clauses included in the original contract.

IFRS 16.36(c), 39–43, B42

The new standard provides guidance on when a lessee should reassess the lease liability and right-of-use asset. However, it is silent for lessors.
Common examples of scenarios that result in reassessments for lessees include changes in the:

- assessment of the lease term;
- assessment of whether a purchase option will be exercised;
- expected amount payable under a residual value guarantee;
- future lease payments from a change in the index or rates used to determine those payments;
- lease payments resulting from a change in floating interest rates; or
- variable lease payments becoming fixed or in-substance fixed payments.

After the commencement date, a lessee remeasures the lease liability to reflect changes to the lease payments. The lessee adjusts the carrying amount of the right-of-use asset for the remeasurement of the lease liability. If the carrying amount of the right-of-use asset has already been reduced to zero and there is a further reduction in the measurement of the lease liability, then the lessee recognises any remaining amount of the remeasurement in profit or loss.

The following diagram summarises the impact of changes in the carrying amount of the lease liability arising from a reassessment on the right-of-use asset.

For details of how to apply the guidance on reassessments, see our publications *Lease payments* and the 15th Edition 2018–19 of *Insights into IFRS*. 
2.3 A separate lease

A key distinction in accounting for lease modifications is assessing whether they create a separate lease. This typically occurs when the modification adds a new right-of-use asset at its stand-alone price (see Section 3.3 and 4.3.1). Lessors also account for a new lease whenever an operating lease is modified (see Section 4.4). When this is the case, the accounting is often straightforward. However, the accounting is more complex when a lease modification is not accounted for as a separate lease.

2.4 Discount rates

A lessee uses a new discount rate whenever there is a lease modification. A lessor, on the other hand, requires a new discount rate for some but not all lease modifications (see Sections 3.2 and 4.2).

2.5 Effective date of a modification

The effective date of the lease modification is the date when both parties agree to the lease modification. For modifications that are not accounted for as separate leases, the lease liability and right-of-use asset are remeasured at this date. Complex application issues arise if the modification is agreed on one date but the change in the right of use happens on a different date (see Chapter 5).
3 Lessee modifications

The new standard provides a general framework for accounting for lease modifications.

3.1 Overview

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

– the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
– the consideration for the lease increases by an amount equivalent to the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

For a modification that is *not a separate lease*, at the effective date of the modification the lessee accounts for it by remeasuring the lease liability using a discount rate determined at that date and:

– for *modifications that decrease the scope of the lease*: decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease, and recognising a gain or loss that reflects the proportionate decrease in scope; and
– for *all other modifications*: making a corresponding adjustment to the right-of-use asset.

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

*Right of use.*
### 3.2 Discount rates

*IFRS 16.45, BC202–BC203*

When a lease modification is accounted for as a new lease, the lessee accounts for the separate lease in the same way as any new lease, using a new discount rate.

A lessee revises the discount rate when there is a modification that is not accounted for as a separate lease. The use of a revised discount rate in remeasuring the lease liability reflects the fact that the lease modification has changed the economics of the lease – because of the change in scope and/or price – which the discount rate is intended to reflect.

The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term, unless this cannot be readily determined. If the implicit rate cannot be readily determined, then the revised discount rate is the lessee’s incremental borrowing rate at the effective date of the lease modification.

#### In which modification scenarios does a lessee revise the discount rate?

*IFRS 16.44–45*

A lessee determines a new or revised discount rate each time a lease is modified. Although the lease modification guidance is complex, there are essentially two possible outcomes, as follows.

<table>
<thead>
<tr>
<th>Modification</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>The modification is accounted for as a separate lease.</td>
<td>The lessee does not revise the discount rate for the original lease. However, the lessee uses a new discount rate to account for the separate lease. The new rate is determined at the effective date of the modification (see Chapter 5). The lessee uses the interest rate implicit in the lease if it is readily determinable; otherwise, the lessee uses its incremental borrowing rate.</td>
</tr>
<tr>
<td>The modification is not accounted for as a separate lease.</td>
<td>The lessee remeasures the lease liability using a revised discount rate. The revised rate is determined at the effective date of the modification (see Chapter 5). The lessee uses the interest rate implicit in the lease if this is readily determinable; otherwise, the lessee uses its incremental borrowing rate.</td>
</tr>
</tbody>
</table>
3.3 Separate lease

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

– the modification increases the scope of the lease by adding the right to use one or more underlying assets; and

– the consideration for the lease increases by an amount equivalent to the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

In this case, the lessee:

– accounts for the separate lease in the same way as any new lease; and

– makes no adjustment to the initial lease.

Example 1 – Increase in scope by adding the right to use one or more underlying assets and corresponding increase in consideration

Lessees Z entered into a lease contract with Lessor L to lease one floor in an office building for 10 years. Z’s business has since expanded and Z now requires additional office space. At the beginning of Year 7, Z and L amend the contract to grant Z the right to use an additional floor of office space in the same building for four years. The new office space is the same size as the original office space and similar in all significant respects.

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

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

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

– the modification increases the scope of the lease by adding the right to use an additional underlying asset – i.e. an additional floor of office space; and

– the lease payments for the additional floor are commensurate with market rentals for a similar office space, as adjusted for the circumstances of the contract. Even though the lease payments for the new office space are 5% below market rentals, the discount reflects L’s sharing with Z of the benefit of not having to market the property or pay a broker’s commission and not having to incur other common origination fees.

Z does not modify the accounting for the original office space lease.
3.4 Not a separate lease

The following flowchart summarises the steps for accounting for a modification that is not a separate lease at the effective date of the modification (see Chapter 5).

1. Allocate the consideration in the modified contract

2. Determine the lease term of the modified lease

3. Remeasure the lease liability – revised payments discounted using a revised discount rate

4. Account for the remeasurement of the lease liability

- Partial or full termination (decrease in scope)
  - Decrease the carrying amount of the right-of-use asset
  - Recognise the gain or loss in profit or loss

- All other modifications
  - Adjust the right-of-use asset

3.4.1 Increase in scope not at stand-alone price

A lessee accounts for a lease modification that increases the scope by adding the right to use one or more underlying assets but for which the consideration is not at a stand-alone price as follows:

- allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components;
- determine the lease term;
- remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- make a corresponding adjustment to the right-of-use asset.
Example 2 – Increase in scope by adding the right to use one or more underlying assets with no corresponding increase in consideration

Assume the same facts as in Example 1, except that the lease payments for the new office space are discounted by 20% of the original lease payments, which are not considered to be market rentals for a similar separate lease.

Although the modification increases the scope of the lease by adding the right to use an additional underlying asset – i.e. the additional floor of office space – the increase in consideration for the lease is not commensurate with the stand-alone price for the increase in office space even after considering the factors that enabled L to forego the costs that it would have incurred if the additional floor had been leased to a new tenant.

Therefore, this lease modification is not accounted for as a separate lease.

At the effective date of the modification, Z remeasures the lease liability by discounting the revised lease payments using a revised discount rate and makes a corresponding adjustment to the right-of-use asset.

In this scenario, because the lease of the new office space commences immediately, and both leases have the same lease term, it does not matter whether Z accounts for the lease of the original office space and the new office space as separate lease components. However, the accounting would be more complex if the lease of the new office space commenced at the beginning of Year 8, rather than at the beginning of Year 7 (see Example 20).

3.4.2 Decrease in scope

A lessee accounts for a lease modification that decreases the scope – i.e. removes the right to use one or more underlying assets or shortens the contractual lease term – as follows:

- allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components;
- determine the lease term;
- remeasure the lease liability by discounting the revised lease payments at the revised discount rate;
- decrease the pre-modification right-of-use asset (and pre-modification lease liability) and recognise any gain or loss in profit or loss to reflect partial or full termination; and
- adjust the remaining right-of-use asset for the difference between the remaining lease liability and modified lease liability.
Example 3 – Decrease in scope and consideration

Lessee E entered into a 10-year lease for 10,000m² of office space with Lessor F. The rental payments are 100,000 per annum payable in arrears. The incremental borrowing rate at commencement of the lease is 7% (assume that the interest rate implicit in the lease cannot be readily determined).

Assuming no initial direct costs, lease incentives or dismantlement costs, E records a right-of-use asset and a lease liability of 702,358 at the commencement date.

Subsequently, E downscales its operations and requires less office space. Therefore, at the beginning of Year 7, E and F agree to reduce the space to 7,500m² (i.e. a reduction of 2,500m²).

E and F also agree to reduce the lease payments to 75,000 per annum, payable in arrears for the remaining four years. The incremental borrowing rate at this date is 8% (assume that the interest rate implicit in the lease cannot be readily determined).

The decreases in scope (office space) and consideration were not included in the original terms and conditions of the lease. Therefore, this is a lease modification.

At the beginning of Year 7 (the effective date of the modification), the carrying amount of the right-of-use asset is 280,943 and the lease liability is 338,721.

There are two elements to be accounted for:
- the decrease in the right-of-use asset and lease liability for the partial termination of the lease (reduction of 2,500m²); and
- the decrease in the remaining lease payments (reduction of 25,000 per annum).

**Remeasurement of the lease liability**

At the effective date of the modification – i.e. the beginning of Year 7 – E remeasures the lease liability at 248,410 based on:
- annual lease payments payable in arrears of 75,000;
- a remaining lease term of four years; and
- a revised incremental borrowing rate of 8%.

E accounts separately for the reduction of space and change in consideration.

**Accounting for the remeasurement of the lease liability**

**Partial termination of the lease**

As a first step, E accounts for the partial termination of the lease (reduction of 2,500m²) by reducing the carrying amount of the right-of-use asset and lease liability and recognising any resulting gain or loss as follows.
E determines the proportionate decrease in the carrying amount of the right-of-use asset based on the remaining right-of-use asset.

<table>
<thead>
<tr>
<th>Original square metres</th>
<th>10,000</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remaining square metres</td>
<td>(7,500)</td>
<td>(75%)</td>
</tr>
<tr>
<td><strong>Reduction in square metres</strong></td>
<td><strong>2,500</strong></td>
<td><strong>25%</strong></td>
</tr>
</tbody>
</table>

E therefore reduces the carrying amount of the right-of-use asset and lease liability to reflect the 25% decrease in scope. The remaining right-of-use asset is measured as 210,707 (280,943 x 75%). The remaining lease liability for the original office space is 254,041 – i.e. the present value of four annual lease payments of 75,000, discounted at the original rate of 7%.

E recognises the difference between the decrease in the right-of-use asset and the decrease in the lease liability as a gain in profit or loss at the effective date of the modification (i.e. the beginning of Year 7).

<table>
<thead>
<tr>
<th></th>
<th>Pre-modification carrying amount</th>
<th>Remaining carrying amount after Step 1 (75% of pre-modification)</th>
<th>Difference (reduction by 25%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>338,721</td>
<td>254,041</td>
<td>(84,680)</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>280,943</td>
<td>210,707</td>
<td>(70,236)</td>
</tr>
<tr>
<td><strong>Gain on modification</strong></td>
<td></td>
<td></td>
<td><strong>14,444</strong></td>
</tr>
</tbody>
</table>

**Change in consideration**

As a second step, at the effective date of the modification – i.e. the beginning of Year 7 – E recognises the difference between the remaining carrying amount of the lease liability after Step 1 of 254,041 and the modified lease liability of 248,410 (i.e. 5,631) as an adjustment to the right-of-use asset. This reflects the change in the consideration paid for the lease and the revised discount rate.

### 3.4.3 Other lease modifications

#### Increase in lease term

IFRS 16.45–46

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

- allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components;
- determine the lease term;
- remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- make a corresponding adjustment to the right-of-use asset.
Example 4 – Increase in lease term

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

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

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

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

The effective date of the modification is the end of Year 18 (see Chapter 5). At this date, the lease liability is 278,912, the right-of-use asset is 186,933 and X’s incremental borrowing rate is 8% (assume that the interest rate implicit in the lease cannot be readily determined).

X remeasures the lease liability at 1,130,412 based on:
- annual lease payments payable in arrears of 150,000;
- a remaining lease term of 12 years (two years remaining on the original lease term plus the 10-year extension); and
- a revised incremental borrowing rate of 8%.

X recognises the difference between the carrying amount of the lease liability before the modification (278,912) and the carrying amount of the modified lease liability (1,130,412) of 851,500 as an adjustment to the right-of-use asset.
How does an increase in the lease term impact a restoration obligation included in the right-of-use asset?

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

The obligation for these costs is recognised and measured in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

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

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

In this case, a change to the provision for restoration costs due to the change in scope will be recognised in the right-of-use asset and accounted for prospectively over the remaining useful life of the right-of-use asset.

Change in consideration only

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

- allocate the consideration to each lease component on the basis of the relative stand-alone price of the lease components and the aggregate stand-alone price of the non-lease components;
- determine the lease term;
- remeasure the lease liability by discounting the revised lease payments at the revised discount rate; and
- make a corresponding adjustment to the right-of-use asset.
Example 5 – Reduction in rent (consideration)

Lessee X enters into a 20-year lease of office space with Lessor Y. The annual lease payments are 150,000 payable in arrears and X’s incremental borrowing rate at commencement of the lease is 5% (assume that the interest rate implicit in the lease cannot be readily determined). X does not provide any residual value guarantee. There are no initial direct costs, lease incentives or other payments between X and Y. Therefore, X initially recognises the lease liability and right-of-use asset at 1,869,332 each.

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

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

The effective date of the modification is the end of Year 10 (see Chapter 5). At this date, the lease liability is 1,158,260, the right-of-use asset is 934,666 and X’s incremental borrowing rate is 6% (assume that the interest rate implicit in the lease cannot be readily determined).

X remeasures the lease liability at 736,009 based on:
- annual lease payments payable in arrears of 100,000;
- a remaining lease term of 10 years; and
- a revised incremental borrowing rate of 6%.

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

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

Example 6 – Rental rebates

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

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

The rental rebate represents a reduction in the lease payments that was not included in the original agreement. Therefore, it is a lease modification. (For an illustration of a reduction in consideration, see Example 5.)
More complex combinations of modifications

When there are multiple elements to a modification – e.g. a change in scope and consideration of the original lease – each element needs to be addressed separately, as follows:

– account for the separate lease as described in Section 3.3; and
– account for the modified lease as described in Section 3.4.

Example 7 – Modification that adds the right to use an underlying asset and increases the term but decreases the consideration ('blend and extend')

Lessee C enters into a 10-year lease of a floor of office space with Lessor D. The annual payments are 150,000 payable in arrears and C’s incremental borrowing rate at commencement of the lease is 5% (assume that the interest rate implicit in the lease cannot be readily determined).

Due to high vacancy rates in the real estate market, D would like to encourage C to commit to staying in the office space for longer. Further, market rentals for similar office space in the area have declined to 120,000 per annum. At the end of Year 6, D and C enter into negotiations and agree to:

– extend the original lease of the floor of office space by an additional five years after Year 10;
– lower the annual payments for the original lease to 120,000 for the remaining nine years (i.e. four remaining years of the original lease term plus a five-year extension); and
– lease an additional floor of office space for 120,000 per annum payable in arrears and for a term of nine years commencing at the end of Year 6 (i.e. the leases of the original floor and the new additional floor end at the same time).

At the end of Year 6, the carrying amount of the right-of-use asset is 463,304 and the carrying amount of the lease liability is 531,893.

The annual lease payments of 120,000 are considered to be commensurate with the stand-alone price for the increase in the scope of the lease.

At this date, C’s incremental borrowing rate is 6% (assume that the interest rate implicit in the lease cannot be readily determined).

Additional floor

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

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

– the modification increases the scope of the lease by adding the right to use an additional underlying asset – i.e. an additional floor of office space; and
– the lease payments for the additional floor are commensurate with stand-alone rentals of this space.
Therefore, C recognises a lease liability and right-of-use asset of 816,203 based on:

- annual lease payments payable in arrears of 120,000;
- a lease term of nine years; and
- an incremental borrowing rate of 6%.

**Original lease of floor – Increase in lease term and decrease in consideration**

The original agreement did not include renewal options or decrease-in-consideration clauses. Therefore, this is a lease modification. The modification includes an increase in the lease term and change in the consideration for the lease that were not part of the original terms and conditions of the lease.

These elements of the modification do not add the right to use more underlying assets, although the consideration has changed. Therefore, this is not accounted for as a separate lease.

At the effective date of the modification – i.e. end of Year 6 – C remeasures the lease liability at 816,203 based on:

- annual lease payments payable in arrears of 120,000;
- a remaining revised lease term of nine years; and
- a revised incremental borrowing rate of 6%.

C recognises the difference between the pre-modification lease liability of 531,893 and the modified lease liability of 816,203 (i.e. 284,310) as an adjustment to the right-of-use asset.

**Co-terminous lease term and the same terms and conditions**

Although the lease of the additional floor is a separate lease, because the right to use the new space commences on the effective date of the modification and the lease terms of the original lease and those for the additional floor space end at the same time and have the same terms and conditions, C could account for the modifications together.

---

**Does extending the term of a lease give rise to a separate lease?**

No, because there is no additional right-of-use asset (see Example 4).
Can you rely on the stated payments in the modified contract when assessing whether the lessee should account for the modification as a separate lease?

No. The lessee cannot make the separate lease assessment on the basis of just the stated price for the additional right of use.

If the additional right to use an underlying asset is part of a larger contract modification, then the substance of the changes needs to be considered and the allocation of the consideration of the modified contract should be done first.

In Example 7, given that the payments are the same as for what appears to be an equivalent existing right of use this may have little practical effect. However, if the modification had been structured so as to leave the original lease payments of 150,000 unchanged and to introduce lease payments of 90,000 for the additional space, then the total charge for the lessee would have been the same total of 240,000. In this case, the lessee could not have made the separate lease assessment on the basis of just the stated price in the contract and concluded that the increase is not commensurate with the stand-alone price for the increase in scope. Rather, the total new consideration would have needed to be allocated to the components of the larger contract. The lessee should have reached the same conclusion as in Example 7.

Example 8 – Modification that adds the right to use an underlying asset and decreases the lease term

Assume the same pre-modification facts as in Example 5. At the end of Year 10, X and Y agree to:

- decrease the total lease term from 20 years to 15 years;
- include an additional office space in the same building; and
- increase the total annual lease payments to 200,000 payable in arrears for both the original lease space and the additional office space (assume that this increase is not commensurate with the stand-alone price for the increase in scope).

The effective date of the modification is the end of Year 10 (see Chapter 5). At this date, the lease liability is 1,158,260, the right-of-use asset is 934,666 and X’s incremental borrowing rate is 6% (assume that the interest rate implicit in the lease cannot be readily determined).

Lease modification

The decrease in lease term, increase in office space and increase in consideration were not part of the original terms and conditions of the lease. Therefore, this is a lease modification.

Although the modification adds the right to use an underlying asset, the increase in consideration is not commensurate with the stand-alone price for the increase in scope and therefore it is not accounted for as a separate lease.
Remeasurement of the lease liability

At the effective date of the modification, X remeasures the lease liability at 842,473 based on:

- annual lease payments payable in arrears of 200,000;
- a remaining lease term of five years; and
- a revised incremental borrowing rate of 6%.

X accounts separately for the decrease in lease term and the increase in the office space and consideration.

Accounting for the remeasurement of the lease

Partial termination of the lease

As a first step, X accounts for the partial termination of the lease (reduction of the lease term to five years) by reducing the pre-modification right-of-use asset and lease liability and recognising any resulting gain or loss as follows.

X determines the proportionate decrease in carrying amount of the right-of-use asset based on the remaining right-of-use asset for the original office space. The remaining right-of-use asset is measured as 467,333 (934,666 x 5 / 10 – i.e. based on five years remaining).

The remaining lease liability for the original office space is 649,422 – i.e. present value of five annual lease payments of 150,000, discounted at the original discount rate of 5%.

X recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset as a gain in profit or loss at the effective date of the modification (i.e. end of Year 10).

<table>
<thead>
<tr>
<th></th>
<th>Pre-modification carrying amount</th>
<th>Remaining carrying amount after Step 1</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>1,158,260</td>
<td>649,422</td>
<td>(508,838)</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>934,666</td>
<td>467,333</td>
<td>(467,333)</td>
</tr>
<tr>
<td>Gain on modification</td>
<td></td>
<td></td>
<td>41,505</td>
</tr>
</tbody>
</table>

X records the following entries.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td></td>
<td>508,838</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>467,333</td>
</tr>
<tr>
<td>Gain on modification</td>
<td></td>
<td>41,505</td>
</tr>
</tbody>
</table>

To recognise partial termination of lease
**Increase in leased space and consideration**

As a second step, at the effective date of the modification X recognises the difference between the remaining carrying amount of the lease liability after Step 1 of 649,422 and the modified lease liability of 842,473 (i.e. 193,051) as an adjustment to the right-of-use asset. This reflects the increase in the lease payments and the revised discount rate.

X records the following entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>193,051</td>
</tr>
<tr>
<td>Lease liability</td>
<td>193,051</td>
</tr>
</tbody>
</table>

To recognise increase in leased space and consideration

Similar to Example 2, there is no need to account for the lease of the original office space and the new office space as separate lease components because the lease of the new office space commences immediately and both components have the same lease term. However, the accounting becomes more complex when the effective date of the modification precedes the date on which the additional office space is available to the lessee (see Example 20).

**Summary**

Based on the above accounting, X recognises the following at the effective date of the modification.

<table>
<thead>
<tr>
<th>Lease liability</th>
<th>Right-of-use asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before modification</td>
<td>1,158,260</td>
</tr>
<tr>
<td>Decrease in lease term</td>
<td>(508,838)</td>
</tr>
<tr>
<td>Increase in leased space and consideration</td>
<td>193,051</td>
</tr>
<tr>
<td><strong>After modification</strong></td>
<td><strong>842,473</strong>*</td>
</tr>
</tbody>
</table>

*Annual lease payments of 200,000, discounted at 6% over five years.*
3.5 Termination or break of a lease

Sometimes a lessee terminates a lease earlier than the term contemplated in the original agreement. In these circumstances, the lessee will often pay to the lessor a termination penalty (also referred to as a ‘break clause’), even if one was not included in the original contract, to compensate the lessor for the loss of revenue.

Lease payments include penalties for terminating the lease. However, unlike a termination penalty considered in the initial measurement and determination of the lease term, some break clauses or termination penalties are not contemplated in the original agreement. They result from negotiation between the lessee and the lessor when they reach a modified agreement. It appears that these termination penalties should be considered part of the revised lease payments.

Example 9 illustrates a typical scenario.

Example 9 – Termination/break of the lease clause not included in original contract

Lessee L enters into a 10-year contract with Lessor M to lease a building. The annual payments are 100,000 payable in arrears and L’s incremental borrowing rate at commencement of the lease is 5% (assume that the interest rate implicit in the lease cannot be readily determined). There are no termination or break clauses in the original contract.

During Year 5, L begins experiencing financial difficulties and wants to end the lease earlier than originally planned. At the end of Year 5, L and M enter into negotiations and agree to ‘break’ or terminate the lease at the end of Year 7 (i.e. in two years’ time, three years earlier than the original expiry of the lease). In addition, L agrees to pay M a termination or break fee of 120,000 at the end of Year 6.

At the end of Year 5, the carrying amount of the right-of-use asset is 386,087 and the carrying amount of the lease liability is 432,948.

At that date, L’s incremental borrowing rate is 9% (assume that the interest rate implicit in the lease cannot be readily determined).

Lease modification

The original terms and conditions of the lease did not include an option to terminate or break the lease or reduce the lease term. Therefore, L treats it as a lease modification that is not accounted for as a separate lease. Further, the reduction in the lease term represents a partial termination of the lease (see Example 8).

Remeasurement of the lease liability

At the effective date of the modification, L remeasures the lease liability at 286,003 based on:

- lease payments of 220,000 payable at the end of Year 6 (the annual payment of 100,000 plus the termination or break fee of 120,000) and 100,000 payable at the end of Year 7;
- a remaining lease term of two years; and
- a revised incremental borrowing rate of 9%.
In this case, the lease contains only a single lease component; therefore, the break fee forms part of the revised lease payments.

L accounts separately for the decrease in lease term and change in consideration.

**Accounting for the remeasurement of the lease**

**Partial termination of the lease**

As a first step, L accounts for the partial termination of the lease by reducing the pre-modification right-of-use asset and lease liability and recognising any resulting gain or loss as follows.

L determines the proportionate decrease in carrying amount of the right-of-use asset based on the remaining right-of-use asset for the building. The remaining right-of-use asset is measured as 154,435 (386,087 x 2 / 5 – i.e. based on two years remaining).

The remaining lease liability for the original lease payments is 185,941 – i.e. present value of two annual lease payments of 100,000, discounted at the original discount rate of 5%.

L recognises the difference between the decrease in the lease liability and the decrease in the right-of-use asset as a gain in profit or loss at the effective date of the modification.

<table>
<thead>
<tr>
<th></th>
<th>Pre-modification carrying amount</th>
<th>Remaining carrying amount after Step 1</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>432,948</td>
<td>185,941</td>
<td>(247,007)</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>386,087</td>
<td>154,435</td>
<td>(231,652)</td>
</tr>
<tr>
<td><strong>Gain on modification</strong></td>
<td></td>
<td></td>
<td><strong>15,355</strong></td>
</tr>
</tbody>
</table>

L records the following entries.

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>247,007</td>
<td></td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td></td>
<td>231,652</td>
</tr>
<tr>
<td>Gain on modification</td>
<td></td>
<td>15,355</td>
</tr>
</tbody>
</table>

*To recognise the partial termination of the lease*
Change in consideration

As a second step, at the effective date of the modification L recognises the effect of remeasuring the remaining lease liability based on the revised discount rate of 9% as an adjustment to the right-of-use asset.

| Remaining lease liability for the original lease payments at original discount rate | (Present value of 100,000 at 5% for two years) | (185,941) |
| Remaining lease liability for the modified lease payments at revised discount rate | (Present value of 220,000 payable at the end of Year 6 and 100,000 payable at the end of Year 7 at 9%) | 286,003 |

Adjustment to right-of-use asset | 100,062 |

L records the following entries.

| Debit | Credit |
| Right-of-use asset | 100,062 |
| Lease liability | 100,062 |

To recognise remeasurement of remaining lease liability

Summary

Based on the above accounting, L recognises the following at the effective date of the modification.

<table>
<thead>
<tr>
<th>Lease liability</th>
<th>Right-of-use asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before modification</td>
<td>432,948</td>
</tr>
<tr>
<td>Decrease in lease term</td>
<td>(247,007)</td>
</tr>
<tr>
<td>Remeasurement of lease liability</td>
<td>100,062</td>
</tr>
<tr>
<td>After modification</td>
<td><strong>286,003</strong>*</td>
</tr>
</tbody>
</table>

* Lease payments of 220,000 at the end of Year 6 and 100,000 at the end of Year 7, discounted at 9%.
Example 10 illustrates how the scenario in Example 9 compares with one in which a termination penalty clause was included in the original terms of the contract.

### Example 10 – Termination/break of the lease clause was included in original contract

Assume the same facts as Example 9, except that the original lease agreement included an option for L to terminate the lease at the end of Year 7, subject to a termination penalty of $120,000 payable at the end of Year 6. Therefore, when L exercises its termination option there is no lease modification.

At commencement of the original lease, L and M assessed whether it was reasonably certain that L would not exercise the termination or break option. This was included in the determination of the lease term.

- **If it was not reasonably certain that L would continue the lease after Year 7** (i.e. not reasonably certain that L would not exercise the termination option), then at the commencement date, in the absence of other factors affecting the lease term, the lease term would have been assessed to be seven years and the break fee would have been included in the lease payments used in the initial measurement of the lease.

- **If it was reasonably certain that L would continue the lease after Year 7** (i.e. reasonably certain that L would not exercise the termination option), then at the commencement date, in the absence of other factors affecting the lease term, the lease term would have been assessed to be 10 years and the break fee would not have been included in the lease payments included in the initial measurement of the lease liability.

On the assumption that at commencement of the original lease it was reasonably certain that L would not exercise the termination option (i.e. the lease term was assessed as 10 years), L revises the lease term when it exercises the termination or break option – i.e. at the end of Year 5.

This results in a remeasurement of the lease liability at $286,003 by discounting the revised lease payments (including the termination or break penalty), using a revised discount rate of 9% on the basis of the revised lease term (i.e. two years remaining as at the end of Year 5). L recognises the effect of remeasuring the lease liability as an adjustment to the right-of-use asset.
Lease liability at the end of Year 5 before reassessment of the lease term | (432,948)
---|---
Revised lease liability based on the revised lease term, at the revised discount rate
(Present value of 220,000 payable at the end of Year 6 and 100,000 payable at the end of Year 7 at 9%) | 286,003
**Adjustment to right-of-use asset** | (146,945)

L records the following entries.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td>146,945</td>
</tr>
<tr>
<td>Right-of-use asset</td>
<td>146,945</td>
</tr>
</tbody>
</table>

*To recognise remeasurement of remaining lease liability*

**Summary**

Based on the above accounting, L recognises the following at the end of Year 5.

<table>
<thead>
<tr>
<th></th>
<th>Lease liability</th>
<th>Right-of-use asset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before remeasurement</td>
<td>432,948</td>
<td>386,087</td>
</tr>
<tr>
<td>Decrease in lease term</td>
<td>(146,945)</td>
<td>(146,945)</td>
</tr>
<tr>
<td><strong>After remeasurement</strong></td>
<td><strong>286,003</strong>*</td>
<td><strong>239,142</strong>*</td>
</tr>
</tbody>
</table>

* Lease payments of 220,000 at the end of Year 6 and 100,000 at the end of Year 7, discounted at 9%.
3.6 Master lease agreements

When applying the new standard, the approach to performing the analysis can be summarised as follows:

– identify the contract(s);
– identify the lease components; and
– assess whether each draw-down under the terms and conditions of the master lease agreement is a lease component or a modification that should be accounted for as a separate lease component.

The new standard does not specifically address master lease agreements.

Generally, a master lease agreement permits the lessee to gain control over the use of additional underlying assets during the term of the agreement but does not require it to do so. When the lessee takes control over the use of an additional underlying asset, at its stand-alone price, the lessee accounts for a separate lease. This is illustrated in Example 11.

Example 11 – Master lease agreement with no minimum commitment and each right-of-use asset priced at stand-alone price

Lessee C enters into a master lease agreement (MLA) with Lessor D under which Lessor D will provide up to 30 vehicles of the same type over a five-year period; the period begins with delivery of the first vehicle. Delivery of all of the vehicles will take place at different times over the five-year period, as C requires them. The lease payment is fixed at 5,000 per vehicle per annum, which is the stand-alone price for such a vehicle, and is pro-rated if a vehicle is delivered during the year. There is no requirement for C to take any vehicles – i.e. if no vehicles are taken, then no payment is due.

As each vehicle is delivered, C applies separate lease accounting for its right to use that vehicle.

One rationale for this conclusion is that the MLA does not create enforceable rights and obligations between C and D – i.e. the MLA is not itself a contract. Instead, it is the combination of the MLA and C’s order that creates a contract.

Application of the lease modification guidance leads to the same conclusion. The scope of the lease is increased because C receives the right to use another underlying asset. The consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope. Therefore, C accounts for a separate lease (see Example 1).

However, in certain cases the agreement may specify a minimum number of units or currency value of equipment that the lessee is required to take into use during the term of the agreement. In this case, the contract includes a number of lease components, as illustrated in Example 12.
Example 12 – Master lease agreement with minimum commitment and same commencement date, and each additional right-of-use asset priced at stand-alone price

Lessee C enters into an MLA with Lessor E to lease 30 vehicles for a fixed monthly payment of 5,000 per vehicle for a total term of five years from delivery of the first vehicle. The monthly per-vehicle payment does not change depending on how many vehicles are delivered to C.

In this case, the MLA creates enforceable rights and obligations and is itself a contract.

C takes delivery of the 30 vehicles immediately. C applies the guidance in the new standard on identifying separate lease components and allocates the consideration in the contract to those components.

In certain scenarios, delivery of the underlying assets takes place over a period of time, resulting in different commencement dates. In this case, the entity (whether a lessee or a lessor) does not apply the lease modification guidance when it gains control over the use of those additional underlying assets. Rather, the entity identifies the separate lease components and allocates the consideration in the contract to those components, and accounts for each separate lease component from its commencement date.

Example 13 – Master lease agreement with minimum commitment and different commencement dates, and each additional right-of-use asset priced at stand-alone price

Lessee C enters into an MLA with Lessor E to lease up to 50 vehicles for a fixed monthly payment of 5,000 per vehicle for a total term of five years from delivery of the first vehicle. The monthly payment per vehicle is the stand-alone price and does not change depending on how many vehicles are delivered to C.

C is required to take delivery of 20 vehicles immediately and to take delivery of a minimum of 10 additional vehicles from E by the end of Year 2. Again, the MLA creates enforceable rights and obligations and is itself a contract.

When C takes delivery of any of the 10 mandated additional vehicles, there is no lease modification. That is, for draw-downs up to the minimum required quantity of 30 there is no lease modification. For these vehicles, C applies the guidance in the new standard on identifying separate lease components and allocating the consideration in the contract to those components. C accounts for each vehicle lease from its commencement date.

However, if C takes delivery of more than 30 vehicles in total (the minimum required), then, as each additional vehicle is delivered, C applies separate lease accounting for its right to use that vehicle. This is consistent with Example 11 above.
When there are draw-downs under a master lease agreement up to the minimum required quantity, there is no lease modification. Instead, the lessee applies the guidance in the standard on identifying separate lease components and allocating the consideration in the contract to those components.

Therefore, in Example 13 although there would be no lease modification resulting from drawing down 10 additional vehicles after taking delivery of the first 20, some measurement and allocation complexities could arise if there were, for example, residual value guarantees or if the monthly lease payments escalated during the lease term based on an index or rate – e.g. consumer price index.

Additional complications arise if the lease contains a number of lease components but with different commencement dates – e.g. when there is a price inter-dependency (e.g. a volume discount) or other non-lease components (e.g. maintenance costs).

It appears that in this case a lessee should make a preliminary estimate of the consideration in the contract. This includes doing all of the following at the point in time when the parties need to begin their accounting:

- measuring any variable lease payments that depend on an index or rate based on the index or rate at that point in time;
- assessing the likelihood of lessee option exercises (renewal, termination and/or purchase options) based on the then-current facts and circumstances; and
- assessing amounts probable of being owed under a residual value guarantee based on then-current facts and circumstances.

We believe that an entity should subsequently make the adjustments to the initial estimate.
Lessor modifications

The accounting for lessor modifications depends on – and may change – the lease classification.

4.1 Overview

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

However, additional complexities arise for modifications of a finance lease receivable not accounted for as a separate lease for which, under paragraph 80(b) of IFRS 16, the lessor applies the requirements of IFRS 9 Financial Instruments. A number of issues arise due to differences in the basic concepts between IFRS 16 and IFRS 9.

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

* A lessee reassessment of whether it is reasonably certain to exercise an option to extend, or not to exercise a termination option, included in the original lease contract is not a lease modification (see Section 2.2).
4.2 Discount rates

Generally, a lessor does not reassess the discount rate when accounting for leases. However, it will use a revised discount rate in some modification scenarios.

**In which modification scenarios does a lessor revise the discount rate?**

Whether a lessor revises the discount rate on a lease modification depends on:

- whether the modification is accounted for as a separate lease; and
- the lease classification.

In addition, a lessor may not need to determine a discount rate for many modifications of operating leases.

<table>
<thead>
<tr>
<th>Type of modification</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>The modification of a finance lease is accounted for as a separate lease.</td>
<td>The lessor determines the rate implicit in that separate lease. The lessor does not revise the discount rate of the original lease.</td>
</tr>
<tr>
<td>The modification of a finance lease is not accounted for as a separate lease and the lessor reassesses the lease classification as if the modified terms were in effect at inception.</td>
<td>The new standard is silent on whether the lessor uses the original discount rate or a new discount rate to assess classification in the context of a modification. Therefore, the lessor needs to determine the appropriate discount rate when performing the classification test – i.e. to determine whether the lease would have been a finance lease or an operating lease had the modified terms been in effect at inception.</td>
</tr>
<tr>
<td>The modification of a finance lease is not accounted for as a separate lease and the lease would have been classified as a finance lease had the modified terms been in effect at inception.</td>
<td>The lessor accounts for the modification under IFRS 9. If, under IFRS 9, the modification results in derecognition of the original finance lease receivable, then the discount rate for the new finance lease receivable is determined in accordance with IFRS 16. For modifications that do not result in derecognition, it is less clear whether the lessor continues to use the original discount rate or uses the revised discount rate (see 4.3.3.3).</td>
</tr>
</tbody>
</table>
### Lessor modifications to finance leases

A lessor’s accounting for a modification to a finance lease depends on whether the modification, in substance, represents the creation of a new lease that is separate from the original lease. Like the lessee, the lessor accounts for such a modification as a separate lease.

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

#### Separate lease

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

- the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- the consideration for the lease increases by an amount equivalent to the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

In this case, the lessor:

- accounts for the separate lease in the same way as any new lease; and
- makes no adjustment to the initial lease.
Example 14 – Modification that is a separate lease

Lessor L enters into an eight-year lease of 40 lorries with Lessee M. The lease term approximates the lorries’ economic life and no other features indicate that the lease does not transfer substantially all of the risks and rewards incidental to ownership of the lorries. Therefore, L classifies the lease as a finance lease.

M’s business has expanded and M now requires additional lorries. At the beginning of Year 5, L and M amend the contract to grant M the right to use 20 additional lorries of the same type for the remaining contractual period – i.e. for four years. The lease payments for these additional lorries are 5% higher than originally, due to an increase in their purchase price.

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

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

– the modification increases the scope of the lease by adding the right to use additional underlying assets – i.e. 20 additional lorries; and
– the lease payments for the additional lorries are commensurate with their stand-alone rentals. Even though the lease payments for the new lorries are 5% higher than the prices in the original lease, this change reflects the increase in purchase prices.

L does not modify the accounting for the original lease of 40 lorries. L classifies the lease of 20 additional lorries as an operating lease because the lease term for those additional lorries is not for the major part of their economic life and no other features indicate that the lease transfers substantially all of the risks and rewards incidental to ownership of the lorries. (In practice, this scenario might involve a master lease agreement – see Section 3.6).

4.3.2

Not a separate lease – Finance to operating

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

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

– accounts for the lease modification as the termination of the original lease and the creation of a new lease from the effective date of the modification; and
– measures the carrying amount of the underlying asset as the net investment in the original lease immediately before the effective date of the lease modification.
Example 15 – Modification that is not a separate lease and lease would have been classified as an operating lease

Modifying Example 14, at the end of Year 2 Lessee M decides to cease one of its activities in two years and therefore needs to terminate the lease of 40 lorries early. At the beginning of Year 3, L and M amend the contract so that it now terminates after Year 4.

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

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

At the beginning of Year 3, L accounts for the modified lease as a new operating lease. Consequently, L:

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

4.3.3 Not a separate lease – Finance to finance

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

This section provides an overview of the principles to be applied when a lease receivable is modified. For detailed guidance on the application of IFRS 9, see the 15th Edition 2018/19 of our publication Insights into IFRS.
The following flowchart summarises the accounting in this case.

![Flowchart](image-url)

### 4.3.3.1 Determining whether the modification is substantial

*IFRS 9.3.2.3, B5.5.25*

In our view, the holder of the financial asset should perform a quantitative and qualitative evaluation of whether the modification is substantial – i.e. whether the cash flows of the original financial asset and the modified or replacement financial asset are substantially different.

If the cash flows are substantially different, then we believe that the contractual rights to cash flows from the original financial asset should be deemed to have expired.

In our view, in making this evaluation an entity needs to develop its own policies and methods. In doing so it may, but is not required to, analogise to the guidance on the derecognition of a financial liability.

### 4.3.3.2 Accounting for a substantial modification

*IFRS 9.B5.5.25–B5.5.26, Insights 7.7.360*

A substantial modification results in derecognition of the financial asset. The following guidance applies under IFRS 9.

- When the modification results in derecognition, the modified asset is recognised as a new financial asset and initially measured at its fair value plus eligible transaction costs.

- Ignoring any other fees and costs, derecognition effectively results in an overall gain or loss equal to the difference between:
  - the amortised cost of the old asset; and
  - the fair value of the new asset minus the amount of expected credit losses recognised as an impairment allowance on the new asset.
IFRS 9 is not explicit about the accounting for modification costs and fees incurred when the new financial asset is not classified as at fair value through profit or loss – i.e. whether they are:

- eligible for capitalisation as incremental transaction costs that are directly attributable to the acquisition of the new asset; or
- expensed immediately as relating to the derecognition of the old asset.

Consequently, it appears that an entity should apply judgement in developing its accounting policy for determining whether and which transaction costs are eligible for capitalisation. For additional guidance, see Chapter 7.7 in the 15th Edition 2018/19 of our publication Insights into IFRS.

### 4.3.3.3 Accounting for a modification that is not substantial

IFRS 9 contains guidance on the following aspects of modifications of financial assets that do not result in derecognition of the asset, irrespective of the reason for the modification:

- measuring the gross carrying amount of financial assets; and
- recognising the resulting gains or losses.

Under IFRS 9, for modifications that do not result in derecognition the gross carrying amount of the asset is generally recalculated by discounting the modified contractual cash flows using the original effective interest rate. Any difference between this recalculated amount and the existing gross carrying amount is recognised in profit or loss as a modification gain or loss.

When a finance lease receivable is modified and not accounted for as a separate lease, under paragraph 80(b) of IFRS 16, the lessor applies the requirements of IFRS 9. However, a number of issues arise due to differences in the basic concepts between IFRS 16 and IFRS 9.

<table>
<thead>
<tr>
<th>How does this apply to a modification to a finance lease that is not a separate lease and that would have been classified as a finance lease if the modification had been in effect at inception?</th>
</tr>
</thead>
<tbody>
<tr>
<td>When a modified finance lease is not accounted for as a separate lease and would have been classified as a finance lease had the modification been in effect at the inception date, the new standard requires the lessor to apply IFRS 9. However, a number of issues arise due to conceptual differences between the two standards. It is unclear how to apply that guidance in practice. These differences include the following (the list is not exhaustive).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Under IFRS 16</th>
<th>Under IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement on initial recognition</strong></td>
<td><strong>A finance lease receivable is measured at an amount equal to the net investment in the lease.</strong></td>
</tr>
</tbody>
</table>
### 4.4 Lessor modifications to operating leases

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

#### Example 16 – Lessor modifications to operating leases

Lessor Y enters into a 10-year lease of office space with Lessee X. Y classifies this lease as an operating lease because it does not transfer substantially all of the risks and rewards incidental to ownership of the office space.

The lease agreement specifies a starting rent of 100,000 payable in arrears and requires the lease payments to be increased by 2% per annum – i.e. 1,094,972 for the whole 10-year period. X does not provide any residual value guarantee. There are no initial direct costs, lease incentives or other payments between X and Y.

<table>
<thead>
<tr>
<th>Under IFRS 16</th>
<th>Under IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Discount rate</strong></td>
<td><strong>A financial asset in the scope of IFRS 9 that is classified as measured at amortised cost is accounted for using an effective interest rate. This is the rate that, on initial recognition, equalises the fair value of the financial asset plus transaction costs to the future cash flows.</strong></td>
</tr>
<tr>
<td><strong>Cash flows</strong></td>
<td><strong>Cash flows are determined based on the estimated amounts by considering all contractual terms and include the estimate of all variability in cash flows. Estimated cash flows are revised when there is a change in the underlying facts and circumstances of cash flows.</strong></td>
</tr>
<tr>
<td><strong>Unguaranteed residual value</strong></td>
<td><strong>No equivalent is included in the measurement of a financial asset in the scope of IFRS 9.</strong></td>
</tr>
</tbody>
</table>

Under IFRS 16

A finance lease receivable is measured using the interest rate implicit in the lease.

Cash flows

Only certain types of cash flows are considered when determining the net investment in the lease. Many of the variable cash flows (e.g. variable lease payments not depending on indexes or rates) are ignored. Reassessment of cash flows is made only in certain circumstances (e.g. if there is a change in the non-cancellable period of a lease).

Unguaranteed residual value

Unguaranteed residual value is included in the measurement of the finance lease receivable.
The accounting for the lease payments on a straight-line basis is performed by first determining the annual rental income of 109,497 (1,094,972 / 10), which takes into account the annual indexation. Therefore, Y accounts for the lease payments over the first half of the lease term (i.e. Years 1–5) as follows.

<table>
<thead>
<tr>
<th>Date</th>
<th>Lease payment (A)</th>
<th>Annual rental income (B)</th>
<th>Accrual period end balance (C)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>100,000</td>
<td>109,497</td>
<td>9,497</td>
</tr>
<tr>
<td>Year 2</td>
<td>102,000</td>
<td>109,497</td>
<td>16,994</td>
</tr>
<tr>
<td>Year 3</td>
<td>104,040</td>
<td>109,497</td>
<td>22,451</td>
</tr>
<tr>
<td>Year 4</td>
<td>106,121</td>
<td>109,497</td>
<td>25,827</td>
</tr>
<tr>
<td>Year 5</td>
<td>108,243</td>
<td>109,497</td>
<td>27,081</td>
</tr>
</tbody>
</table>

* C = C prior year + (B – A).

Due to high vacancy rates in the real estate market, Y would like to encourage X to commit to staying in the office space for longer. At the beginning of Year 6, Y and X enter into negotiations and agree to:

- extend the original lease of the floor of office space by an additional five years after Year 10; and
- fix the annual payments for the original lease at 110,000 payable in arrears for the remaining 10 years (i.e. five remaining years of the original lease term plus a five-year extension).

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

<table>
<thead>
<tr>
<th>Date</th>
<th>Lease payment (A)</th>
<th>Annual rental income (B)*</th>
<th>Accrual period end balance (C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 6</td>
<td>110,000</td>
<td>107,292</td>
<td>24,373</td>
</tr>
<tr>
<td>Year 7</td>
<td>110,000</td>
<td>107,292</td>
<td>21,665</td>
</tr>
<tr>
<td>Year 8</td>
<td>110,000</td>
<td>107,292</td>
<td>18,957</td>
</tr>
<tr>
<td>Year 9</td>
<td>110,000</td>
<td>107,292</td>
<td>16,249</td>
</tr>
<tr>
<td>Year 10</td>
<td>110,000</td>
<td>107,292</td>
<td>13,541</td>
</tr>
<tr>
<td>Year 11</td>
<td>110,000</td>
<td>107,292</td>
<td>10,833</td>
</tr>
<tr>
<td>Year 12</td>
<td>110,000</td>
<td>107,292</td>
<td>8,125</td>
</tr>
<tr>
<td>Year 13</td>
<td>110,000</td>
<td>107,292</td>
<td>5,417</td>
</tr>
<tr>
<td>Year 14</td>
<td>110,000</td>
<td>107,292</td>
<td>2,709</td>
</tr>
<tr>
<td>Year 15</td>
<td>110,000</td>
<td>107,292</td>
<td>-</td>
</tr>
</tbody>
</table>

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**4.5 Termination or break of a lease**

Occasionally a lessee terminates a lease earlier than the term contemplated in the original agreement and pays the lessor a termination penalty (see Section 3.5).

Lease payments include penalties for terminating the lease. However, unlike a termination penalty considered in the initial measurement and determination of the lease term, some termination payments result from negotiation between the lessee and the lessor when they reach a modified agreement. It appears that if the lease modification is accounted for under the new standard, then these termination penalties should be considered part of the revised lease payments.

Example 17 illustrates the lessor accounting in a typical scenario.

**Example 17 – Termination/break of the lease not included in original contract**

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

M classifies the lease as an operating lease.

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

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

The original terms and conditions of the lease did not include an option to terminate or break the lease, reduce the lease term or reduce lease payments. Therefore, M treats this as a modification to an operating lease. That is, M treats the modification as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease (see Section 4.4).

In this case, the lease contains only a single lease component; therefore, the termination or break fee forms part of the revised lease payments.
Example 18 illustrates how Example 17 compares with a scenario in which the termination penalty clause was included in the original terms of the contract.

**Example 18 – Termination/break of the lease was included in original contract**

Assume the same facts as Example 17, except that the original lease agreement included an option for L to terminate the lease at the end of Year 7, subject to a termination penalty. Therefore, when L exercises its termination option there is no lease modification.

At commencement of the original lease, L and M assessed whether it was reasonably certain that L would not exercise the termination or break option. This was included in the determination of the lease term.

- If it was not reasonably certain that L would continue the lease after Year 7 (i.e. not reasonably certain that L would not exercise the termination option), then at the commencement date, in the absence of other factors affecting the lease term, the lease term would have been assessed to be seven years and the break fee would have been included in the lease payments used in the initial measurement of the lease.

- If it was reasonably certain that L would continue the lease after Year 7 (i.e. reasonably certain that L would not exercise the termination option), then at the commencement date, in the absence of other factors affecting the lease term, the lease term would have been assessed to be 10 years and the break fee would not have been included in the lease payments included in the initial measurement of the lease liability.

At the end of Year 5, L exercises its termination option, which was not included in the original determination of the lease term. This changes the non-cancellable period of the lease and causes M to revise the lease term. M does not reassess the lease classification because this is not a lease modification – i.e. the lease remains classified as an operating lease.

The new standard does not address the lessor’s accounting for reassessment. Therefore, there is no guidance on the accounting for a break fee included in the original contract that was not originally included in the lease payments from operating leases but subsequently becomes payable because the option to terminate the lease is exercised.

We believe that when the termination option is exercised by L and M revises the lease term because of the change in the non-cancellable period of the lease, M should include the break fee in the revised lease payments. In this case, M will recognise the fees as income, generally on a straight-line basis over the remaining term of the lease.

The accounting for the amounts received by the lessor in connection with the modification may be different if the lease modification is accounted for in accordance with IFRS 9 (see Chapter 7.7 in the 15th Edition 2018/19 of our publication *Insights into IFRS*).
Effective date of a lease modification

The date on which to account for a lease modification is a key consideration – and may be earlier than you think.

Lease modifications are accounted for at the effective date of the lease modification. This is the date on which both parties agree to the lease modification. For modifications that are not accounted for as separate leases, the lease liability and right-of-use asset are remeasured at this date. Complex application issues arise if the modification is agreed on one date but an additional right of use starts on a later date. This section illustrates some issues.

The following diagram summarises the accounting for common scenarios in which a modification is agreed on one date but the change in the right of use or consideration happens at a different date.
When a modification is accounted for as a separate new lease, it is accounted for in the same way as any other new lease.

**Example 19 – Effective date of modification is before a termination of the right to use an underlying asset takes effect**

Lessee Y enters into a lease for a five-year term with Lessor L for a retail building. Under the lease, Y obtains the right to use 10,000m² of the retail space.

At the end of Year 3, Y and L sign a modified contract whereby Y will lease 7,000m² of the original space for the last year of the lease – i.e. a decrease in scope by partially terminating the right of use. The lease payments are reduced accordingly. That is, 3,000m² of retail space will be returned to L at the end of Year 4 and Y will lease 7,000m² for Year 5.

**Effective date of modification**

The modified contract is signed at the end of Year 3. This is the date when both Y and L agree to the lease modification; therefore, this is the **effective date of the modification**.

**Measurement and recognition of modification**

This is a lease modification that is not accounted for as a separate lease (see Section 3.4).

Y accounts for the reduction in scope by reducing the lease liability, reducing the right-of-use asset and recognising any related gain or loss (for the lessee accounting for modifications, see Section 3.4).

Y recognises and measures the decrease in scope at the end of Year 3 when the decrease in scope is contractually agreed, and not when it actually takes place at the end of Year 4. This is because at the end of Year 3 both parties have contractually agreed on Y’s obligation to pay for the right of use for only 7,000m² in Year 5, Y’s rights related to use of the underlying asset of 7,000m² in Year 5 and the cost of Y’s right-of-use asset.

Even though Y still has 10,000m² of the underlying asset under its control for Year 4, under lessee accounting Y recognises its right of use, not the underlying asset.
At the end of Year 3, Y adjusts the right-of-use asset to reflect the contractual agreement that Y has the right to use 10,000m² in Year 4 but only 7,000m² in Year 5. This adjustment to the right-of-use asset will impact subsequent depreciation. In this case, depreciation in Year 4 will be calculated as \((10,000 / 17,000) \times \) the carrying amount of the right-of-use asset at the beginning of Year 4.

As noted above, complex application issues arise when a modification that increases the scope by adding the right to use an additional underlying asset is not accounted for as a separate new lease, and the modification is agreed on one date but the additional right of use starts at a later date. In this case, a lessee calculates the modified lease liability at the effective date of the lease modification.

However, IFRS 16 is not clear on when the lessee should recognise the increase in the lease liability and the right-of-use asset related to the additional underlying asset. An acceptable approach is to recognise the increase in the lease liability and the right of use when the lessee gets access to this additional underlying asset – i.e. when the lease of the additional underlying asset commences. This is consistent with the general requirement to recognise the lease at the commencement date.

**Example 20 – Effective date of modification is before an addition to the right to use an underlying asset takes effect**

Lessee Y enters into a lease for a five-year term with Lessor L for part of a retail building. Under the lease, Y obtains the right to use 10,000m² of the retail space.

At the end of Year 3, Y and L sign a modified contract whereby Y will lease 15,000m² of retail space for the last year of the lease – i.e. an increase in scope by adding the right to use one or more underlying assets. That is, Y leases an additional 5,000m² of retail space effective from the end of Year 4. Assume that the modification is not accounted for as a separate lease because the price for the additional space is not commensurate with the stand-alone price (see 3.4.1).

**Effective date of modification**

The modified contract is signed at the end of Year 3. This is the date when both Y and L agree to the lease modification; therefore, this is the effective date of the modification.
Measurement and recognition of modification

In this scenario, at the end of Year 3, the effective date of the modification, Y has entered into a new contract with two lease components – i.e. the original office space and the new office space. The first component starts immediately but the second component is forward-starting.

Consequently, at the end of Year 3, Y determines the amounts that should be recognised in respect of each component. This includes allocating the total consideration of the modified contract between the two components, determining the lease term and remeasuring the lease liability by discounting the revised lease payments at a revised discount rate. The portion allocated to the original lease component is accounted for from the effective date of the modification. It is acceptable to account for the portion allocated to the new lease component at the commencement date of the new office space at the end of Year 4 – i.e. when L makes available the additional right to use the 5,000m² to Y. At that time, Y recognises the lease liability and right-of-use asset with respect to the new office space based on amounts determined at the effective date of the modification – i.e. at the end of Year 3.

Example 21 – Effective date of modification when there is an increase in lease term

Lessee Y enters into a lease for a five-year term with Lessor L for part of a retail building. Under the lease, Y obtains the right to use 10,000m² of the retail space.

At the end of Year 3, Y and L sign a modified contract whereby Y will lease the 10,000m² of original space for an additional five years. That is, the lease term is now 10 years in total.

Effective date of modification

The modified contract is signed at the end of Year 3. This is the date when both Y and L agree to the lease modification; therefore, this is the effective date of the modification.

Measurement and recognition of modification

This is a lease modification that is not accounted for as a separate lease (see Section 3.1).

Y already has the right to use the underlying asset; there has been no change in its rights except that it can now use the asset for a longer period. Y measures and recognises the change in lease term at the end of Year 3.
Example 22 – Effective date of modification: Forward-starting lease

Lessee Y enters into a five-year lease of earth-moving equipment with Lessor Z. At the beginning of Year 3, Y and Z enter into a new agreement to lease the same earth-moving equipment for five years commencing immediately at the end of Year 5 (i.e. when the original five-year lease expires). This new agreement is known as a ‘forward-starting lease’. The original agreement remains effective until the end of Year 5 without any changes, at which point the modified terms come into effect.

The forward-starting lease is a lease modification. This is because Y already has the right to use the underlying asset.

No additional right to use one or more underlying assets has been added. Therefore, Y remeasures the right-of-use asset and the lease liability at the beginning of Year 3, which is the effective date of the modification.
6

Transition issues

The extent of information required by lessees when transitioning to the new standard will depend on the transition approach chosen.

6.1

Overview

The transition method will have a significant impact on the lease liability measured on the date of initial application, the extent of data gathering and the timing of system and process changes.

A lessee is permitted to:

– adopt the standard retrospectively; or

– follow a modified retrospective approach with some optional practical expedients. Under this approach, a lessee does not restate comparative information. Instead, it recognises the cumulative effect of initially applying the standard as an adjustment to equity at the date of initial application.

A lessee applies the election consistently to all of its leases.

A lessor accounts for its leases in accordance with the new standard from the date of initial application.

Of the two transition methods available to a lessee, the retrospective method is the more challenging.

What’s the impact if lease modifications occur between commencement and the date of initial application?

Retrospective approach

Under the retrospective approach, modifications will need to be reconstructed – which may be onerous if an entity has long leases that have been modified many times.

A company will need extensive information about its leasing transactions to apply the new standard retrospectively.

– This includes historical information about lease payments, discount rates, reassessments and modifications – including the historical information that management would have used (i.e. the role of hindsight is limited) to make the various judgements and estimates that are necessary to apply the lessee accounting model.

– The information is required as at lease commencement and as at each date on which the company would have been required to recalculate lease assets and liabilities on a reassessment or modification of the lease.

Further, there are no practical expedients available to a company under the retrospective approach.
Modified retrospective approach

Under the modified retrospective approach, previous modifications will not affect the measurement of the lease liability on the date of initial application.

A key benefit of the modified retrospective approach is a reduction in the cost of transition because:

- there is no requirement to restate comparative financial information;
- it is possible to apply a modified retrospective approach using only current-period information – that is:
  - the lessee’s incremental borrowing rate at the beginning of the period in which it first applies the new standard; and
  - the lessee’s remaining lease payments; and
- additional practical expedients are available.

It is therefore possible for a lessee to transition to the new standard using only information about future lease payments – i.e. payments payable after the date of initial application. For many lessees, this will be a significant simplification – in terms of the data and the calculations required – compared with the retrospective approach. That is, a lessee need not go back to each lease reassessment or modification in the past and can instead use information at the date of initial application – i.e. based on the most recent lease agreements.

If a lessee applies a modified retrospective approach but elects to measure the right-of-use asset for certain assets as if the new standard had always been applied, then modifications will need to be reconstructed, as for the retrospective approach.
Appendix I - IFRS 16 at a glance

<table>
<thead>
<tr>
<th>Topic</th>
<th>Key facts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lease definition</strong></td>
<td>- New lease definition with an increased focus on control of the underlying asset</td>
</tr>
</tbody>
</table>
| **Lessee accounting model** | - Single lease accounting model  
- No lease classification test  
- Most leases on-balance sheet:  
  - lessee recognises a right-of-use asset and lease liability  
  - treated as the purchase of an asset on a financed basis |
| **Lessor accounting model** | - Dual lease accounting model for lessors  
- Lease classification test based on IAS 17 Leases classification criteria  
- Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset  
- Operating lease accounting model based on IAS 17 operating lease accounting |
| **Practical expedients and targeted reliefs** | - Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under the new standard is 12 months or less and that do not contain a purchase option  
- Portfolio-level accounting permitted for leases with similar characteristics if the effect on the financial statements does not differ materially from applying the requirements to individual leases  
- Optional lessee exemption for leases of low-value items – e.g. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate |
| **Effective date** | - Accounting periods beginning on or after 1 January 2019  
- Early adoption is permitted if IFRS 15 Revenue from Contracts with Customers is also adopted  
- Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard |
## Appendix II - List of examples

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About this publication

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

This edition considers the requirements of IFRS 16 *Leases* published by the IASB in January 2016.

The text of this publication refers to IFRS 16 and to selected other current standards in issue at 15 August 2018.

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

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