Applying IFRS in consumer products and retail

IASB issues new leases standard – consumer products and retail

June 2016

Building a better working world

Contents

What you need to know

- The IASB has issued a new leases standard that requires lessees to recognise most leases on their balance sheets. For consumer products and retail entity lessees, this means recognising assets and liabilities for most leases of stores and distribution centres that they may currently account for as operating leases.
- Lessees will apply a single accounting model for all leases (with certain exemptions).
- Lessor accounting is substantially unchanged and the IAS 17 classification principle has been carried over to IFRS 16.
- Consumer products and retail entities will need to exercise judgement to determine whether contract manufacturing and other arrangements contain a lease.
- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.

Overview

Consumer products and retail entities will need to change certain lease accounting practices when implementing IFRS 16 *Leases*, the new leases standard issued by the International Accounting Standards Board (IASB). IFRS 16 significantly changes the accounting for leases by lessees and could have far-reaching implications for consumer products and retail entities' finances and operations. The requirement for lessees to recognise right-of-use assets and lease liabilities for most leases may have a significant effect on these entities balance sheet metrics, given the number of leases they typically have. The IASB's *Effects Analysis* accompanying IFRS 16 shows that for the retail entities included in the IASB's sample, the estimated present value of future payments for their operating leases today is 21.4 per cent of their total assets, or US$431 billion.[1]

Lessor accounting is substantially unchanged from current accounting. As with IAS 17 *Leases*, IFRS 16 requires lessors to classify their leases into two types: finance and operating leases. Lease classification determines how and when a lessor recognises lease revenue and what assets a lessor records.

IFRS 16 requires lessees to recognise most leases on their balance sheets as lease liabilities with corresponding right-of-use assets. Lessees apply a single model for most leases. Generally, the profit or loss recognition pattern will change as interest and depreciation expense is recognised separately in the statement of profit or loss (similar to today's finance lease accounting). However, lessees can make accounting policy elections to apply accounting similar to IAS 17's operating lease accounting to 'short-term' leases and leases of 'low-value' assets.

For consumer products and retail lessees, recognising lease-related assets and liabilities could have significant financial reporting and business implications. Recognising a lease obligation for most leases may affect certain key metrics, and the effect may be significant for entities that lease a large number of stores and/or stores in high-rent locations. Implementing the standard could also require an entity to develop new processes and controls to track and account for leases, including: (1) identifying a lease; (2) initially and subsequently measuring lease-related assets and liabilities; (3) identifying and allocating consideration to the lease and non-lease components; and (4) collecting and aggregating information necessary for disclosure.

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Early application is permitted provided the new revenue standard, IFRS 15 *Revenue from Contracts with Customers*, has been or is applied at the same date as IFRS 16. Lessees must apply IFRS 16 using either a full retrospective or a modified retrospective approach.

This publication summarises the new standard and describes some sector-specific issues consumer products and retail entities may want to consider. Like all other entities, they will also need to apply the new standard to leases of office space, office equipment and all other assets within the scope of IFRS 16.

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[1] IFRS 16 *Leases, Effects Analysis,* Section 3 – Companies affected by changes in lease accounting.

Our forthcoming publication, *Applying IFRS*, *A closer look at the IASB's new leases standard,* will provide an in-depth discussion of IFRS 16. Refer to that publication for further information about the technical accounting topics and concepts discussed here. In addition, our *IFRS Practical Matters*, *Leases make their way onto the balance sheet: Navigating the journey for a smooth landing* (EYG No. AU3725), is designed to help entities to understand the business impacts of the new standard. Refer to that publication for further information about the impacts of the standard and the steps entities should be taking to apply it. This publication summarises the key implications for consumer products and retail entities.

The views we express in this publication are preliminary as of June 2016. We may identify additional issues as we analyse IFRS 16 and entities begin to interpret it, and our views may evolve during that process.

1. Key considerations

1.1 Scope and scope exclusions

IFRS 16 applies to leases of all assets, except for the following:

- Leases to explore for or use non-regenerative resources
- Leases of biological assets held by a lessee
- Service concession arrangements
- Licences of intellectual property granted by a lessor
- Rights held by a lessee under certain licensing agreements (e.g., motion picture films, patents and copyrights)

A lessee may, but is not required to, apply IFRS 16 to leases of intangible assets other than those described above.

1.2 Definition of a lease

A lease is a contract (i.e., an agreement between two or more parties that creates enforceable rights and obligations), or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. To be a lease, a contract must convey the right to control the use of an identified asset.

1.2.1 Identified asset

The concept of an identified asset is generally consistent with the 'specified asset' concept in IFRIC 4 *Determining whether an Arrangement contains a Lease*. Under IFRS 16, an identified asset can be either implicitly or explicitly specified in a contract and can be a physically distinct portion of a larger asset (e.g., a store located in a shopping centre). Even if an asset is specified, a customer does not have the right to use an identified asset if, at inception of the contract, a supplier has the substantive right to substitute the asset throughout the period of use. A substitution right is substantive if the supplier has the practical ability to substitute alternative assets throughout the period of use and the supplier would benefit economically from exercising its right to substitute the asset. If the customer cannot readily determine whether the supplier has a substantive substitution right, the customer presumes that any substitution right is not substantive.

Consumer products and retail entities enter into a variety of supply arrangements that will need to be evaluated to determine whether they involve the use of an identified asset. For example, some contract manufacturing arrangements require the use of an explicitly or implicitly specified asset (e.g., an entire facility) or involve the use of a portion of a larger asset (e.g., a production line within a facility). Even if the arrangement specifies an asset, consumer products and retail entities will also need to carefully evaluate whether the supplier has substantive substitution rights, as discussed above, to determine if there is an identified asset that may be a lease.

IFRS 16 includes the following example illustrating the definition of a lease for concession space:

Extract from IFRS 16 Illustrative Examples

Example 2 – Concession space

A coffee company (Customer) enters into a contract with an airport operator (Supplier) to use a space in the airport to sell its goods for a three-year period. The contract states the amount of space and that the space may be located at any one of several boarding areas within the airport. Supplier has the right to change the location of the space allocated to Customer at any time during the period of use. There are minimal costs to Supplier associated with changing the space for the Customer: Customer uses a kiosk (that it owns) that can be moved easily to sell its goods. There are many areas in the airport that are available and that would meet the specifications for the space in the contract.

The contract does not contain a lease.

Although the amount of space Customer uses is specified in the contract, there is no identified asset. Customer controls its owned kiosk. However, the contract is for space in the airport, and this space can change at the discretion of Supplier. Supplier has the substantive right to substitute the space Customer uses because:

(a) Supplier has the practical ability to change the space used by Customer throughout the period of use (see paragraph B14(a)). There are many areas in the airport that meet the specifications for the space in the contract, and Supplier has the right to change the location of the space to other space that meets the specifications at any time without Customer's approval.

(b) Supplier would benefit economically from substituting the space (see paragraph B14(b)). There would be minimal cost associated with changing the space used by Customer because the kiosk can be moved easily. Supplier benefits from substituting the space in the airport because substitution allows Supplier to make the most effective use of the space at boarding areas in the airport to meet changing circumstances.

1.2.2 Right to control the use of the identified asset

A contract conveys the right to control the use of an identified asset for a period of time if, throughout the period of use, the customer has both of the following:

- The right to obtain substantially all of the economic benefits from the use of the identified asset
- The right to direct the use of the identified asset

A customer can obtain economic benefits either directly or indirectly (e.g., using, holding or subleasing the asset). Economic benefits include the asset's primary outputs (i.e., goods or services) and any by-products (e.g., renewable energy credits that are generated through use of the asset), including potential cash flows derived from these items. Economic benefits also include benefits from using the asset that could be realised from a commercial transaction with a third party (e.g., subleasing the asset). However, economic benefits arising from ownership of the identified asset (e.g., tax benefits related to excess tax depreciation and investment tax credits) are not considered economic benefits derived from the use of the asset.

A customer has the right to direct the use of an identified asset throughout the period of use when either:

(a) The customer has the right to direct how and for what purpose the asset is used throughout the period of use

Or

(b) The relevant decisions about how and for what purpose the asset is used are predetermined and the customer either:

i. Has the right to operate the asset, or direct others to operate the asset in a manner that it determines, throughout the period of use, without the supplier having the right to change the operating instructions

Or

ii. Designed the asset, or specific aspects of the asset, in a way that predetermines how and for what purpose the asset will be used throughout the period of use

When evaluating whether a customer has the right to direct how and for what purpose the asset is used throughout the period of use, the focus is on whether the customer has the decision-making rights that will most affect the economic benefits that will be derived from the use of the asset. The decision-making rights that are most relevant are likely to depend on the nature of the asset and the terms and conditions of the contract. The standard also says that if the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term.

IFRS 16 includes a flowchart that may assist entities in making the assessment of whether a contract is, or contains, a lease. Appendix A of this publication includes this flowchart.

IFRS 16 includes the following example illustrating the definition of a lease for retail space:

Extract from IFRS 16 Illustrative Examples

Example 4 – Retail unit

Customer enters into a contract with a property owner (Supplier) to use Retail Unit A for a five-year period. Retail Unit A is part of a larger retail space with many retail units.

Customer is granted the right to use Retail Unit A. Supplier can require Customer to relocate to another retail unit. In that case, Supplier is required to provide Customer with a retail unit of similar quality and specifications to Retail Unit A and to pay for Customer's relocation costs. Supplier would benefit economically from relocating Customer only if a major new tenant were to decide to occupy a large amount of retail space at a rate sufficiently favourable to cover the costs of relocating Customer and other tenants in the retail space. However, although it is possible that those circumstances will arise, at inception of the contract, it is not likely that those circumstances will arise.

The contract requires Customer to use Retail Unit A to operate its well-known store brand to sell its goods during the hours that the larger retail space is open. Customer makes all of the decisions about the use of the retail unit during the period of use. For example, Customer decides on the mix of goods sold from the unit, the pricing of the goods sold and the quantities of inventory held. Customer also controls physical access to the unit throughout the five-year period of use.

The contract requires Customer to make fixed payments to Supplier, as well as variable payments that are a percentage of sales from Retail Unit A.

Supplier provides cleaning and security services, as well as advertising services, as part of the contract.

The contract contains a lease of retail space. Customer has the right to use Retail Unit A for five years.

Retail Unit A is an identified asset. It is explicitly specified in the contract. Supplier has the practical ability to substitute the retail unit, but could benefit economically from substitution only in specific circumstances. Supplier's substitution right is not substantive because, at inception of the contract, those circumstances are not considered likely to arise (see paragraph B16).

Customer has the right to control the use of Retail Unit A throughout the five-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of Retail Unit A over the five-year period of use. Customer has exclusive use of Retail Unit A throughout the period of use. Although a portion of the cash flows derived from sales from Retail Unit A will flow from Customer to Supplier, this represents consideration that Customer pays Supplier for the right to use the retail unit. It does not prevent Customer from having the right to obtain substantially all of the economic benefits from use of Retail Unit A.

Extract from IFRS 16 Illustrative Examples *(cont'd)*

(b) Customer has the right to direct the use of Retail Unit A because the conditions in paragraph B24(a) exist. The contractual restrictions on the goods that can be sold from Retail Unit A, and when Retail Unit A is open, define the scope of Customer's right to use Retail Unit A. Within the scope of its right of use defined in the contract, Customer makes the relevant decisions about how and for what purpose Retail Unit A is used by being able to decide, for example, the mix of products that will be sold in the retail unit and the sale price for those products. Customer has the right to change these decisions during the five-year period of use.

Although cleaning, security, and advertising services are essential to the efficient use of Retail Unit A, Supplier's decisions in this regard do not give it the right to direct how and for what purpose Retail Unit A is used. Consequently, Supplier does not control the use of Retail Unit A during the period of use and Supplier's decisions do not affect Customer's control of the use of Retail Unit A.

Consumer products and retail entities will have to carefully analyse supply arrangements to determine whether a contract is or contains a lease. For example, the customer in a contract manufacturing arrangement may have the right to direct the use of the identified asset (e.g., the production facility, a dedicated production line) when it decides what type of output will be produced (e.g., different sizes or colours of shirts) and the timing and quantity of production or has the right to make changes to these decisions throughout the period of use. The Illustrative Examples to IFRS 16 include the following example related to contract manufacturing:

Extract from IFRS 16 Illustrative Examples

Example 8 – Contract for shirts

Customer enters into a contract with a manufacturer (Supplier) to purchase a particular type, quality and quantity of shirts for a three-year period. The type, quality and quantity of shirts are specified in the contract.

Supplier has only one factory that can meet the needs of Customer. Supplier is unable to supply the shirts from another factory or source the shirts from a third party supplier. The capacity of the factory exceeds the output for which Customer has contracted (ie Customer has not contracted for substantially all of the capacity of the factory).

Supplier makes all decisions about the operations of the factory, including the production level at which to run the factory and which customer contracts to fulfil with the output of the factory that is not used to fulfil Customer's contract.

The contract does not contain a lease.

The factory is an identified asset. The factory is implicitly specified because Supplier can fulfil the contract only through the use of this asset.

Customer does not control the use of the factory because it does not have the right to obtain substantially all of the economic benefits from use of the factory. This is because Supplier could decide to use the factory to fulfil other customer contracts during the period of use.

Extract from IFRS 16 Illustrative Examples *(cont'd)*

Customer also does not control the use of the factory because it does not have the right to direct the use of the factory. Customer does not have the right to direct how and for what purpose the factory is used during the three-year period of use. Customer's rights are limited to specifying output from the factory in the contract with Supplier. Customer has the same rights regarding the use of the factory as other customers purchasing shirts from the factory. Supplier has the right to direct the use of the factory because Supplier can decide how and for what purpose the factory is used (ie Supplier has the right to decide the production level at which to run the factory and which customer contracts to fulfil with the output produced).

Either the fact that Customer does not have the right to obtain substantially all of the economic benefits from use of the factory, or that Customer does not have the right to direct the use of the factory, would be sufficient in isolation to conclude that Customer does not control the use of the factory.

How we see it

Under IFRS 16, it will be more important for customers in supply agreements, including contract manufacturing agreements, to determine whether a contract contains a lease because lessees are required to account for most leases on their balance sheets.

1.3 Identifying and separating components of a contract and allocating contract consideration

Judgement may be required to identify lease and non-lease components.

For contracts that contain the rights to use multiple assets (e.g., a warehouse and equipment, multiple pieces of equipment), the right to use each asset is considered a separate lease component if both of the following conditions are met: (1) the lessee can benefit from the use of the underlying asset either on its own or together with other resources that are readily available to the lessee; and (2) the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract. For example, the lease contract for a warehouse and an adjacent land parcel to be used for future development by the lessee will generally be considered to contain two lease components because the lessee could benefit from the warehouse without development of the adjacent land parcel.

Many contracts contain a lease coupled with an agreement to purchase or sell other goods or services (non-lease components). For these contracts, the non-lease components are identified and accounted for separately from the lease component, in accordance with other standards. For example, the non-lease components may be accounted for as executory arrangements by lessees (customers) or as contracts subject to IFRS 15 by lessors (suppliers).

IFRS 16 provides a practical expedient that permits lessees to make an accounting policy election, by class of underlying asset, to account for each separate lease component of a contract and any associated non-lease components as a single lease component. Lessees that do not make an accounting policy election to use this practical expedient are required to allocate the consideration in the contract to the lease and non-lease components on a relative stand-alone price basis. Lessees are required to use observable stand-alone prices (i.e., prices at which a customer would purchase a component of a contract separately) when available. If observable stand-alone prices are not readily available, lessees estimate stand-alone prices, maximising the use of observable information.

Lessors do not have a practical expedient to account for lease and non-lease components as a single lease component. Lessors are required to apply IFRS 15 to allocate the consideration in a contract between the lease and non-lease components generally on a relative stand-alone selling price basis. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. When stand-alone selling prices are not directly observable, the lessor must estimate the stand-alone selling price. IFRS 15 also provides suitable methods for estimating the stand-alone selling price.

Retailers' store leases frequently include payments for maintenance activities including common area maintenance (CAM) (e.g., cleaning the reception area of a building, removing snow from a car park for employees and customers) and other goods or services transferred to the lessee (e.g., providing utilities or trash removal). Under IFRS 16, payments for these activities are considered non-lease components because they provide the lessee with a service.

In some leases, a lessee may also reimburse, or make certain payments on behalf of, the lessor that relate to the leased asset for activities and costs that do not transfer a good or service to the lessee and would not be considered a non-lease component (e.g., payments made for real estate taxes that would be owed by the lessor regardless of whether it leased the building and regardless of who the lessee is, payments made for the insurance that protects the lessor's investment in the building and the lessor will receive the proceeds from any claim). Under IFRS 16, such costs are not separate components of the contract, but are considered to be part of the total consideration that is allocated to the separately identified components of the contract (i.e., the lease and non-lease components).

For such payments that are allocated to the lease component, entities will need to evaluate whether they are fixed (or in-substance fixed) lease payments or variable lease payments. Fixed lease payments are included in the initial measurement of the lease asset and liability. See section **5.2 Variable lease payments** for a discussion of the accounting for variable lease payments.

How we see it

Identifying non-lease components of contracts (e.g., common area maintenance) may change practice for some lessees in the consumer products and retail industries. Today, entities may not focus on identifying lease and non-lease components because their accounting treatment (e.g., the accounting for an operating lease and a service contract) is often the same. However, because most leases are recognised on lessees' balance sheets under IFRS 16, lessees may need to put more robust processes in place to identify the lease and non-lease components of contracts.

2. Lease classification

Under IFRS 16, lessors classify all leases in the same manner as under IAS 17, distinguishing between two types of leases: finance and operating. Lessors are required to reassess lease classification upon a modification (i.e., a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease) that does not result in a separate lease.

Lessees, however, apply a single accounting model for all leases, with options not to recognise short-term leases and leases of low-value assets on the balance sheet. See sections **3.1 Short-term leases recognition exemption** and **3.2 Leases of low-value assets recognition exemption** for discussions of these exemptions.

3. Lessee accounting

Lease incentives affect the initial measurement of lease assets and liabilities.

At the commencement date of a lease, a lessee recognises a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset).

Lessees measure the lease liability using the interest rate implicit in the lease, if that rate is readily determinable. If that rate cannot be readily determined, the lessee is required to use its incremental borrowing rate. Lessees measure the right-of-use asset at the amount of the lease liability, adjusted for lease prepayments, lease incentives received, the lessee's initial direct costs (e.g., commissions) and an estimate of restoration, removal and dismantling costs.

Lessees are required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset. When the right-of-use asset is depreciated on a straight-line basis, this will generally result in a front-loaded expense recognition pattern, which is consistent with the subsequent measurement of finance leases under IAS 17.

IFRS 16 specifies the accounting for lease incentives (e.g., lessor reimbursement for a lessee's real estate commissions) when measuring a lease liability and right-of-use asset. Lease incentives receivable from the lessor at the commencement date are deducted from the right-of-use asset. Lease incentives received at or before the commencement date reduce the initial measurement of the right-of-use asset. 'Key money', which is paid by an incumbent tenant to an outgoing tenant to secure a prime location, is not included in lease payments and, therefore, not included in the lessee's lease liability.

3.1 Short-term leases recognition exemption

Lessees can make an accounting policy election, by class of underlying asset to which the right of use relates, to apply accounting similar to IAS 17's operating lease accounting to leases that, at the commencement date, have a lease term of 12 months or less and do not include an option to purchase the underlying asset (short-term leases). If a lessee applies this exemption, short-term leases are not recognised on the balance sheet and the related lease expense is recognised on a straight-line basis over the term of the lease or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

In considering whether to apply the short-term lease exemption, entities will need to consider the lease term (i.e., the non-cancellable period of the lease together with periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option and periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option). A lease that contains a purchase option is not a short-term lease.

3.2 Leases of low-value assets recognition exemption

Lessees can also make an election, on a lease-by-lease basis, to apply accounting similar to current operating lease accounting to leases for which the underlying asset is of low value (low-value assets). To be a low-value asset, a lessee must be able to benefit from the asset on its own or together with other resources that are readily available to the lessee. In addition, a low-value asset must not be highly dependent on, or highly interrelated with, other assets. At the time of reaching its decisions about the exemption, the IASB had in mind leases of underlying assets with a value, when new, in the amount of US$5,000 or less.

4. Lessor accounting

Consumer products and retail entities may be lessors if they sublease assets or have supply or contract manufacturing arrangements with a customer that are determined to contain a lease.

IFRS 16 requires lessors to account for operating leases using an approach that is substantially unchanged from IAS 17. That is, lessors continue to recognise the underlying asset and lease payments are recognised as income over the lease term, either on a straight-line basis or another systematic basis that is more representative of the pattern in which the benefits from the use of the underlying asset is diminished.

Under IFRS 16, lessors are required to account for finance leases also using an approach that is substantially unchanged from IAS 17. That is, lessors derecognise the carrying amount of the underlying asset, recognise a lease receivable[2] and recognise, in profit or loss, any selling profit or loss.

4.1 Subleases – intermediate lessor accounting

It is common for consumer products and retail entities to sublease retail space to a third party. Under IFRS 16, an intermediate lessor accounts for the head lease as described in section **3. Lessee accounting** and the sublease (as lessor) as described above. However, an intermediate lessor considers the lease classification criteria with reference to the remaining right-of-use asset rather than the underlying asset (e.g., building subject to a lease) arising from the head lease when classifying a sublease as finance or operating.

IFRS 16 requires the intermediate lessor to measure right-of-use assets arising from leased property in accordance with IAS 40 *Investment Property* if a leased property meets the definition of investment property, the sublease is classified as an operating lease and the intermediate lessor elects the fair value model in IAS 40 as an accounting policy. This represents a change from the current scope of IAS 40. Under existing requirements, this is an election that is available on a property-by-property basis.

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[2] At the commencement date, the sum of lease payments receivable and any unguaranteed residual value, discounted at the interest rate implicit in the lease.

An intermediate lessor generally accounts for a head lease (as a lessee) and a sublease (as a lessor) as two separate lease contracts. However, when contracts are entered into at or near the same time with the same counterparty or related parties of the counterparty, an intermediate lessor is required to consider the criteria for combining contracts (i.e., whether the contracts are negotiated as a package with a single commercial objective, the consideration to be paid in one contract depends on the price or performance of the other contract or rights to use the underlying assets conveyed in the contract form a single lease component). If any criterion is met, the intermediate lessor accounts for the head lease and sublease as a single combined transaction.

5. Other considerations

5.1 Sale and leaseback transactions

Sale and leaseback transactions will no longer provide seller-lessees with a source of off-balance sheet financing.

Because lessees are required to recognise most leases on the balance sheet (i.e., all leases except for short-term leases and leases of low-value assets if the lessee makes accounting policy elections to use those exemptions), sale and leaseback transactions will no longer provide lessees with a source of off-balance sheet financing.

IFRS 16 requires seller-lessees and buyer-lessors to apply the requirements in IFRS 15 to determine whether a sale has occurred in a sale and leaseback transaction. If control of an underlying asset passes to the buyer-lessor, the transaction is accounted for as a sale (or purchase) and a lease by both parties. If not, the transaction is accounted for as a financing by both parties.

How we see it

The new requirements are a significant change from current practice for seller-lessees. Under IFRS 16, seller-lessees must apply the requirements in IFRS 15 to determine whether a sale has occurred. Also, even if the criteria for a sale have been met, sale and leaseback transactions generally would no longer lead to an off-balance sheet financing.

5.2 Variable lease payments

Variable lease payments that depend on an index or rate are included in lease payments and are measured using the prevailing index or rate at the measurement date (e.g., lease commencement date for initial measurement). Variable payments that do not depend on an index or rate, such as those based on performance (e.g., a percentage of sales) or usage of the underlying asset, are not included as lease payments.

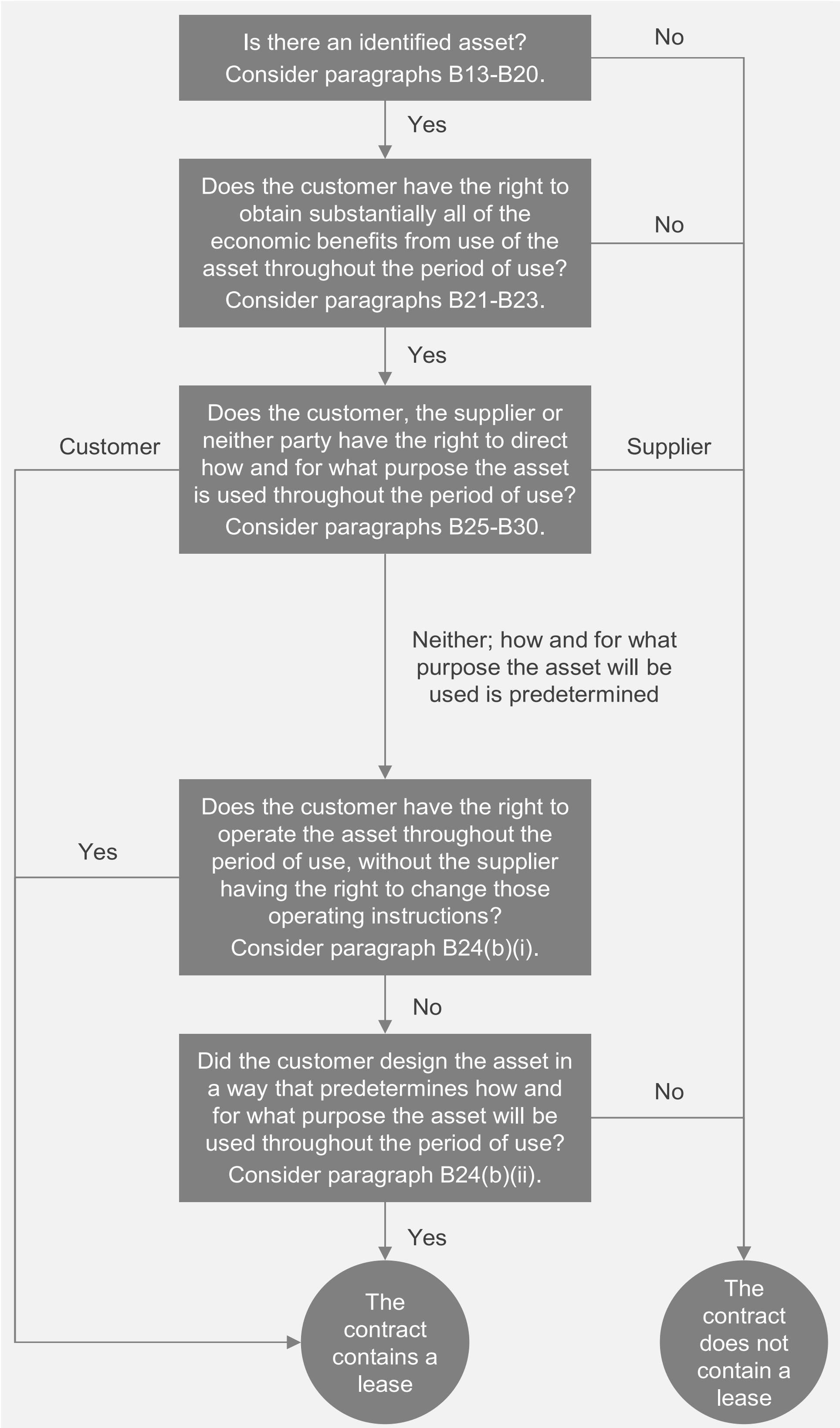
Variable payments that are not based on an index or rate and are not in-substance fixed lease payments are recognised in a manner similar to today's accounting. Lessees recognise an expense in the period in which the event that triggers those payments occurs. Although IFRS 16 does not specify the lessor's accounting for variable lease payments that do not depend on an index or rate, given that the IASB decided to substantially carry forward the lessor accounting model in IAS 17, a lessor recognises such variable lease payments as income in the period in which they are earned, consistent with current accounting.

Under IFRS 16, lessees are required to remeasure the lease liability under certain circumstances, including when there is a change in future lease payments resulting from a change in an index or rate used to determine those payments. The lessee is required to remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (i.e., when the adjustment to the lease payments takes effect). For example, if the contractual lease payments change every two years and the change is linked to a change in the Consumer Price Index (CPI) during the two-year period, a lessee would reassess the lease liability every two years when the contractual payments change, not each time the CPI changes. See example in Appendix B.

Next steps

- Entities should perform a preliminary assessment as soon as possible to determine how their lease accounting will be affected. Two critical first steps include: (1) identifying the sources and locations of an entity's lease data; and (2) accumulating the data in a way that will facilitate the application of IFRS 16. For entities with decentralised operations (e.g., an entity that is geographically dispersed), this could be a complex process, given the possibility for differences in operational, economic and legal environments.
- Entities will need to make sure they have the processes, including internal controls, and systems in place to collect the necessary information to implement IFRS 16 (including making the necessary financial statement disclosures).
- Consumer products and retail entities should consider how they might communicate changes to their financial reporting to investors and other stakeholders.

Appendix A: Extract from IFRS 16 B31 – Flowchart of lease definition



Appendix B: Lessee accounting examples

Illustration — Lessee accounting

Food Ltd (Lessee) enters into a three-year lease of a forklift for use in its distribution warehouse. Food Ltd agrees to make the following annual payments at the end of each year: CU10,000 in year one, CU12,000 in year two and CU14,000 in year three. For simplicity, there are no purchase options, payments to the lessor before the commencement date, lease incentives from the lessor or initial direct costs. The initial measurement of the right-of-use asset and lease liability is CU33,000 (present value of lease payments using a discount rate of 4.235%). Food Ltd uses its incremental borrowing rate as the discount rate because the rate implicit in the lease cannot be readily determined. Food Ltd depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Food Ltd recognises the right-of-use asset and lease liability in a manner similar to a finance lease today:

Right-of-use asset	CU33,000	
Lease liability		CU33,000

To initially recognise the lease-related asset and liability

The following journal entries would be recorded in the first year:

Interest expense	CU1,398	
Lease liability		CU1,398

To record interest expense and accrete the lease liability using the interest method (CU33,000 x 4.235%)

Depreciation expense	CU11,000	
Right-of-use asset		CU11,000

To record depreciation expense on the right-of-use asset (CU33,000 ÷ 3 years)

Lease liability	CU10,000	
Cash		CU10,000

To record lease payment

A summary of the lease contract's accounting (assuming no changes due to reassessment) is as follows:

	Initial	Year 1	Year 2	Year 3
Cash lease payments		CU10,000	CU12,000	CU14,000
Lease expense recognised				
Interest expense		CU1,398	CU1,033	CU569
Depreciation expense		11,000	11,000	11,000
Total periodic expense		CU12,398	CU12,033	CU11,569
Balance sheet				
Right-of-use asset	CU33,000	CU22,000	CU11,000	CU–
Lease liability	CU(33,000)	CU(24,398)	CU(13,431)	CU–

Immaterial differences may arise in the re-computation of amounts in the example above due to rounding.

IFRS 16 contains the following example illustrating lessee accounting for variable lease payments:

Extract from IFRS 16 Illustrative Examples

Example 14 – Variable lease payments dependent on an index and variable lease payments linked to sales

Example 14A—Lessee enters into a 10-year lease of property with annual lease payments of CU50,000, payable at the beginning of each year. The contract specifies that lease payments will increase every two years on the basis of the increase in the Consumer Price Index for the preceding 24 months. The Consumer Price Index at the commencement date is 125. This example ignores any initial direct costs. The rate implicit in the lease is not readily determinable. Lessee's incremental borrowing rate is 5 per cent per annum, which reflects the fixed rate at which Lessee could borrow an amount similar to the value of the right-of-use asset, in the same currency, for a 10-year term, and with similar collateral.

At the commencement date, Lessee makes the lease payment for the first year and measures the lease liability at the present value of the remaining nine payments of CU50,000, discounted at the interest rate of 5 per cent per annum, which is CU355,391.

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

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000

Lessee expects to consume the right-of-use asset's future economic benefits evenly over the lease term and, thus, depreciates the right-of-use asset on a straight-line basis.

During the first two years of the lease, Lessee recognises in aggregate the following related to the lease.

Interest expense	CU33,928	
Lease liability		CU33,928
Depreciation charge	CU81,078 (CU405,391 ÷ 10 × 2 years)	
Right-of-use asset		CU81,078

At the beginning of the second year, Lessee makes the lease payment for the second year and recognises the following.

Lease liability	CU50,000	
Cash		CU50,000

Extract from IFRS 16 Illustrative Examples (*cont'd*)

At the beginning of the third year, before accounting for the change in future lease payments resulting from a change in the Consumer Price Index and making the lease payment for the third year, the lease liability is CU339,319 (the present value of eight payments of CU50,000 discounted at the interest rate of 5 per cent per annum = CU355,391 + CU33,928 – CU50,000).

At the beginning of the third year of the lease the Consumer Price Index is 135.

The payment for the third year, adjusted for the Consumer Price Index, is CU54,000 (CU50,000 × 135 ÷ 125). Because there is a change in the future lease payments resulting from a change in the Consumer Price Index used to determine those payments, Lessee remeasures the lease liability to reflect those revised lease payments, ie the lease liability now reflects eight annual lease payments of CU54,000.

At the beginning of the third year, Lessee remeasures the lease liability at the present value of eight payments of CU54,000 discounted at an unchanged discount rate of 5 per cent per annum, which is CU366,464. Lessee increases the lease liability by CU27,145, which represents the difference between the remeasured liability of CU366,464 and its previous carrying amount of CU339,319. The corresponding adjustment is made to the right-of-use asset, recognised as follows.

Right-of-use asset	CU27,145	
Lease liability		CU27,145

At the beginning of the third year, Lessee makes the lease payment for the third year and recognises the following.

Lease liability	CU54,000	
Cash		CU54,000

Example 14B – Assume the same facts as Example 14A except that Lessee is also required to make variable lease payments for each year of the lease, which are determined as 1 per cent of Lessee's sales generated from leased property.

At the commencement date, Lessee measures the right-of-use asset and the lease liability recognised at the same amounts as in Example 14A. This is because the additional variable lease payments are linked to future sales and, thus, do not meet the definition of lease payments. Consequently, those payments are not included in the measurement of the asset and liability.

Right-of-use asset	CU405,391	
Lease liability		CU355,391
Cash (lease payment for the first year)		CU50,000

Lessee prepares financial statements on an annual basis. During the first year of the lease, Lessee generates sales of CU800,000 from the leased property.

Lessee incurs an additional expense related to the lease of CU8,000 (CU800,000 x 1 per cent), which Lessee recognises in profit or loss in the first year of the lease.

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