Applying IFRS in telecommunications

IASB issues new leases standard - telecommunications

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 telecommunications entities, this means recognising assets and liabilities for most leases of property, plant and equipment, including signal transmission devices (e.g., transponders), mobile towers and office equipment 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.
- Telecommunications entities may need to exercise judgement to determine whether a contract is or contains a lease.
- Most telecommunications entities will be affected, not only because of the impact on their financial statements, but also on their systems and processes.
- The new standard is effective for annual periods beginning on or after 1 January 2019, with limited early application permitted.

Overview

Telecommunications (telecom) 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 telecom entities' finances and operations. For example, the impact on telecom entities' financial reporting, financial ratios and metrics, asset financing, IT systems, processes and controls could be substantial.

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 telecom lessees, recognising lease-related assets and liabilities could have significant financial reporting and business implications. 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 telecom 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.

Our forthcoming publication, *Applying IFRS*, *A closer look at the IASB's new leases standard*, will provide an in-depth discussion of IFRS 16. We refer to that publication as our *General Applying IFRS*. 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 telecom 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 dedicated cable that is part of a larger network infrastructure). Even if an asset is specified, a customer does not have the right to use an identified asset if, at the 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.

In some cases, determining whether there is an identified asset can be relatively straightforward. However, in other cases this assessment may require judgement. Telecom entities enter into a variety of arrangements (often with other telecom entities) for the right to use or access a portion of a network asset. Examples include designated space on mobile towers, pole attachments, capacity in fibre cables and co-location space within a central office. While dedicated space on a mobile tower would be an identified asset, a capacity portion of an asset that is less than substantially all of that asset's capacity would not be an identified asset because it is not physically distinct from the remaining capacity of the asset.

How we see it

Some contracts involve a dedicated cable that is part of the larger network infrastructure (e.g., unbundled network element arrangements for the 'last mile' to a customer location, 'special access' arrangements for a dedicated connection between two locations). IFRS 16 does not specify, or provide examples that clarify, that these arrangements are identified assets. However, the FASB's new standard has an additional example that is similar to a dedicated cable (i.e., a segment of a pipeline that connects a single customer to a larger pipeline). That example clarifies that such segments of a larger pipeline are identified assets.[1] Because the IASB has stated that the IASB and the FASB have reached the same conclusions on how to define a lease,[2] we believe that under IFRS 16, the last mile of a telecommunications network that connects a single customer to a larger network may be an identified asset. Telecom entities will need to be sensitive to this matter in both these and similar arrangements.

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, 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 the 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 those 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

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1 Accounting Standards Codification (ASC) 842, *Leases*, ASC 842-10-15-16.

2 Effects Analysis, International Financial Reporting Standard, IFRS 16 *Leases*, January 2016, Section 8 - Effects of differences between IFRS and US GAAP.

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.

When an agreement involves an identified asset, telecom entities will need to evaluate which party has the right to control the use of the asset. This evaluation will require entities to apply judgement. Example 3 from IFRS 16 below illustrates some of these considerations:

Extract from IFRS 16 Illustrative Examples

Example 3 – Fibre optic cable

Example 3A: Customer enters into a 15-year contract with a utilities company (Supplier) for the right to use three specified, physically distinct dark fibres within a larger cable connecting Hong Kong to Tokyo. Customer makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (ie Customer 'lights' the fibres and decides what data, and how much data, those fibres will transport). If the fibres are damaged, Supplier is responsible for the repairs and maintenance. Supplier owns extra fibres, but can substitute those for Customer's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

The contract contains a lease of dark fibres. Customer has the right to use the three dark fibres for 15 years.

There are three identified fibres. The fibres are explicitly specified in the contract and are physically distinct from other fibres within the cable. Supplier cannot substitute the fibres other than for reasons of repairs, maintenance or malfunction (see paragraph B18).

Customer has the right to control the use of the fibres throughout the 15-year period of use because:

(a) Customer has the right to obtain substantially all of the economic benefits from use of the fibres over the 15-year period of use. Customer has exclusive use of the fibres throughout the period of use.

(b) Customer has the right to direct the use of the fibres because the conditions in paragraph B24(a) exist. Customer makes the relevant decisions about how and for what purpose the fibres are used by deciding (i) when and whether to light the fibres and (ii) when and how much output the fibres will produce (i.e., what data, and how much data, those fibres will transport). Customer has the right to change these decisions during the 15-year period of use.

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

Although Supplier's decisions about repairing and maintaining the fibres are essential to their efficient use, those decisions do not give Supplier the right to direct how and for what purpose the fibres are used. Consequently, Supplier does not control the use of the fibres during the period of use.

Example 3B: Customer enters into a 15-year contract with Supplier for the right to use a specified amount of capacity within a cable connecting Hong Kong to Tokyo. The specified amount is equivalent to Customer having the use of the full capacity of three fibre strands within the cable (the cable contains 15 fibres with similar capacities). Supplier makes decisions about the transmission of data (ie Supplier lights the fibres, makes decisions about which fibres are used to transmit Customer's traffic and makes decisions about the electronic equipment that Supplier owns and connects to the fibres).

The contract does not contain a lease.

Supplier makes all decisions about the transmission of its customers' data, which requires the use of only a portion of the capacity of the cable for each customer. The capacity portion that will be provided to Customer is not physically distinct from the remaining capacity of the cable and does not represent substantially all of the capacity of the cable (see paragraph B20). Consequently, Customer does not have the right to use an identified asset.

Some arrangements involve assets, such as set-top boxes, and gateways (e.g., modems and routers) that are located on the customer's premises (i.e., customer premises equipment or CPE). Telecom entities will need to determine whether the customer has the right to direct the use of the CPE. This will involve understanding the functionality of the CPE in order to identify the relevant decisions that most significantly affect the economic benefits that can be derived from the use of the underlying asset.

Telecom entities may locate other assets on land or buildings owned by other parties. A right to use land or a space on a building will need to be evaluated to determine whether the contract conveys the right to control the use of the identified asset (i.e., the land or space on a building).

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

For contracts that contain the rights to use multiple assets (e.g., a building 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 an office building 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 office building without development of the adjacent land parcel.

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

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.

Telecom entities typically enter into mobile towers site sharing arrangements with other telecom entities to maximise synergies between the entities by sharing mobile towers and associated power infrastructures. Generally, such arrangements include a lease component (i.e., mobile towers or identified portions of the towers), and non-lease components (i.e., operation and maintenance services including access to commonly used generators, power connections, batteries and the related maintenance of such commonly used equipment). Under IFRS 16, payments for operation and maintenance services 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 asset 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., maintenance services provided with a mobile tower arrangement that is treated as a lease) may change practice for some lessees in the telecom sector. Today, lessees 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

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.

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.

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.

How we see it

The requirement that lessees recognise assets and liabilities for most leases will impact both the balance sheet and statement of profit or loss of lessees. Lessees' debt and equity ratios are likely to be affected by the gross-up of their balance sheets. Rent expense is replaced by depreciation and interest expense. This will affect some performance measures, such as EBIT or EBITDA that are key performance measures for almost all telecom companies, but may also affect other performance measures, such as interest cover, depending on the characteristics of the lease portfolio and the effects on the expense recognition pattern.

This could influence the leasing strategies of telecom entities. For example, some lessees may make different decisions about whether to lease or purchase an asset. In addition, some lessees may seek to negotiate lease terms with fewer years than they do currently in order to reduce the balances of recorded assets and liabilities. Many factors will influence a lessee's decisions, including the nature of its business, its business requirements, the economics of leasing versus buying, debt and equity covenant restrictions, and access to capital.

4. Lessor accounting

Telecom entities often enter into arrangements with other telecom entities for the right to use or access a portion of their network assets (discussed above). As a result, these entities would be lessors if these arrangements are leases.

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[3] and recognise, in profit or loss, any selling profit or loss.

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

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 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 payment takes effect). For example, lease payments under tower sites leases are often linked to the annual change in the Consumer Price Index (CPI); lessees with such clauses in their leases remeasure their lease liability whenever a change in CPI triggers a change in the contractual lease payments.

Absent a lease modification, lessors do not remeasure the lease receivable for variable lease payments that depend on an index or rate.

Example 14 from IFRS 16 illustrates 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.

IFRS 16 requires lease modifications that meet certain criteria to be accounted for as a separate lease.

5.3 Lease modifications

IFRS 16 defines a lease modification as 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 (e.g., adding or terminating the right to use one or more underlying assets, extending or shortening the contractual lease term).

IAS 17 does not address the accounting for lease modifications. Under IFRS 16, lessees and lessors of finance leases are required to account for a lease modification as a separate, new lease when both of the following conditions are met:

- The modification increases the scope of the lease by adding the right to use one or more underlying assets (e.g., the use of additional square footage of leased space) not included in the original lease
- The consideration for the lease increases by an amount commensurate with 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

If both of these conditions are met, the lease modification results in two separate leases: the unmodified original lease and the new lease.

For a lease modification that does not result in a separate lease (e.g., a change in lease term), lessees generally remeasure the existing lease liability and right-of-use asset without affecting profit or loss. However, for a modification that decreases the scope of a lease (e.g., reducing the square footage of leased space), lessees remeasure the lease liability and recognise a proportionate reduction (e.g., the proportion of the change in the lease liability to the pre-modification lease liability) to the right-of-use asset. Any difference between those adjustments is recognised in profit or loss.

For lessors, a modification to a finance lease that is not a separate lease is accounted for as follows:

- If the lease would have been an operating lease had the modification been in effect at inception, the modification is treated as a new lease from the effective date of the modification. The lessor 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.
- If the lease classification does not change as a result of the modification, the modification is accounted for in accordance with IFRS 9 *Financial Instruments*.

Lessors account 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.

Refer to our forthcoming *General Applying IFRS* for more details on lease modifications, including the accounting for a lease when the modification does not result in a separate, new contract.

5.4 Effective date and transition

IFRS 16 is effective for annual periods beginning on or after 1 January 2019. Earlier application is permitted if IFRS 15 has been applied, or is applied on the same date as IFRS 16.

IFRS 16 permits lessees to use either a full retrospective or a modified retrospective approach on transition for leases existing at the date of transition, with options to use certain transition reliefs.

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).
- Evaluating the effects of IFRS 16 and implementing it could require significant effort given the number of contracts that are potentially in its scope.
- Timely assessment and management of the impact on financial ratios, IT systems, processes, controls and resource requirements will help entities control the effect on their business. For example, lessees should start discussing the effect on covenants and financing agreements with lenders, rating agencies and other users of the company's financial data.
- Telecom entities should begin to educate leasing and lessee coordination departments about IFRS 16. An entity may want these departments to evaluate its current portfolio of leases and/or prospective targets to identify lessees that may seek to alter their leasing strategies as a result of IFRS 16.

Appendix A: Lessee accounting example

Illustration 1 — Lessee accounting

Telecom Inc. (lessee) enters into a three-year contract with Telecommunications Plc (lessor) for the right to use three specified fibres of a 20-fibre cable from New York to London. Telecom Inc. 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%). Telecom Inc. uses its incremental borrowing rate as the discount rate because the rate implicit in the lease cannot be readily determined. Telecom Inc. depreciates the right-of-use asset on a straight-line basis over the lease term.

Analysis: At lease commencement, Telecom Inc. 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 rise in the computation of amounts in the example above due to rounding.

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