Adviser alert – *Insights into IFRS 16 – Lease payments*

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Overview

The Grant Thornton International IFRS team has published *Insights into IFRS 16 – Lease payments*.

The *Insights into IFRS 16* series provides insights on applying IFRS 16 *Leases* in key areas. Each edition will focus on an area of IFRS 16 to assist you in preparing for the required changes on adoption of the standard.

The bulletin *Insights into IFRS 16 – Lease Payments* provides guidance on how to determine which lease payments to include in the measurement of the lease liability when accounting for a lease under IFRS 16.

The issue

IFRS 16 requires a lessee to measure the lease liability at the present value of the lease payments that are not paid at that date. This liability includes both fixed lease payments (including in-substance fixed payments) and variable lease payments that depend on an index or rate, and it represents the starting point for the measurement of the related right-of-use asset.

Deciding which payments need to be recognized in the measurement of the liability and how changes in those payments are recognized often involves considerable judgment. The bulletin *Insights into IFRS 16 – Lease payments* aims to help you with this judgment.

Resource

The bulletin *Insights into IFRS 16 – Lease Payments* follows this *Adviser alert*.

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Lease payments

At the commencement of a lease, IFRS 16 requires a lessee to measure the lease liability at the present value of the lease payments that are not paid at that date. This liability includes both fixed payments (including in-substance fixed payments) and variable lease payments that depend on an index or rate, and represents the starting point for the measurement of the related right-of-use asset.

Deciding which payments need be recognised in the measurement of the liability and how changes in those payments are recognised often involves considerable judgement. Our article aims to help you with this judgement.

Lease payments used to measure the lease liability at commencement date include the following (to the extent they have not yet been paid):

- fixed payments – including in-substance fixed payments (described further below) less any lease incentives receivable
- variable lease payments that depend on an index or a rate (described further below)
- amounts expected to be payable by the lessee under residual value guarantees
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

We will discuss some of these areas in more detail below.

Fixed payments

Fixed payments are payments, excluding variable payments, that are made to the lessor by the lessee for the right to use an underlying asset during the lease term. These are included in the lease liability at the commencement date.

In-substance fixed lease payments

The lessee must include in the lease liability any in-substance fixed lease payments. In-substance fixed lease payments are payments whose form appears to contain some variability although they are, in substance, unavoidable. This can occur where:

- payments are structured as variable but there is no genuine variability in those payments
- there is more than one set of payment options described in the lease but only one set of those payments is realistic, or
- there is more than one realistic set of payments described in the lease, but the lessee must select at least one of those sets of payments.

Examples of payments lacking genuine variability include:

- payments that must be made only if an event occurs that has no genuine possibility of not occurring
- payments that must be made only if an asset is proven to be capable of operating during the lease
- payments that are initially structured as variable lease payments linked to the use of an underlying asset, but for which the variability will be resolved after the commencement date such that the payments become fixed for the remainder of the term (in this case the payments become in-substance fixed and are included in the lease liability only once the variability is resolved).

The above examples are all variable in legal form but should be treated as in-substance fixed.

Example 1 – Minimum lease payments with more than one set of payments

P is an established Motorway Service Area operator. P leases a Motorway Service Area and under the terms of the lease, P must keep the Service Area open 24 hours per day and cannot sublease the Service Area. Annual rentals are payable under the contract as follows:

- CU100,000 if no sales are made at the service area; or
- CU10,000,000 if any sales are made during the year.

Analysis

P concludes that the lease contains in-substance fixed lease payments of CU10,000,000 per annum, on the basis that there is no realistic possibility that P will make no sales at the Service Area, as P is an established Motorway Service Area operator, with a history of successful operations.

Variable lease payments

Variable lease payments that depend on an index or rate are initially included in the lease liability using the index or rate at the commencement date of the lease. Variable lease payments include payments linked to a consumer price index, payments linked to a benchmark interest rate (such as EURIBOR) or payments that vary to reflect changes in market rental rates.

After the commencement date, the lessee increases the carrying amount to reflect interest on the lease liability and reduces the liability for lease payments made. It also remeasures the carrying amount to reflect changes in the lease payments arising from changes in the index or rate.

In remeasuring the carrying amount, the lessee uses an unchanged discount rate unless the change in lease payments results from a change in floating interest rates. In that scenario the lessee shall use a revised discount rate that reflects changes in the interest rate.

Example 2 – Variable lease payments dependent on an index

Entity Q enters into a ten-year lease of a property with annual payments of CU5,000 payable at the beginning of each year. The agreement specifies that the lease payments will increase every two years based on the increase in the consumer price index for the preceding 24 months. The Consumer Price Index at commencement is 125. Entity Q estimates its incremental borrowing rate at 5% per annum; i.e. the fixed rate at which it could borrow for the amount equivalent to the value of the right-of-use asset for the same term and in the same currency.

Analysis

At commencement, Entity Q measures the lease liability at CU35,539, being the present value of the remaining nine payments of CU5,000 discounted at 5%. It measures the right-of-use asset at CU40,539, being the present value of the lease liability plus the CU5,000 lease payment made at commencement.

At the end of year two, the lease liability is CU33,932, being the present value of the eight remaining payments of CU5,000. The consumer price index is 135, and the rental payment for year three is set at CU5,400, being "CU5,000 X 135 / 125".

Because there is a change in the future lease payments, Entity Q remeasures the lease liability to reflect the net present value of the eight remaining payments of CU5,400, discounted at the original discount rate of 5%. This increases the lease liability by CU2,714. This is the difference between the lease liability of CU33,932 and the remeasured liability of CU36,646. A corresponding adjustment is made to the right-of-use asset.

Example 3 – Variable lease payments linked to sales

Assume the same fact pattern as for Example 2 but Entity Q is also required to make variable lease payments equal to 0.1% of sales generated from the leased property. At commencement, the lease liability is measured at the same amount as in Example 2. This is because the additional lease payments, while variable, are linked to future sales rather than an index or rate. As a result, they do not meet the definition of lease payments under IFRS 16 and are not included in the measurement of the lease liability or the right-of-use asset.

During the first year of the lease, the lessee generates sales of CU800,000. Entity Q incurs an additional expense of CU800 (CU800,000 X 0.1%). This is recognised in profit or loss during the first year.

Example 4 – Variable lease payments becoming fixed

Entity S enters into a four-year lease for a specialised photocopier. The lease payments are CU500 per month if the copier is used to produce 100,000 copies or less over the lease term. If the copier is used to make more than 100,000 copies, then the monthly rental is adjusted to CU700 per month (which is applied from the commencement of the lease).

The copier exceeds 100,000 copies at the start of year three. At this point Entity S is required to make a catch-up payment of CU4,800. The remaining payments are adjusted upwards to CU700 per month.

Analysis

In our view on commencement the lease liability is based on lease payments of CU500 per month.

At the start of year three the catch-up payment is recorded in profit or loss. The right-of-use asset and lease liability are adjusted for the increase of CU200 per month for the remaining lease term (on a discounted basis). This is because these payments have become in-substance fixed payments.

Example 6 – Property tax payments

A contract to lease a building specifies that the lessee must reimburse the lessor for property taxes paid. While this tax will ultimately be paid by the lessee, it isn't a tax obligation of the lessee because the taxing authority imposes the tax on the lessor, as owner of the property. The lessee needs to ascertain whether this represents a lease payment and, if so, whether it is variable based on an index or a rate and therefore should be included when calculating the right-of-use asset and lease liability.

Analysis

In our view this represents a lease payment. Whether or not it is included in the lease liability will depend on whether it represents a variable payment based on an index or rate, and the exact wording used in the lease agreement to describe the payment will be key. There are mixed views within the marketplace on this issue. While the answer will ultimately be driven by the facts and circumstances specific to each situation, judgement will be required and as a result we expect some diversity in practice to arise.

Market rent reviews

Increases in lease payments resulting from market rent reviews are considered to be variable payments based on an index or rate and should therefore be taken into account when assessing lease payments and at the commencement of the lease.

Example 5 – Impact of market rent reviews affecting optional renewal periods

Entity A enters into a three-year lease for a property with an option to extend for a further three years. As the entity is reasonably certain the option will be exercised, the lease term is determined to be six years. The terms of the renewal option specify that a market rent review will be performed at the end of year three and the results of this review will determine the lease payments to be made for years four to six. Lease payments belonging to the renewal period will be included when measuring the right-of-use asset and the lease liability at commencement, but at what amount?

Analysis

Lease payments subject to future market rent reviews are considered to be payments based on an index or a rate and IFRS 16.27(b) requires Entity A to measure the right-of-use asset and lease liability at commencement using the rate in effect on that date. When the actual rate for years four to six differs on renewal, the lease liability would be remeasured at that time to reflect the revised payments. If the market rent review occurred annually, then the lease liability would be remeasured each year assuming the revised rent applied for all remaining years in the lease term.

Allocation of non-lease components

A contract may include an amount payable by the lessee for additional services related to the lease. For example, a contract for the lease of a building may require the lessee to make additional payments for maintenance of common areas, or for other goods and services it receives. These are considered non-lease components because they provide the lessee with an additional good or service.

In other cases, a lessee may be required to compensate the lessor for activities and tasks that do not provide a good or service to the lessee. Such charges do not give rise to a separate component of the contract, but are seen to be part of the total consideration that is allocated to the separately identified components of the contract.

When a contract contains a lease component and one or more non-lease components, the lessee allocates the consideration in the contract to each lease component based on the relative stand-alone prices of the lease components and the aggregate standalone price of the non-lease components. If a standalone price is not available then the lessee must estimate it, maximising the use of observable information.

Example 7 – Lease and non-lease components

A lessee (Entity U) enters into a five-year lease of equipment, with fixed annual payments of CU6,000. The contact itemises the payments as follows:

- equipment CU4,500
- maintenance CU1,250
- administration CU250.

What are the relevant lease and non-lease components?

Analysis

Entity U identifies two components: (a) a lease of equipment and (b) maintenance services. The amount paid for administrative tasks does not transfer a service and so represents additional consideration to be allocated between the lease (equipment) and non-lease (maintenance) components. The total consideration of CU30,000 is allocated between the lease and non-lease components based on their relative standalone prices (not given). The non-lease component is accounted for under the relevant accounting standard.

Practical expedient – Include non-lease components in the lease accounting

IFRS 16 provides a practical expedient where the lessee may elect, by class of asset, not to separate non-lease components. A lessee making this election accounts for the lease and non-lease components together, as a single lease component.

While taking advantage of this practical expedient will simplify the accounting for contracts containing a lease, it will increase the amount of recognised assets and liabilities and could have implications for impairment.

Contact us

We hope you find this article helpful in giving you some detail into aspects of IFRS 16. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.global/locations to find your local member firm.

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