

**IATA Industry Accounting
Working Group Guidance
IFRS 16, Leases**

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IFRS 16, Leases

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Assessment of Lease Term

Background:

IFRS 16, Leases requires the recognition of a Right of Use (ROU) Asset for all leases that require recognition under the standard. In order to determine the value and the amortization period of this asset, the lease term must be assessed in accordance with the provisions of the standard. The lease period includes rent-free periods.

Issues:

This paper discusses how to assess the lease term for aircraft lease contracts.

Analysis of Issues:

Determining the lease term

IFRS 16.18 defines the lease term as the non-cancellable period of a lease and both:

- (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

IFRS 16.B35 clarifies that if only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease. Logically, if the option is exercised by the lessor or is legally bound to exercise the option that period would no longer be part of the lease term.

IFRS 16.B34 indicates that a lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. If that were the case the period covered by these rights would not be part of the lease term. If the penalty was deemed to be significant to either or both parties both the lessor and lessee have a right to terminate the lease without permission from the other party, the lessee would have an option to terminate the agreement and would apply IFRS16.18 to determine if the exercise of the option is reasonably certain. If it is reasonably certain that the lessee will exercise the option, then this period forms part of the lease term.

Timing of the assessment

IFRS 16.19 requires that at the commencement date all relevant facts and circumstances that create an economic incentive for the lessee to exercise the option to extend the lease, or not to exercise the option to terminate the lease as described in paragraphs B37–B40 be considered.

Examples of factors to consider include, but are not limited to:

- (a) contractual terms and conditions for the optional periods compared with market rates, such
- (b) significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract
- (c) costs relating to the termination of the lease,
- (d) the importance of that underlying asset to the lessee's operations, and
- (e) conditionality associated with exercising the option.

A lessee's past practice regarding the period over which it has typically used particular types of assets (whether leased or owned), and its economic reasons for doing so, may provide information that is helpful in assessing whether the lessee is reasonably certain to exercise, or not to exercise, an option.

Concerning the airline industry, the emergence of new actors like low-cost carriers, ultra low-cost carriers, the rapid growing of certain airlines (example: Gulf carriers) among other factors could be taken into account to assess the future policy of aircraft-lease extensions by the lessee.

Reassessing whether the lessee is reasonably certain to exercise or not exercise an option

IFRS 16.20 requires a lessee to reassess whether the lessee is reasonably certain to exercise or not exercise an option upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee and affects the likelihood of the exercise of the option. Examples of significant events or changes in circumstances include:

- (a) significant leasehold improvements not anticipated at the commencement date;
- (b) a significant modification to, or customization of, the underlying asset that was not anticipated at the commencement date;
- (c) the inception of a sublease of the underlying asset for a period beyond the end of the previously determined lease term; and
- (d) A business decision of the lessee that is directly relevant.

Concerning the airline industry, the deployment of a new business-class cabin may be “a significant modification to, or customization of, the underlying asset that was not anticipated at the commencement date”. Likewise, if an airline entered into a maintenance contract after the inception of the lease and this agreement substantially extended beyond the lease period, this could be a change in circumstances affecting the likelihood of any options being exercised.

IFRS 16.21 requires the lease term to be revised if there is a change in the non-cancellable period of a lease. For example, the non-cancellable period of a lease will change if:

- (a) the lessee exercises an option not previously included in the entity's determination of the lease term;
- (b) the lessee does not exercise an option previously included in the entity's determination of the lease term;
- (c) an event occurs that contractually obliges the lessee to exercise an option not previously included in the entity's determination of the lease term; or
- (d) an event occurs that contractually prohibits the lessee from exercising an option previously included in the entity's determination of the lease term.

IAWG View:

As described above the lessee will assess the lease term at inception and reassess the lease term if there is a significant event or changes in circumstances that could affect the lease term.

A series of 12 illustrative examples follow:

Note: It is assumed for all examples that the agreement meets the definition of a lease and is enforceable unless otherwise stated.

SCENARIO		ROU ASSET & LEASE LIABILITY
1	<p>Cancellable clause states both lessor and lessee can terminate the agreement at any time by giving a 2-month notice.</p> <p>IAWG VIEW: This is a cancellable lease and a short-term lease under IFRS 16 definitions unless the lessee is reasonably certain that they will not cancel the lease when an assessment is made. No measurement of ROU asset and liability to be done. However, disclosures are required in financial statements of short-term leases.</p>	NO
2	<p>Cancellable clause states both lessor and lessee can terminate a 5-year agreement at any time after a period of 2 years by giving a notice 2 months in advance of the termination. Notice can be served by either party only after the initial term of 2 years is over.</p> <p>IAWG VIEW: Non-cancellable term here is 2 years and 2 months as that is the minimum period that is enforceable, there is no significant penalty and both parties individually can terminate. Measurement of ROU asset and liability to be done only for such term.</p>	YES
3	<p>Cancellable clause states lessee can terminate the agreement at any time by giving a 2-month notice. Lessor has no such right over the term of the agreement.</p> <p>IAWG VIEW: Non-cancellable period is the 2 months and then the reasonable certainty of lessee to not exercise its option needs to be considered.</p>	Depends on lessee's assessment of lease period.
4	<p>A cancellation clause that allows the lessor to terminate the agreement at any time by giving 2 months' notice. Lessee has no right of cancellation.</p> <p>IAWG VIEW: The non-cancellable lease period covers the full term of the lease agreement as the lessee cannot exercise the option (IFRS 16.B35). The lessee does not assess whether or not the lessor is reasonably certain of exercising the option, but would remeasure the lease when the option is exercised.</p>	YES
5	<p>There is no explicit cancellation clause, but there is a clause that provides for the termination of the agreement due to a default event (e.g., failure to make payment or insolvency) of the lessee.</p> <p>IAWG VIEW: These are protective rights and have no impact on the lease term.</p>	YES

SCENARIO		ROU ASSET & LEASE LIABILITY
6	<p>Agreement is silent about the lease term and the agreement is enforceable.</p> <p>IAWG VIEW: This require a high level of judgment as the lease term is indefinite. One approach could be to use a relevant cycle (e.g. funding, business, budgets or product). Others could include the remaining life of the asset, a period based on historical behaviour or an industry benchmark. The approach used should be consistent with the objective of estimating the reasonably certain period of the lessee.</p>	<p>Depends on lessee's assessment of the agreement.</p>
7	<p>Agreement states that both lessor and lessee cannot terminate the agreement during the initial term of 5 years. Lessee has the right to extend the agreement for an additional period of 2 years. An internal assessment at lease commencement date concludes that lessee is reasonably certain to extend the term.</p> <p>IAWG VIEW: The lease term is 7 years (5 + 2) since the lessee is reasonably certain to exercise the extension right.</p>	<p>YES</p>

	SCENARIO	ROU ASSET & LEASE LIABILITY
8	<p>Non-cancellable lease term is 5 years. Lessee has the right to extend the agreement by a further 2 years and will decide that at a later date. While doing this initial assessment, it is important to consider any economic incentives.</p> <p>Example of an economic incentive – A significant investment in leasehold improvements that have a useful life substantially longer than the initial term of 5 years. Based on this, it may be reasonably certain that the lessee will exercise the extension right in order to obtain the benefit of more of the useful life of the leasehold improvements. This is a judgement made based on all relevant factors (including history of exercising options and not just the existence of a significant penalty (economic incentive).</p> <p>IAWG VIEW:</p> <p><u>Where there is no reasonable certainty of exercising the right to extend the lease term:</u></p> <p>Non-cancellable term here is 5 years at lease commencement date. Measurement of ROU asset and liability to be done only for such term. At later date, when lessee becomes reasonably certain of extending, this will be treated as a lease adjustment and the lease liability will be revalued at that later date with a corresponding adjustment to ROU asset.</p> <p><u>Where at inception there reasonably certain that the extension will be exercised:</u></p> <p>The lease term is 7 years (5+2) at lease commencement date. At later date, if the lessee decides not to extend, this will be treated as a lease adjustment and the lease liability will be revalued at that later date with a corresponding adjustment to ROU asset. This may also require adjustment to the life of the leasehold improvement.</p>	YES
9	<p>Lease term is for one year with an annual auto renewal clause for another one year unless lessor or lessee terminate the agreement by written notice to the other party. There is no significant penalty to cancel.</p> <p>IAWG VIEW: This is a non-cancellable lease for 1 year and a short-term lease under IFRS 16 definition. No measurement of ROU asset and liability to be done. The treatment applies even if lessee is reasonably certain not to terminate at lease commencement date because the lessor has a right to terminate therefore the contract is not enforceable.</p>	NO

SCENARIO		ROU ASSET & LEASE LIABILITY
10	<p>Lease term expires before the date of adoption of IFRS 16 and there is no option for the lessee to renew the lease that is reasonably certain of being exercised. A modified retrospective approach is applied.</p> <p><u>Illustration:</u></p> <p>ABC Airways (Lessee) entered into a lease arrangement for office space with XYZ Ltd (Lessor). This lease agreement is effective for the period 1 January 2017 to 31 December 2018. The lease is renewable at the discretion of lessor at the end of lease. ABC Airways adopts IFRS 16 on 1 January 2019.</p> <p>IAWG VIEW: This lease expires on 31 December 2018 and is not reflected in the 2019 accounts except for the renewal period from 1 January 2019 if the lessor renewed the lease.</p>	<p>The original lease would not be reflected in 2019, only any renewal. If a full retrospective treatment was adopted the original lease would be reflected in the comparative information.</p>
11	<p>Lease term has expired, and Lessee continues to use the leased asset as the lease agreement renewal is taking significant time. Lessee does not know the revised rent or revised lease term.</p> <p>IAWG VIEW: If a contract is determined to exist (based on actions or verbal agreement), the terms established by any agreement or actions of the counterparties would be reflected until such time as the new lease terms were established. Past actions of the counterparties to renew these leases on similar terms would be a basis for recognizing a new lease on similar terms until the actual terms are established.</p>	<p>Depends on lessee's assessment of the agreement.</p>

	SCENARIO	ROU ASSET & LEASE LIABILITY
12	<p>The lease term is for 4 years with a mutual right of termination at that point. Alternatively, the lease renews for an additional 4 years. Lessee has invested in leasehold improvements with a useful life of five years.</p> <p>IAWG VIEW: The lease term is assessed based on whether the lessee is reasonably certain of renewing the lease for future periods. The leasehold improvements, history of renewals and other factors may support a conclusion that the lessee is reasonably certain of renewal for one or more periods.</p> <p>In this example, if an airline determined that the lease term at inception is 4 years and the useful life of the leasehold improvements was 5 year, this would appear to create an inconsistency in assumptions. While it would be reasonable to align the lease term and useful life of relevant leasehold improvements, it is not required as the lease term and useful life of the leasehold improvements do not measure the same level of probability. IAS 16.53 requires the useful life of an asset to be based on the expected period of use by the holder of the asset and IFRS 16 measures the lease term based on non-cancellable period plus optional periods that that the lessee is reasonably certain to exercise.</p>	<p>Depends on lessee's assessment of lease period.</p> <p>See pages 27-28 for the IFRIC Agenda Decision that provides guidance on this issue consistent with what IAWG has shown here.</p>

Assessment of the Maintenance Obligation in Relation to Leased Aircraft

Background:

Accounting for maintenance costs related to aircraft held under an operating lease has been an area where there has been diversity in accounting practices. IFRS 16 does not establish any new requirements with regard to accounting for the maintenance obligations related to a leased asset, but it does require the issue to be reconsidered. Under IFRS 16, restoration costs related to returning a leased asset must be capitalized as part of the Right-of-Use (ROU) asset when the obligation is created and depreciated over the remaining life of the lease. The requirement to recognize the provision already exists under IAS 37, so a consistent outcome would be expected.

Issues:

How should a lessee account for major maintenance events (engine overhaul and airframe inspection) costs in relation to a leased aircraft?

Analysis of Issues:

A number of approaches are currently used to account for operating leased aircraft. These methods include, but are not limited to:

- Expense as Incurred - recognizing the cost of major maintenance in profit and loss as incurred and providing over the lease term for any expected required cash compensation for maintenance obligations at the end of the lease.
- Components Approach - capitalizing the estimated costs of major maintenance events and depreciating them until next maintenance event or end of lease term and providing over the lease term for any expected cash compensation for maintenance obligations at the end of the lease.
- Provisions Approach – recognizing a provision for the costs of major maintenance events over the interval from start of the lease or the maintenance event until the next event or end of the lease, whichever is relevant. These costs may be related to the performance of the maintenance or cash payments in lieu.

IFRS 16.24 (d) states that the cost of the ROU asset shall comprise an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period.

IFRS 16.25 states that a lessee shall recognize the costs described in paragraph 24(d) as part of the cost of the right-of-use asset when it incurs an obligation for those costs. A lessee applies IAS 2 Inventories to costs that are incurred during a particular period as a consequence of having used the ROU asset to produce inventories during that period. The obligations for such costs accounted for applying this Standard or IAS 2 are recognized and measured applying IAS 37.

Lease contracts commonly require the lessee to undertake and pay for major maintenance events or to pay to the lessor upon return of the aircraft an estimated amount based on one or measures of use. While IAS 16 states that a provision cannot be taken for overhauls on owned aircraft, as the costs could be avoided by selling or decommissioning the aircraft, these costs cannot be avoided for leased

aircraft. Therefore, they require a provision under IAS 37, as there is a present obligation and a probable outflow of economic benefit.

IFRS 16.31 states that a lessee shall apply the depreciation requirements in IAS 16 Property, Plant and Equipment in depreciating the ROU asset. That guidance refers to the components approach. An example of how an airline may apply a components approach under IFRS 16 is shown in the topic: *Components Approach for Accounting for Major Maintenance Events in a Lease*, in this booklet.

One approach that could be applied in relation to a leased aircraft is to:

- Recognize a provision and as part of the ROU asset the costs to be incurred in returning the aircraft (likely stripping of the paint and a final check), as this obligation would exist from inception and therefore be spread over the life of the lease.
- Major maintenance events (engine overhauls, airframe inspections other than the final check, etc) would then be provided for over the life of the lease and released when costs are incurred by the lessee.
- Other maintenance costs would be expensed as incurred. This would appear to comply with the requirements of IFRS 16 and IAS 37, and produce a recognition pattern consistent with the use of the asset. This would not be the only viable approach that would achieve the same outcome.

IAWG View:

A lessee should take into account the contractual terms of the lease agreement and the requirements of IFRS 16 and IAS 37 in accounting for major maintenance events in relation to a leased aircraft.

Assessment of Whether Contracts at Airports Contain Leases

Background:

IFRS 16 requires an entity at inception or modification of a contract to determine if the contract is or contains one or more leases. This may be complicated with regard to contracts in relation to airports where there may be multiple airlines and non-airlines within the facility with exclusive, preferential, shared, and common use areas.

Issues:

This paper clarifies how to apply IFRS 16 to contracts at airports.

Analysis of Issues:

At inception of a contract, an entity shall assess whether the contract is, or contains, a lease.

Airlines often have a number of contracts at airports, such as lounge and office space and contracts to use airport capacity to transit customers through terminals, gates etc. In determining the relevant contracts for consideration, airlines should consider the contract combination guidance in IFRS 16.B2.

A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. IFRS 16.B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

Identifying a lease

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following under IFRS 16.B9:

- (a) the right to obtain substantially all of the economic benefits from use of the identified asset; and
- (b) the right to direct the use of the identified asset.

Contracts may contain the right to use multiple assets (e.g., a building and equipment). The right to use each asset will be considered a separate lease component if (both):

- (1) the lessee can benefit from the use of the asset either on its own or together with other resources that are readily available to the lessee and
- (2) the underlying asset is neither dependent on, nor highly interrelated with, the other underlying assets in the contract. This may require multiple contracts to be assessed together or a single contract to be assessed in multiple parts.

Right to obtain economic benefits from use

IFRS 16.B21 states that to control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period).

What is meant by exclusive use? In an airport there are areas that are dedicated to a single user (an airline specific lounge, an airline's dedicated office, hangars, etc) and areas that are shared with other users (restrooms, baggage claim areas, etc). An airline would need to determine if the criteria in IFRS 16.B9 were met.

Even if a specified asset is for exclusive use, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

- a) the supplier has the practical ability to substitute alternative assets throughout the period of use; and
- b) the supplier would benefit economically from the exercise of its right to substitute the asset.

If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier's substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.

An entity's evaluation of whether a supplier's substitution right is substantive is based on facts and circumstances at inception of the contract and shall exclude consideration of future events that, at inception of the contract, are not considered likely to occur.

Each contract should be componentized into its different "potential" lease and non-lease components. The assessment whether or not there is a substantive substitution right would be made on the level of the "potential" lease component in accordance with IFRS 16.12, B32-33.

Right to direct the use

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

- (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or
- (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
 - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
 - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

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.

It is highly unlikely that an airline would direct the use or obtain all of the economic benefits from common use or shared assets. Exclusive use and preferential use identified assets may or may not meet these criteria, but need to be assessed based on fact patterns and the terms of the contract.

Variable payments

If a contract is determined to contain a lease as described above and does not meet the short-term or low value exceptions in the standard, a financial liability and a Right of Use (ROU) asset need to be recorded. The measurement of both the asset and liability include all fixed lease payments and any variable lease payments that depend on an index or a rate (such as CPI).

It is common in contracts related to the use of airport facilities for the price to be on a per passenger use basis and as a result these payments if not subject to a minimum amount (in substance fixed) would not be included in the measurement of the financial liability and ROU asset. Nevertheless, IFRS 16.53 contains disclosure requirements that would need to be met. IFRS 16.IE Example 22 provides an illustrative disclosure.

Allocation of payments for contracts containing lease and non-lease elements

If an agreement contains both lease and non-lease (service) elements IFRS 16.13-14 requires the allocation of the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

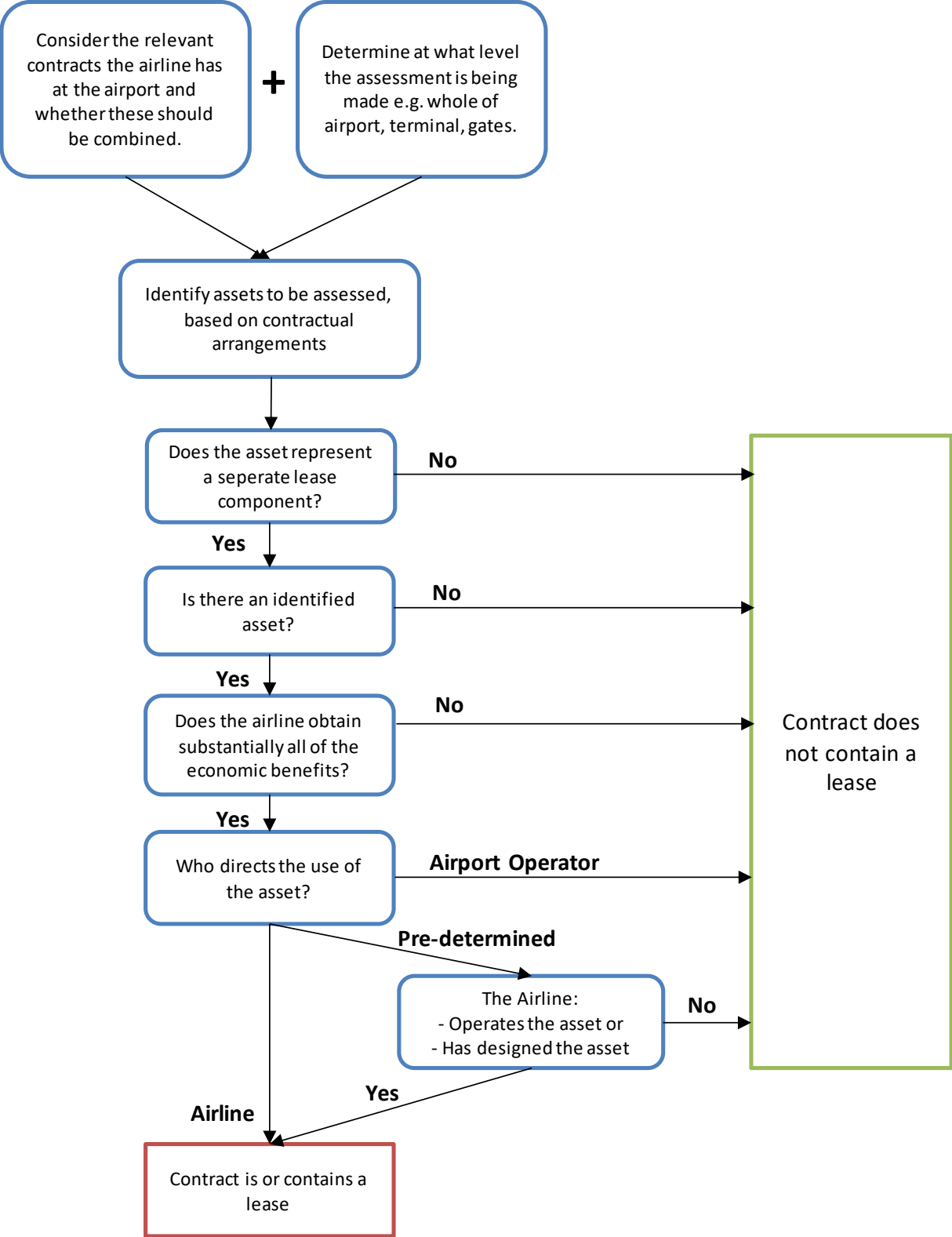
As a practical expedient, IFRS 16.15 allows a lessee to elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component.

IAWG View:

Contracts at airports need to be evaluated to determine if they contain one or more assets that meet the criteria in IFRS 16 for a lease and should be accounted for separately from the other elements of the contract. For lease elements where the payments are fully variable it is unlikely to result in any asset or liability being recognized for those payments. However, those payments would need to be disclosed in accordance with IFRS 16.53.

A decision tree is shown on the next page that may be helpful in assessing contracts at airports.

Decision Tree



FACTORS TO CONSIDER:

Relevant contracts

What arrangements at the airport are relevant for this assessment? For example, retail, landing rights, lounge, gates etc.

Identify assets for which a lease assessment should be made (for example, terminal, gates, lounges, common spaces).

Does the asset represent a separate component?

At what level are decisions made about the use of the asset (i.e. can it be controlled independently of other assets)?

Can the asset be operated independently of a larger asset or other assets?

Does the asset generate economic benefits independent of a larger asset or other assets?

Is the asset priced independently of larger assets or other assets?

Is the use of the asset highly dependent on, or interrelated with other assets?

Is the asset physically distinct?

Is the asset easily reconfigured or interchangeable by the airport operator (i.e. substitutable)?

Is there an identified asset?

Is the asset used by the airline physically distinct?

Does the airport operator have the practical ability to change/substitute the asset used by the airline?

Are there alternative spaces/assets available which can be used by the airline?

Are there benefits to the airport operator from substitution?

Does the airline obtain substantially all of the economic benefits?

Do third parties use more than an insignificant amount the asset and receive economic benefits (i.e. more than 20%)?

Is the capacity of the asset constrained or is there spare capacity unused by users for example at the airport terminal level, is there spare capacity unused by e.g. retail, restaurants, advertisers, airlines etc?

Who controls the use of spare capacity identified for the specific asset?

Does the airline receive substantially all of the economic benefits from the use of the asset (including spare capacity)?

Who directs the use of the asset?

Who has the rights to change the type of output produced by the asset?

Who has the rights to change when the output is produced?

Who has the rights to change where the output is produced?

Who has the rights to change whether the output is produced, and the quantity of that output?

Who has the rights to allocate spare capacity (e.g. landing slots, retail, restaurants, advertisers etc)?

Who makes capital expenditure decisions in relation to the asset?

Who makes decisions about how the asset is allocated to users of the asset?

Other factors

Is the asset highly dependent on or highly interrelated with other assets in the contract?

Is the airline contracting for an integrated deliverable that incorporates a number of different assets?

Does the airline obtain and control the use of the underlying asset at the commencement of the contract or does the airline receive the benefit of the services when the asset is made available when required and only pays for usage?

Components Approach for Accounting for Major Maintenance Events in a Lease

Background:

Airlines that lease aircraft and engines are required by contractual agreement to return the assets to the lessor at the end of the lease in a predefined state. They agree to provide cash compensation to lessors for any "shortfall" in the production capacity (potential) of the aircraft and engines. These overhauls and inspections take place at intervals determined by factors such as flight cycles, flight hours, passage of time or a combination of factors. Therefore, these events frequently do not align with the return of the aircraft resulting in a need to compensate the lessor in cash. These payments are independent of any maintenance reserves paid to the lessor. Those payments are utilized during the life of the lease to pay for any actual maintenance performed.

Under IAS 17, leased aircraft and engines were not recognized and airlines have used variations of the following methods in accounting for required maintenance (including heavy maintenance) and the payments to be made in lieu of maintenance upon the return of the asset to the lessor:

- Expense as Incurred - recognizing the cost of major maintenance in profit and loss as incurred and providing over the lease term for any expected required cash compensation for maintenance obligations at the end of the lease.
- Components Approach - capitalizing the estimated costs of major maintenance events and depreciating them until next maintenance event or end of lease term and providing over the lease term for any expected cash compensation for maintenance obligations at the end of the lease.
- Provisions Approach – recognizing a provision for the costs of major maintenance events over the interval from start of the lease or the maintenance event until the next event or end of the lease, whichever is relevant. These costs may be related to the performance of the maintenance or cash payments in lieu.

With the adoption of IFRS 16, airlines should revisit their approach to ensure that it complies with the provisions of the accounting standards and most importantly is reflective of the economic reality of the transaction.

Issues:

If an airline applies a components approach as described in IAS 16 to leased aircraft or engines accounted for IFRS 16, how should they account for the major (heavy) maintenance elements using this approach?

Analysis of Issues:

Relevant sections of the IFRS Standards

IFRS 16 addresses how to account for the leased asset (ROU Asset) and related Financial Liability. It does not address how to account for the major maintenance costs incurred during the life of the lease.

Regardless of the method used to address how to account for major maintenance and inspections, IFRS 16 requires that the lessee recognize a ROU Asset that is amortized over its useful life and a Financial Liability that is recorded at present value and then treated as an amortizing loan with payments being allocated to principal and interest based on the established discount rate. The ROU Asset will include an estimate of the restoration costs, those costs that will be incurred to return the aircraft to

the lessor at the end of the lease. Whether the costs related to restoring the aircraft's potentials are restorations cost is a matter of judgment.

Accounting for maintenance of property plant and equipment, which applies to owned aircraft and engines in an airline, is addressed in IAS 16.12-14. This guidance requires routine repair or maintenance to be expense as incurred and major overhauls, replacements or inspections to be capitalized when incurred and the previous asset that has been replaced derecognized.

The specific contractual return condition obligations in leases preclude the application of this approach. For owned aircraft an obligation to maintain the aircraft's potentials does not exist and therefore provisions are not allowed under IAS 37 for major overhauls and inspections. These obligations exist for leased aircraft from the date the aircraft is accepted by the lessee. Therefore, a provision would be appropriate.

IFRS 16.31 indicates that a lessee shall apply the depreciation requirements in IAS 16 Property, Plant and Equipment in depreciating the right-of-use asset. IAS 16 requires that a components approach be applied in depreciating assets subject to IAS 16 whereby major components with different useful lives are identified separately. IAS 16.43 states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. Therefore, the asset recognized for the potentials would need to be recognized separately from that of the aircraft ROU asset as there is a different useful life.

How is the Obligation to return the Potential Treated?

The lease of an aircraft could be viewed as obtaining the right of use of the aircraft with an obligation to return that aircraft with like potentials or to compensate for any shortfall. Essentially the potentials are accounted for as consumed. The appropriate way to reflect that view is through a provisions approach. This approach is illustrated in topic: *Assessment of the Maintenance Obligation in Relation to Leased Aircraft* in this booklet.

The lease may also be viewed as obtaining the right of use of the aircraft and borrowing or purchasing the potentials. In that case, a components approach would be appropriate, and the potential would be treated as a separate component. As the obligation to return the potentials does not necessarily require payments to the lessor, a Financial Liability is not appropriate, but rather a constant provision for the full value of the potentials obtained is appropriate.

The amount capitalized at the start of the lease for the then available restorable productive units (full potential or less), which equals the amount (at the start of the lease) of the obligation for restoration to be fulfilled at the end of the lease, is depreciated over the use of productive units until there are none remaining. The then expended maintenance event that restores the quantity of productive units to full potential is in turn capitalized and depreciated over productive use until the next event. When the lease ends before an upcoming maintenance event and assuming a restoration obligation at full potentials, the then remaining book value of the last performed and capitalized maintenance, which represents the value of the remaining restorable productive units from that last performed maintenance, is surrendered to the lessor and as such is recorded as withdrawal on settlement of the liability for the restoration obligation, together with the payment in cash for the used productive units, also from the last performed maintenance.

The asset recorded for the potentials provided with the ROU Asset would form a separate asset. One label for this asset would be "Incremental ROU Asset". Others could also be used.

The cost allocation pattern for the depreciation of the major maintenance events asset under this approach is substantially the same as the provisions approach. The difference is that this approach increases the asset and liability totals on the balance sheet.

IAWG View:

IAWG is of the view that a component approach is one of the acceptable approaches to recognizing major overhaul and inspection costs in relation to a leased aircraft.

An example of this approach recognizes an asset for the potentials received in the form of these major maintenance events and a provision for their return. That provision remains constant over the life of the lease and the asset is amortized over its useful life. When the major maintenance event takes place, the asset is derecognized, and the cost of the major maintenance event is capitalized. Upon return of the aircraft the provision (liability) is satisfied through the transfer of the remaining asset value and any cash compensation due the lessor. Any difference would be recognized in profit or loss.

Other approaches are also acceptable if they result in accounting information consistent with the consumption of the leased asset and aircraft potentials. This may be evaluated on a fleet basis subject to materiality.

Components of Lease Payments Included in ROU Asset

Background:

IFRS 16, *Leases*, requires the lessee to recognize a Right of Use (ROU) asset and financial liability in relation to the lease agreement. Previously an operating lease was not recognized on the balance sheet.

Issues:

This paper clarifies the thought requirements and thought process to be applied in determining the value of the ROU asset under IFRS 16.

Analysis of Issues:

IFRS 16.24 requires the cost of the right-of-use asset to include:

- (a) the amount of the initial measurement of the lease liability;
- (b) any lease payments made at or before the commencement date, less any lease incentives received;
- (c) any initial direct costs incurred by the lessee; and
- (d) An estimate of costs to be incurred by the lessee in restoring the underlying asset to the condition required by the terms and conditions of the lease. These costs are added to the ROU asset as the obligation is created.

These components are described below. Note that there are transitional provisions that may be applied on initial recognition of this standard that would reduce the need to determine a number of these items and are described at the end of this section.

Amount of the initial measurement of the lease liability

IFRS 16.26 requires at the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- (a) fixed payments (including in-substance fixed payments), less any lease incentives receivable;
- (b) variable lease payments that depend on an index (for example, payments linked to a consumer price index) or a rate (such as LIBOR), initially measured using the index or rate as at the commencement date;
- (c) amounts expected to be payable by the lessee under residual value guarantees;
- (d) the exercise price of a purchase option if the lessee is reasonably certain to exercise that option; and
- (e) payments of penalties for terminating the lease, if the lease term applied to the lease reflects the lessee exercising an option to terminate the lease.

Lease payments made at or before the commencement date, less any lease incentives received

The ROU asset would include all lease payments made, including those made prior to the commencement date of the lease. This would include any advance payments, but not deposits or other payments that are to be returned to the lessee upon termination of the lease.

Specific consideration might need to be given to deposits that do not carry interest or that are not expected to be netted with certain obligations the lessee may have according to the provisions of the contract. In these cases, some or all of the payment relating to the "deposit" might be considered an in-substance lease payment.

Initial direct costs incurred by the lessee

Initial costs included in the valuation of the lessee's ROU asset are limited to incremental costs directly attributable to negotiating and arranging the lease and that are incurred only if the lease is obtained.

See the IAWG paper addressing this issue for more detailed information including guidance applicable to initial adoption of IFRS 16.

Costs to be incurred by the lessee in restoring the underlying asset

This requirement is based on the requirements for provisions under IAS 37. While IFRS 16 provides no clear guidance as to what expenditures would fall into this category in relation to aircraft or buildings, it is clear that it would not include normal maintenance costs. Costs incurred solely for the purpose of returning an asset, such as stripping the paint from an aircraft, a final inspection or the removal of leasehold improvements would clearly fall into this category.

See the IAWG paper addressing accounting for maintenance costs of an aircraft for more detailed information.

Transitional provisions

If a lessee elects to apply this standard by not restating the prior period(s), the lessee would recognize a right-of-use asset at the date of initial application for leases previously classified as an operating lease in one of two ways.

1. The carrying amount as if the standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application. A lessee applying this method may exclude initial direct costs from the measurement of the right-of-use asset at the date of initial application.
2. An amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognized in the statement of financial position immediately before the date of initial application.

This choice would be applied to each lease.

IAWG View:

The thought process described above should be used in determining the value of the ROU asset when adopting IFRS 16 or upon entering into a lease after adopting IFRS 16.

COVID-19 Practical Expedient for Lease Payment Concessions

Background:

The IASB has amended IFRS 16, *Leases* (“IFRS 16”) to provide lessees with practical relief during the Covid-19 pandemic to allow, but not require, lessees to not assess whether a lease payment concession is a lease modification and to account for the lease contract as though it is not a modification on a temporary basis.

IFRS 16 contains requirements for lease modifications to be remeasured. It is not entirely clear as to the type of lease payment concessions (payment deferrals, partial or full lease payment forgiveness, etc.) that would be deemed to be a change in consideration or lease term. It is also not clear how a lease payment concession would be treated if it were deemed not to be a modification. The amendment provides some clarity around these issues and the purpose of this paper is to explain the provisions of the amendment, the clarifications provided and the views of the IAWG where the guidance remains unclear.

The IASB subsequently revised this relief to extend the scope to include reliefs covering periods on or before June 30, 2021 to on or before June 30, 2022.

Issues:

This paper discusses how the IAWG believes that the COVID-19 practical expedient could be applied.

Analysis of Issues:

Is the amendment mandatory?

The amendment provides an option to apply the relief and is only available in relation to accounting by lessees. There is no relief granted to lessors in head leases or sub-leases.

The relief is to be applied consistently to contracts with similar characteristics and in similar circumstances.

If you adopted this relief you must apply it to contracts covered by the revised period ending June 30, 2022. If you did not adopt this relief, you may not use the revised date as an opportunity to elect the relief.

What is the scope of relief?

The practical relief provided for by the amendment only applies to “rent concessions” that reduce (defer, partially or fully forgive, etc.) lease payments originally due on or before 30 June 2022 (revised in March 2021).

If, for example, monthly lease payments for a lease were reduce for the period from 1 July 2020 to 1 December 2023, IAWG would be of the view that the practical expedient could not be applied to that lease as the expedient is considered at a contract level and not at a payment level.

The amendment uses the term “rent concession” that for some may suggest a property lease, but the practical relief applies to all leases.

Would deferred lease payments be a modification?

IAWG believes that a deferral of lease payment(s) for substantially the same amount of consideration would not be treated as a modification under the existing IFRS 16. The accounting treatment for this scenario is addressed in BC7(b) of the ED as follows:

A change in lease payments that reduces payments in one period but proportionally increases payments in another does not extinguish the lessee's lease liability or change the consideration for the lease— instead, it changes only the timing of individual payments. In this case, a lessee would continue to reduce the lease liability for payments made to the lessor applying paragraph 36(b) of IFRS 16.

IFRS 16.36(b) states that a lessee shall measure the lease liability by reducing the carrying amount to reflect the lease payments made. BC9 of the ED states that a lessee applying the practical expedient would generally recognise the effects of forgiveness of lease payments in profit or loss in the period in which the event or condition that triggers that forgiveness occurs.

We believe a valid approach for lessees in accounting for this scenario is to recognize the interest expense during the deferral period as originally calculated. There would be no impact on the ROU Asset, discount rate or interest calculation. See Scenario 1 of attached illustrative examples.

How would reduced or waived lease payments be treated?

IAWG believes that this fact pattern meets the criteria in paragraph 46B for relief and would otherwise be treated as a modification as the consideration would be substantially modified. The accounting treatment for this scenario is addressed in BC7(a) as follows:

A lessee applying the practical expedient would generally account for a forgiveness or waiver of lease payments as a variable lease payment applying paragraph 38 of IFRS 16. The lessee would also make a corresponding adjustment to the lease liability—in effect, derecognising the part of the lease liability that has been extinguished by the forgiveness or waiver of lease payments.

Paragraph BC9 of the ED indicates that a lessee applying the practical expedient would generally recognise the effects of forgiveness of lease payments in profit or loss in the period in which the event or condition that triggers that forgiveness occurs.

We believe a valid approach for lessees in accounting for this scenario is to reduce the lease liability by the amount forgiven and recognize the interest expense as originally calculated. Paragraph BC9 of the ED indicates that the ROU Asset would not be adjusted if the relief was applied. See Scenario 2 of attached illustrative examples.

How would lease payments suspended for a period with the lease extended to match the suspended period be treated?

Paragraph BC5(c) of the ED states the following:

This condition reflects the Board's view that lessees should not apply the practical expedient to lease modifications that are unrelated to the covid-19 pandemic but

are negotiated at the same time as a covid-19-related rent concession (although, for example, a three-month rent holiday in 2020 followed by three additional months of substantially equivalent payments at the end of the lease would not prevent a rent concession from being within the scope of the practical expedient).

The language in this subparagraph clarifies that changes in terms and conditions are permissible if they are pandemic related and meet the other criteria in paragraph 46B.

We believe a valid approach for lessees is to continue to recognize the interest expense during the deferral period as originally calculated without regard to the deferred interest element. There would be no impact on the ROU Asset, discount rate or interest calculation. The ROU Asset would be discounted over the original lease term. See Scenario 3 of attached illustrative examples.

Effective date and transitional provisions

A lessee would apply the amendment:

- (a) for annual reporting periods beginning on or after 1 June 2020. Earlier application is permitted, including in financial statements not yet authorised for issue at the date the amendment is issued; and
- (b) retrospectively, recognising the cumulative effect of initially applying the amendment as an adjustment to the opening balance of retained earnings in the year of adoption.

The purpose of the effective date is to permit those with reporting periods ending near that issuance date of the amendment from being barred from adopting the relief at a later time if the amendment was made effective immediately.

The effective date would allow for the reporting entity to not apply the practical expedient in an interim period(s) or current financial year and then adopt it in 2021 after they have applied IFRS 16 without the benefit of the expedient.

APPENDIX: ILLUSTRATED EXAMPLES (Note that this is one valid approach and not the only approach to accounting for these concessions.)

Background: Lessee enters into a 24-month lease of commercial real estate for two years starting on January 1, 2020. Payments of \$100.00 are due the first of each quarter. The implicit interest rate is not determinable and the incremental borrowing rate on January 1, 2020 is 5%. The present value of the payments discounted at 5% is \$678.64. The ROU Asset is valued at the same amount and depreciated over 8 periods of three months on a straight-line basis. As a result of the Covid-19 crisis lease payment concessions are negotiated with the lessor on April 27, 2020. The incremental borrowing rate at this time increases to 6%.

*Scenario 1: **Deferral of payments:*** payments in Jul and Oct are deferred to Jul and Oct 21

*Scenario 2: **Forgiveness of payments:*** payments on July 1, 2020 and October 1, 2020

*Scenario 3: **Extension of payments:*** payments on July 1, 2020 and October 1, 2020 are deferred to January 1, 2022 and April 1, 2022 with the lease extended by six months on the same terms

Accounting entries determined at inception of the lease

		1JAN20	1APR20	1JUL20	1OCT20	1JAN21	1APR21	1JUL21	1OCT21	1JAN22	1APR22
Lease Payment	Cr Cash	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00	\$100.00		
Interest element	Dr Interest Expense	\$28.93	\$25.38	\$21.65	\$17.73	\$13.62	\$9.30	\$4.76	\$0.00		
Principal element	Dr Lease Liability	\$71.07	\$74.62	\$78.35	\$82.27	\$86.38	\$90.70	\$95.24	\$100.00		
ROU Asset element	Dr Depreciation Cr Accumulated Depreciation	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83	\$84.83		

*Scenario 1: **Deferral of payments***

				<i>Adjusting entries</i>					
	Dr Cash (Note 1)		\$100.00	\$100.00			Cr Cash	\$100.00	\$100.00
	Cr Lease Liability		\$100.00	\$100.00			Dr Lease Liability	\$100.00	\$100.00
Adjusted Lease Liability		\$607.57	\$532.95	\$554.60	\$572.33	\$485.95	\$395.25	\$200.00	\$0.00

*Scenario 2: **Forgiveness of payments***

	Dr Cash (Note 1)		\$200.00						
	Cr Gain		\$200.00						
Adjusted Lease Liability		\$607.57	\$532.95	\$354.60	\$372.33	\$285.95	\$195.25	\$100.00	\$0.00

*Scenario 3: **Extension of payments***

	Dr Cash (Note 1)		\$100.00	\$100.00				Cr Cash	\$100.00	\$100.00	
	Cr Lease Liability		\$100.00	\$100.00				Dr Lease Liability	\$100.00	\$100.00	
Adjusted Lease Liability		\$607.57	\$532.95	\$554.60	\$572.33	\$485.95	\$395.25	\$300.00	\$200.00	\$100.00	\$0.00

Note 1: This entry does not reflect an inflow of cash, but rather a reversal of the entry to show an outflow of cash in the example. No cash flow takes place.

Depreciation of Aircraft Suspended from Commercial Operations by Aviation Authorities

Background:

Aviation authorities have suspended B737MAX series aircraft from commercial operations since March 2019. It is not clear when these aircraft will be retrained to operations.

Recently, airlines have suggested transferring the grounded B737MAX series aircraft that have been put into use from fixed assets to construction-in-progress with depreciation suspended. IAWG has analysed this issue in relation to aircraft suspended from operation by aviation authorities and not in relation to the specific grounding of the B737MAX series aircraft.

Issues:

1. Could aircraft that had already been available for use be transferred from fixed assets to construction-in-progress and depreciation suspended?
2. Could aircraft components that are subject to depreciation based on usage have depreciation suspended while the aircraft is not in use?

Relevant Accounting Standards:

IAS 16.55

Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and the date that the asset is derecognized. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

IAS 16.61

The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with IAS 8.

IAS 16.62A

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

Analysis of Issues:

1. Could aircraft that had already been available for use be transferred from fixed assets to construction-in-progress and depreciation suspended?

IAS 16.55 states that depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

Aircraft that had already been available for intended use may only stop being depreciated in accordance with IAS 16.55 if the asset is classified as held for sale in accordance with IFRS 5 or if the asset is derecognized. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.

It is agreed that the cancellation of the airworthiness certificate of aircraft precludes the asset from being used as intended, but IAS 16.55 provides for only two conditions where depreciation may be suspended, and neither is met by the suspension of airworthiness certification. The aircraft is not held for sale nor is it fully depreciated.

2. Could aircraft components that are subject to depreciation based on usage have depreciation suspended while the aircraft is not in use?

IAS 16 does not distinguish between components of an asset therefore the same analysis as shown above would apply to these components in relation to suspending depreciation.

Airlines generally show a depreciation policy for aircraft components and LLPs based on periods of time (months or years). It is understood that these periods are proxies for usage measures (cycles or miles flown). Therefore, an argument could be made that these components are depreciated on a usage basis and therefore subject to zero depreciation when not in use. This is subject to the contractual terms being based on utilization and not the passage of time.

Furthermore, IAS 16.61 does provide for the method of depreciation to be changed if the pattern of consumption of an asset has changed and IAS 16.55 provides that under usage methods of depreciation the depreciation charge can be zero while there is no production. The pattern of consumption for an aircraft component such as major maintenance would have changed as a result of the aircraft being grounded and as the maintenance intervals are based on usage, a usage method would be appropriate.

We believe that as the pattern of use has changed for this specific aircraft the change in approach could be justified and a change back to the previous approach could be justified when the aircraft is returned to operations based on a separate change in the pattern of use. A change in depreciation method would be a change in estimate in accordance with IAS 8.32 and would be accounted for on a prospective basis with disclosure being made in accordance with IAS 8.39.

IAWG Views:

- 1. IFRS would indicate that aircraft that had already been available for intended use may only stop being depreciated in accordance with IAS 16.55 if the asset is classified as held for sale in accordance with IFRS 5 or if the asset is derecognized. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.**
- 2. IFRS could support that aircraft components that had already been available for intended use could be deemed as assets depreciated under a usage method with the passage of time being used as a proxy, or the depreciation method could be changed based on a change in consumption pattern. If it is established that the airline is depreciating these components in accordance with a usage method, then it would be appropriate to show no depreciation while the aircraft is idled.**

Note that an item of property, plant and equipment that is idled for an extended period of time may be an indicator of impairment in accordance with IAS 36. This would require an assessment of the disposal value or value in use to determine if they are both less than the carrying value of the asset or cash generating unit that applies.

Impact of Payment of the Financial Liability on the Cash Flow Statement

Background:

IFRS 16 will significantly impact the balance sheet and income statement for agreements previously treated as operating leases, but it will also impact the cash flow statement. Airlines need to be aware of the requirements in IFRS 16 and IAS 7, and the choices with regard to accounting for the interest expense that will be recognized under IFRS 16.

Issues:

How should the cash flows for the payment of the financial liability be accounted for with regard to a lease agreement?

Analysis of Issues:

Under IAS 17, operating lease cash flows were accounted for as operating activities in the amount of the cash payment made in the reporting period. This reflected the nature of the activity as a rental agreement.

IFRS 16.50 states that in the statement of cash flows, a lessee shall classify:

- (a) cash payments for the principal portion of the lease liability within financing activities;
- (b) cash payments for the interest portion of the lease liability applying the requirements in IAS 7 Statement of Cash Flows for interest paid; and
- (c) short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities.

IAS 7.17(e) indicates that an example of cash flows arising from financing activities include cash payments by a lessee for the reduction of the outstanding liability (principal amount) relating to a lease. IAWG is of the view that this includes any portion of the principal payments that represent a repayment of any cash incentive received as part of the lease agreement regardless of how that cash flow was used by the lessee.

It should be noted that while IAS 7 requires these cash flows to be treated as financing activities, some debt rating agencies plan to reclassify these amounts in their models and treat them as investing activities. That is designed to align leasing with owning assets, such as aircraft and property, under their models.

The interest expense (portion of the lease payment not allocated to principal) may be treated as an operating, financing or investing activity as explained in IAS 7.33 and appears to be an accounting policy choice based on the language in that paragraph.

IAS 7.31 requires that cash flows from interest paid be disclosed separately and be classified in a consistent manner from period to period as either operating, investing or financing activities.

It should be noted that the cash flow statement may also be impacted by lease incentives and the use of a components approach for major maintenance activities on leased assets. The separate papers on those issues will address the cash flow statement implications.

IAWG View:

Airlines should account for the cash flows for the payment of the financial liability created under a lease agreement as a financing activity for the principal portion and adopt a policy for treating the interest expense portion as either an operating, financing or investing activity.

Note that the interest expense on leases will form part of net income and therefore if this amount is treated as a Financing or Investing Activity it must be adjusted out of the Operating Activity section of the Statement of Cash Flows.

Interaction IFRS 16.18 and B34

Background:

IFRS 16 requires the term of a lease to be determined at inception and when events occur, or circumstances change that may impact that determination. The lease term is the non-cancellable period of a 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.

In determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. IFRS 16, BC127 indicates that if optional periods (eg, renewal periods) are not enforceable (eg, if the lessee cannot enforce the extension of the lease without the agreement of the lessor), the lessee does not have the right to use the asset beyond the non-cancellable period. A lease is also no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

The language in the standard could be read to mean that options and mutual termination clauses are separate issues and that an enforceable mutual termination clause would be considered part of the lease term even if not reasonably certain.

This language around "mutual termination clauses" has raised an issue around what is an "insignificant penalty". This guidance does not address that issue, but it is understood that the term "penalty" was intended to broadly include economic disincentives. This guidance addresses what is the appropriate treatment of a mutual termination clause that is enforceable.

Issue:

How are enforceable mutual termination clauses to be assessed under IFRS 16?

Analysis of the issue:

IFRS 16, Leases contains guidance on dealing with terms that may extend or shorten a lease agreement.

IFRS 16.18 states that an entity shall determine the lease term as the non-cancellable period of a lease, together with both:

- (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and
- (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

IFRS 16.B34 states that in determining the lease term and assessing the length of the non-cancellable period of a lease, an entity shall apply the definition of a contract and determine the period for which the contract is enforceable. A lease is no longer enforceable when the lessee and the lessor each have the right to terminate the lease without permission from the other party with no more than an insignificant penalty.

IFRS 16.B35 states that if only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term. If only a lessor has the right to terminate a lease, the non-cancellable period of the lease includes the period covered by the option to terminate the lease.

IFRS 16.B34 would suggest that mutual termination clauses are not options, but they are an option to both parties as they have a right, but not an obligation to choose a certain outcome, ie, the option to terminate the agreement without the other party's consent.

IAWG View:

Enforceable mutual termination clauses are in substance options and should be assessed for reasonable certainty using the same criteria as options in accordance with IFRS 16.18. Unenforceable clauses would not be assessed as part of the lease term.

The IASB's International Financial Reporting Interpretation Committee (IFRIC) issued IFRIC Agenda Decision, Lease Term and Useful Life of Leasehold Improvements (IFRS 16 *Leases* and IAS 16 *Property, Plant and Equipment*)—November 2019 shown on the following two pages. This is consistent with the guidance IAWG provides on this issue.

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IFRIC Agenda Decision - Lease Term and Useful Life of Leasehold Improvements (IFRS 16 Leases and IAS 16 Property, Plant and Equipment)—November 2019

The Committee received a request about cancellable or renewable leases.

The cancellable lease described in the request is one that does not specify a particular contractual term but continues indefinitely until either party to the contract gives notice to terminate. The contract includes a notice period of, for example, less than 12 months and the contract does not oblige either party to make a payment on termination. The renewable lease described in the request is one that specifies an initial period and renews indefinitely at the end of the initial period unless terminated by either of the parties to the contract.

The request asked two questions:

- a. how to determine the lease term of a cancellable lease or a renewable lease. Specifically, the request asked whether, when applying paragraph B34 of IFRS 16 and assessing 'no more than an insignificant penalty', an entity considers the broader economics of the contract, and not only contractual termination payments. Such considerations might include, for example, the cost of abandoning or dismantling leasehold improvements.
- b. whether the useful life of any related non-removable leasehold improvements is limited to the lease term determined applying IFRS 16. Non-removable leasehold improvements are, for example, fixtures and fittings acquired by the lessee and constructed on the underlying asset that is the subject of the cancellable or renewable lease. The lessee will use and benefit from the leasehold improvements only for as long as it uses the underlying asset.

Lease term

Paragraph 18 of IFRS 16 requires an entity to determine the lease term as the non-cancellable period of a lease, together with both (a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and (b) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option.

In determining the lease term and assessing the length of the non-cancellable period of a lease, paragraph B34 of IFRS 16 requires an entity to determine the period for which the contract is enforceable. Paragraph B34 specifies that 'a lease is no longer enforceable when

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the lessee and the lessor each has the right to terminate the lease without permission from the other party with no more than an insignificant penalty’.

Paragraph BC156 sets out the Board’s view that ‘the lease term should reflect an entity’s reasonable expectation of the period during which the underlying asset will be used because that approach provides the most useful information’.

The Committee observed that, in applying paragraph B34 and determining the enforceable period of the lease described in the request, an entity considers:

- a. the broader economics of the contract, and not only contractual termination payments. For example, if either party has an economic incentive not to terminate the lease such that it would incur a penalty on termination that is more than insignificant, the contract is enforceable beyond the date on which the contract can be terminated; and
- b. whether each of the parties has the right to terminate the lease without permission from the other party with no more than an insignificant penalty. Applying paragraph B34, a lease is no longer enforceable only when both parties have such a right. Consequently, if only one party has the right to terminate the lease without permission from the other party with no more than an insignificant penalty, the contract is enforceable beyond the date on which the contract can be terminated by that part.

If an entity concludes that the contract is enforceable beyond the notice period of a cancellable lease (or the initial period of a renewable lease), it then applies paragraphs 19 and B37–B40 of IFRS 16 to assess whether the lessee is reasonably certain not to exercise the option to terminate the lease.

Useful life of non-removable leasehold improvements

Paragraph 50 of IAS 16 requires an item of property, plant and equipment (asset) to be depreciated over its useful life.

IAS 16 defines the useful life of an asset as (emphasis added) ‘*the period over which an asset is expected to be available for use by an entity*’, or the number of production or similar units expected to be obtained from the asset by an entity’.

Paragraphs 56 and 57 of IAS 16 provide further requirements on the useful life of an asset. In particular, paragraph 56(d) specifies that in determining the useful life of an asset, an entity considers any ‘legal or similar limits on the use of the asset, such as the expiry dates of related leases’. Paragraph 57 specifies that the useful life of an asset ‘is defined in terms of the asset’s expected utility to the entity’, and ‘may be shorter than its economic life’.

An entity applies paragraphs 56–57 of IAS 16 in determining the useful life of non-removable leasehold improvements. If the lease term of the related lease is shorter than the economic life of those leasehold improvements, the entity considers whether it expects to use the leasehold improvements beyond that lease term. If the entity does not expect to use the leasehold improvements beyond the lease term of the related lease then, applying paragraph 57 of IAS 16, it concludes that the useful life of the non-removable leasehold improvements is the same as the lease term. The Committee observed that, applying paragraphs 56–57 of IAS 16, an entity might often reach this conclusion for leasehold improvements that the entity will use and benefit from only for as long as it uses the underlying asset in the lease.

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Interaction between lease term and useful life

In assessing whether a lessee is reasonably certain to extend (or not to terminate) a lease, paragraph B37 of IFRS 16 requires an entity to consider all relevant facts and circumstances that create an economic incentive for the lessee. This includes significant leasehold improvements undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when an option to extend or terminate the lease becomes exercisable (paragraph B37(b)).

In addition, as noted above an entity considers the broader economics of the contract when determining the enforceable period of the lease described in the request. This includes, for example, the costs of abandoning or dismantling non-removable leasehold improvements. If an entity expects to use non-removable leasehold improvements beyond the date on which the contract can be terminated, the existence of those leasehold improvements indicates that the entity might incur a more than insignificant penalty if it terminates the lease. Consequently, applying paragraph B34 of IFRS 16, an entity considers whether the contract is enforceable for at least the period of expected utility of the leasehold improvements.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine the lease term of cancellable and renewable leases. The Committee also concluded that the principles and requirements in IAS 16 and IFRS 16 provide an adequate basis for an entity to determine the useful life of any non-removable leasehold improvements relating to such a lease. Consequently, the Committee decided not to add the matter to its standard-setting agenda.

Lease Incentives under IFRS 16

Background:

Under IAS 17, accounting for lease incentives was clarified by SIC-15. The interpretation indicated that lease incentives (such as rent-free periods or contributions by the lessor to the lessee's relocation costs) should be considered an integral part of the consideration for the use of the leased asset and it required a lessee to treat incentives as a reduction of lease expense over the lease term.

For example, rent free periods were treated as a payable for the portion of the expense recognized during the rent-free period and then allocated to the life of the lease. For the reimbursement of leasehold improvements, the asset was capitalized and the reimbursement amortized to reduce the lease expense.

IFRS 16 integrates this guidance into the standard by adjusting cash incentives (such as a reimbursement of leasehold improvement costs) against the value of the ROU Asset.

This would provide the same accounting outcome as IAS 17.

Issues:

The language of IFRS 16 is unclear in one case and an example provided suggests that a reimbursement may not be an incentive. To clarify these points two questions are addressed in this paper:

1. Are lease incentives only included in the computation of the ROU Asset if a lease payment is received at or before the commencement of the lease?
2. Are reimbursements for leasehold improvements not included in the ROU Asset computation as suggested by Example 13 of the Illustrated Examples to IFRS 16?
3. How are lease incentives received by the lessee in the form of cash treated in the lessee's cash flow statement?

Analysis of Issues:

Are lease incentives received after the commencement of the lease included in the valuation of the ROU Asset?

IFRS 16.24(b) requires that the cost of the right-of-use asset include any lease payments made at or before the commencement date, less any lease incentives received. This language in itself is confusing as it appears lease incentives would only be deducted if any lease payments were made at or before the commencement of the lease, when it should not matter. Appendix A in defining lease payments makes it clear that lease incentives should be deducted regardless of timing of the lease payments.

Are leasehold improvements included in the ROU Asset computation?

Lease incentives are frequently reimbursements of costs incurred by the lessee in relation to entering into the lease or preparing the leased asset for use. These payments are reflected in the calculation of the ROU Asset as a reduction in value. Incentives may also take the form of periods of "free" use of the underlying asset. These incentives require no adjustment to the value of the ROU Asset and are accounted for through the depreciation of the ROU Asset over the period of the lease that includes this free period.

IFRS 16 contains an example on how to apply the standard to IFRS 16 (Example 13). That example is not clear and the IASB has tentatively decided to remove the example.

The example states that as an incentive to Lessee for entering into the lease, Lessor agrees to reimburse to Lessee the real estate commission of CU5,000 and Lessee's leasehold improvements of CU7,000.

It goes on to state that the Lessee accounts for the reimbursement of leasehold improvements from Lessor applying other relevant Standards and not as a lease incentive under IFRS 16. It is explained that this is because costs incurred on leasehold improvements by Lessee are not included within the cost of the right-of-use asset.

Generally, the reimbursement of leasehold improvements would be a lease incentive under IFRS 16 and reduce the value of the ROU Asset, so as not to account for the leasehold improvement twice. For example, if a lessor of an aircraft reimbursed the lessee for the cost of modifications to the cabin required by the lessee, the lessee would record a separate asset and subtract that amount from the NPV of the lease payment in determining the value of the ROU Asset. The leasehold improvement asset would be amortized over its useful life and the ROU Asset over its useful life. The total expense would equal the NPV of the lease payments.

As explained in IASB Staff Paper 12 for May 2018, exceptions where reimbursements of costs incurred by the lessee would not be a lease incentive include fact patterns where:

- the lessor agrees to pay CU7,000 to the lessee for costs of leasehold improvements from which the lessor expects to benefit (not a leasehold improvement to the lessee); and
- the payment from the lessor for leasehold improvements is not associated with the lease, nor does it represent the reimbursement or assumption of costs of the lessee (not a lease incentive).

The IASB tentatively decided to propose amending Illustrative Example 13 to remove the lease improvement part of the example as part of its next annual improvements to IFRS Standards.

Treatment of cash lease incentives in the lessee's cash flow statement

The lease payments to the lessor will include the repayment of any cash lease incentives paid to the lessee by the lessor as the cash lease incentives do not form part of the leased asset. In substance, the cash lease incentives are a borrowing that is repaid to the lessor through the lease payments. This is evidenced by the cash lease incentive being deducted from the NPV of the lease payments in calculating the value of the ROU Asset.

The portion of the payments to the lessor that are not consideration for the ROU Asset, though described as a reimbursement, are in substance a repayment of the amount of the cash lease incentive and are therefore a borrowing by the lessee.

IAWG is of the view that this includes any portion of the principal payments that represent a repayment of any cash incentive received as part of the lease agreement regardless of how that cash flow was used by the lessee. The receipt of the cash lease incentive should be treated as a Financing Activity cash in-flow.

Non-cash lease incentives

Frequently a lessor will provide lease incentives in the form of a period of free use of the leased asset. IFRS 16 requires the period of the lease to include this free period and for the ROU Asset to be amortized over this period. At the same time, the Financial Liability will not be reduced by a payment, but will accrue interest that will be added to the principal.

IAWG Views:

- 1. Lease incentives are included in the computation of the ROU Asset regardless of when a lease payment is made.**
- 2. Reimbursements for leasehold improvements are included in the ROU Asset computation and Example 13 of the Illustrated Examples to IFRS 16 will be amended accordingly.**
- 3. Lease incentives received by the lessee in the form of cash are treated as a Financing Activity inflow in the lessee's cash flow statements when received.**

Management of Foreign Currency Mismatch

Background:

IFRS 16 requires a lessee to record a Right of Use (ROU) Asset and a financial liability in relation to leases currently carried off balance sheet (operating leases). As the ROU Asset is a non-monetary item if it is denominated in a foreign currency it would be translated at historical rates while the financial liability is a monetary item translated at closing (spot) rates. Therefore, when a lease is denominated in a currency other than the functional currency of the reporting entity this will create a foreign exchange (FX) mismatch that does not currently exist in the financial statements even though the FX exposure exists economically. This situation currently exists for finance leases.

This situation is common in the airline industry as aircraft leases are frequently denominated in USD.

Issue:

What approaches could an airline consider in addressing the accounting mismatch resulting from the recognition of a lease denominated in a foreign currency?

Analysis of Issues:

Contract Modification

There are a number of ways to reduce or eliminate FX volatility created by IFRS 16. Two viable approaches would be to:

- denominate the lease agreements in the functional currency of the lessee; and
- shortening the period of the lease agreement.

These approaches would be costly as the risks transferred to the lessor would need to be priced into the agreements.

Structuring Solutions

A structure that would establish an entity with the same functional currency as the currency that of the lease would eliminate this mismatch, but this approach will face a number of challenges and significant cost.

Any structure created to address the FX mismatch would involve the creation of a structured entity with a functional currency of USD to record the lease transactions. This would require the entity to have commercial substance to support the use of a functional currency other than that of the parent. Also, the leased assets would likely need to be transferred to an operating entity resulting in an intercompany finance receivable and payable. While these balances are eliminated on consolidation, the FX movement on the items is not eliminated in accordance with the provisions of IAS 21.45.

Hedge Accounting Solutions

An airline may use FX forwards, swaps and options in either cash flow or fair value hedges, as appropriate, of the recognized financial liability. This approach would require the airline to enter into these contracts with external parties. This solution would be very costly if the life of the lease were to be hedged. Common risk management practices have covered one to two years. A hedge must be established for the life of the hedging instrument, so a hedge could be applied for this limited

period, but it will not alleviate the mismatch as the FX exposure related to periods beyond the life of the hedging instrument would not be hedged.

Approaches that would not require additional cost are shown below. They would require a sufficient level of highly probable USD cash inflows.

Natural hedges

To the extent that an airline would have USD monetary assets a natural hedge would exist, and the FX translation of that balance would offset the FX movement on the lease liability.

Cash Flow Hedge

A cash flow hedge where the lease liability is the hedging instrument and highly probable future receipts of USD cash in-flows would be the hedged item would be an appropriate solution. It would be dependent upon evidencing highly probable USD inflows. This would be more challenging the longer the hedging period and is dependent on the length of the lease agreement.

Fair Value Hedge

USD cash in-flows that are firm commitments such as revenue from maintenance agreements could qualify as hedged items or hedging instruments for fair value hedge treatment in relation to FX exposure. It should be noted that they would also qualify for cash flow hedge treatment and that approach would likely be more efficient as you would be able to use highly probable contracts and not only contracts that are legally binding.

IAWG View:

As described above there are a number of viable approaches to eliminating or minimizing the FX volatility created in the financial statements when IFRS 16 is adopted. There may be other viable approaches.

Pools of Spare Parts Held Under Contract

Background:

Airlines often contract for pools of spare parts under CSP (Component Service Pool) arrangements where a supplier has responsibilities, including:

- to supply spare parts to an airline;
- to repair or overhaul unserviceable part received from an airline; and
- to replace parts due to modifications of the aircraft or at the end of life for certain spare parts.

These arrangements may involve the supplier holding the pools of spare parts at the supplier's premise or at an airline's premise. An airline may pay a number of fees to the supplier separately or these may be bundled together:

- Pool access fee (to access components from the supplier);
- Repair fee which covers the repair or overhaul of parts removed from the aircraft and placed back within the pool; and
- HBS fee for parts that are located at the airline's premises.

Spare parts held at the supplier premises by the supplier

These arrangements commonly require a supplier to give the airline access to a "pool of components" as determined by the airline. Each time the airline finds an unserviceable part, it has the right to transfer the unserviceable part to the supplier. In that case, the ownership of the "old" part is transferred to the supplier, and the airline obtains the ownership of the "new" part. The supplier will typically repair and or modify the part to the standard maintained by the pool, but may or may not return it to the pool.

Most of these components are held by the supplier at the supplier's location, and the airline has no right to the components (ie, the supplier may supply them to someone else), until the airline "calls" the part in accordance with the agreement. The supplier decides which specific part is provided to the airline.

In exchange for this service, the airline will pay the supplier a "pool access fee".

Spare parts held at the airline premises

Some components, for reasons of immediate availability, will be maintained and held by the airline at its home base. These home base components (HBS) in general have the same rights and obligations as other components, including that the airline has no ownership rights to those components (sale, rent, etc.).

The airline is required to return the HBS to the supplier when the contract expires, when the parts have reached the end of their life, when there were modifications to the aircraft that causes the need to replace the spare parts, or in cases where there was no use of a specified part in a specified period. The supplier retains legal title to the HBS parts until they are placed on the aircraft by the airline. The supplier has no right to "call" those parts or substitute them, without the airline's approval, which cannot be unreasonably withheld. Similarly, the supplier typically does not have any rights to change the stock levels in relation to home base components, without the airline's approval, which cannot be unreasonably withheld.

In exchange for this service, the airline will pay the supplier a "HBS fee" based on the quantity of the parts located at its home base.

Scope of this guidance

This paper only addresses arrangements that are limited to a supplier providing an airline access to an airline defined pool of spare parts for a specified period for a specified fee that is a small fraction of the value of the pool of spare parts and where the airline has a right, but not an obligation to purchase the spare parts.

There are a number of similar arrangements entered into by airlines and an analysis would be performed for other fact patterns to determine the appropriate treatment.

In all cases, the accounting treatment will be dependent on the facts and circumstances of the individual airline in determining the appropriate treatment.

Issues:

1. Should an airline account for spare parts that are held by the supplier and subject to being "called" by the airline in exchange for a "pool access fee", as described in this paper, as a lease?
2. Should an airline account for spare parts that are held by the airline in exchange for a "HBS fee", as described in this paper, as a lease?

Analysis of Issues:

Are spare parts within the scope of IFRS 16?

IFRS 16.BC74 indicates that IFRS 16 does not specifically exclude leases of spare parts (including non-depreciating spare parts). The IASB noted that few of these transactions, if any, would meet the definition of a lease because a lessee is unlikely to be able to hold an asset that it leases (and that is owned by another party) for sale in the ordinary course of business, or for consumption in the process of production or for sale in the ordinary course of business.

IAWG notes that in the airline industry, it would be normal for an airline that operates a Maintenance, Repair and Overhaul (MRO) servicing activity and provides those services to external parties to hold assets that it leases under one of these arrangements for consumption in the process of providing that service.

Therefore, IAWG is of the view that spare parts are within the scope of IFRS 16.

Spare parts held at the supplier premises

IFRS 16.9 states that at the inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

It is clear that the supplier owns and controls the use of the assets until the airline "calls" the part as the supplier may use the spare parts for any need and has no obligation to send a specific part, therefore a substantial right of substitution exists. Therefore, this agreement is not a lease, but a supply contract, and the "pool access fee" is compensation to the supplier for access to a pool of spare parts.

Spare parts held at the airline premises by the supplier

The assessment of this fact pattern should begin with the nature of this contractual arrangement. The primary purpose of this part of the agreement is the immediate availability to the airline of the

HBS. The "HBS fee" compensates for the higher degree of availability and supply confidence given by the supplier to the airline, not the use of the parts held by the airline. The parts are only used when purchased by the airline. That is evidenced by the "HBS fee" being a small amount in relation to the value of the HBS and that the supply agreements are typically not for the full life of the spare parts. If the fee was essentially payment for the spare parts, it would suggest that the spare parts have been purchased.

IAWG is of the view that the nature of that part of the contract is a service contract, or more specifically an optional purchase agreement, and the "HBS fee" an option premium over specific spare parts.

Even if the contract is not a service contract, there would still be questions whether the HBS arrangement meets the definition of a lease. We would begin this analysis by first determining if there is an identifiable asset. As the spare parts located at the airline premises are explicitly identified in the agreement and are not subject to substitution without the airline's consent, the assets are identifiable.

We then consider the requirements of IFRS 16.B9 that a contract conveys the right to control the use of an identified asset when customer has the right to obtain substantially all of the economic benefits of using the asset under the agreement, and it has the right to direct the use of the identified asset.

During the period that the spare parts are covered by the agreement, the airline has benefits in the form of immediate access, but this access provides no economic benefits as the parts are not put into use by the airline unless they are used to generate income from operating activities. Likewise, the airline does not take on the price, obsolescence, defect and damage at this time as it has no obligation to purchase the spare parts. Benefits generally transfer along with the risk in commercial transactions. They acquire the right to obtain economic benefits and assume the risks on purchase.

If the airline were to determine in relation to a different fact pattern that it did receive substantially all of the benefits of using the assets, they would then consider whether they have control. IFRS 16 provides relevant guidance in paragraphs B24-30. Control would exist when the airline has decision-making authority over the use of the spare parts and in the fact pattern discussed in this paper that would appear to exist for the airline as the supplier has no control over the spare parts.

IAWG is of the view that for the reasons stated above in relation to this fact pattern, the HBS assets would not qualify as a lease. They would be appropriately accounted for as a conditional purchase contract with the HBS fee allocated to the period of the service provided.

IAWG Views:

- 1. An airline would not account for spare parts that are held by the supplier and subject to being "called" by the airline in exchange for a "pool access fee" as a lease unless the substance of the agreement evidences that the airline controls the spare parts and that they have been put into use.**
- 2. An airline would not account for spare parts that are held by the airline in exchange for a "HBS fee" as a lease unless the substance of the agreement evidences that the airline controls the spare parts and they have been put into use.**

Relevance of Lessor Criteria to Lessees under IFRS 16

Background:

IFRS 16, *Leases* does not apply to agreements that are determined to be purchase/sales agreements. Under the previously standard on leasing, a finance lease was accounted for in the same manner as a financed purchase of the underlying asset. This raises the question whether the criteria for determining if the lease agreement is a finance lease for the lessor under IFRS 16 would also apply in determining if an agreement is in fact a purchase by the buyer (lessee).

Issues:

This paper clarifies whether the criteria used by the lessor to determine if an agreement is a finance lease also applies in determining if the agreement is a purchase agreement for the lessee.

Analysis of Issues:

IFRS 16, BC140 indicates that the standard applies to contracts that convey the right to use an underlying asset for a period of time and does not apply to transactions that transfer control of the underlying asset to an entity—such transactions are sales or purchases within the scope of other Standards (for example, IFRS 15 or IAS 16).

IFRS 16.99 with regard to sales and leasebacks indicates that an entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

The IASB considered whether to include requirements in IFRS 16 to distinguish a lease from the sale or purchase of an asset and decided not to provide these requirements. The IASB observed that the accounting for leases that are similar to the sale or purchase of the underlying asset would be similar to applying the respective requirements of IFRS 15 and IAS 16 (see IFRS 16, BC138-139)

IFRS 15.33 defines control of an asset as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly.

When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the asset (see IFRS15.B64–B76).

IFRS 16.63-64 provides criteria for determining whether a lease is a finance lease or an operating lease. This depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would support a finance lease classification are:

- transfer of ownership of the underlying asset to the lessee by the end of the lease term;
- the lessee has a bargain purchase option;
- the lease term is for the major part of the economic life of the underlying asset;
- at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset;
- underlying asset is significantly customised for the lessee;
- if the lessee can cancel the lease and the lessor's losses are borne by the lessee;
- residual value risk accrue to the lessee; and
- the lessee is able to extend or renew the agreement at a price substantially below market.

IAWG View:

In determining whether an agreement is a sale/purchase agreement or a lease the appropriate criteria to be used is that shown in IFRS 15 in relation to the transfer of control.

Treatment of the Initial Direct Lease Costs by Lessees

Background:

This paper considers the treatment of initial direct lease costs by lessees on adoption of IFRS 16. In order to measure the right-of-use (ROU) asset under the new standard, initial direct costs should be included. These costs differ from the previous definition under IAS 17 as follows:

	IFRS 16	IAS 17
Definition of initial direct costs by lessees	Incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained.	Incremental costs that are directly attributable to negotiating and arranging a lease.

The IFRS 16 definition results in certain costs that may have been capitalized as part of a finance lease asset under IAS 17 being excluded from the ROU asset measurement.

Issues:

This paper clarifies how to apply IFRS 16 to initial direct costs to new and existing leases upon adoption of the standard.

1. What initial costs should be included in the valuation of the lessee's right-of-use (ROU) asset?
2. For existing operating leases, how should the initial direct costs be treated upon adoption of the standard?

Analysis of Issues:

Costs included in the lessee's ROU asset

IFRS 16.24 requires the cost of the ROU Asset to be comprised of:

- (a) the amount of the initial measurement of the lease liability;
- (b) any lease payments made at or before the commencement date, less any lease incentives received;
- (c) any initial direct costs incurred by the lessee; and
- (d) an estimate of dismantling and restoration costs to be incurred by the lessee.

It would not include leasehold improvements such as painting the fuselage or outfitting the cabin.

IFRS 16 requires a lessee to include initial direct costs in the initial measurement of the ROU asset and depreciate those costs over the lease term. Including initial direct costs in the measurement of the ROU asset is consistent with the treatment of costs associated with acquiring other non-financial assets (for example, property, plant and equipment and intangible assets).

The IASB decided that lessees and lessors should apply the same definition of initial direct costs. This decision was made primarily to reduce complexity in applying IFRS 16. As described in paragraph BC237, the IASB also decided that the definition of initial direct costs for lessors should be consistent with the definition of 'incremental costs' in IFRS 15. Consequently, IFRS 16 defines

initial direct costs as incremental costs of obtaining a lease that would not have been incurred if the lease had not been obtained.

IFRS 16, IE Example 13 provides a useful illustration where, in order to obtain a lease for a floor of a building, the lessee makes a CU15, 000 payment to a former tenant and a CU5, 000 payment for a commission to the real estate agent that arranged the lease. In addition, the lessee incurs leasehold improvement costs of CU7, 000. As an incentive to the lessee for entering into the lease, the lessor agrees to reimburse the lessee for the real estate commission of CU5, 000 and the lessee's leasehold improvement costs of CU7, 000.

The payment to the former (CU 15,000) tenant is an incremental cost which would not have been paid had the lease not been obtained. It is therefore included in the ROU asset's value.

The payment for the real estate commission (CU 5,000) is also an incremental cost which would not have been paid had the lease not been obtained. Therefore, the cost incurred by the lessee would be included in the ROU asset's value. However, as the lessor reimbursed the cost to the lessee, there is no cost for the lessee to include in the ROU asset's value. Had the commission been paid regardless of whether the lease was entered into, it would not form part of the ROU asset's value as it would have been incurred even if the lease was not obtained and would have been expensed to the income statement in the period in which it was incurred.

The lessee accounts for the reimbursement of leasehold improvements (CU 7,000) by the lessor by applying other relevant standards rather than as a lease incentive applying IFRS 16. This is because costs incurred on leasehold improvements by the lessee are not directly attributable to negotiating and arranging a lease.

The table below identifies typical costs incurred during a lease negotiation and indicates whether these costs should be capitalized as initial direct costs.

Nature of costs	Not related to obtaining a lease (apply other relevant accounting standards)	Related to obtaining a lease (capitalize as part of the ROU asset and depreciate)
Commission or arrangement fees paid regardless of the lease being obtained	Yes	
Legal fees incurred prior to the lessee entering into the lease	Yes	
Costs required to bring the leased asset into use.	Yes	
Leasehold improvements	Yes	
Overheads	Yes	
Unsuccessful origination efforts	Yes	

Nature of costs	Not related to obtaining a lease (apply other relevant accounting standards)	Related to obtaining a lease (capitalize as part of the ROU asset and depreciate)
Commission or arrangement fees paid on a success basis		Yes
Sales tax, value added tax or excise tax		Yes
Fees paid to existing lessees, for example for them to terminate an existing lease.		Yes
Registration fees or licenses to operate		Yes

Initial Adoption of IFRS 16

IFRS 16 provides two options to apply to existing leases on initial adoption of the standard. Full retrospective treatment under IAS 8 (restate prior periods) or modified retrospective treatment with the cumulative effect of the change recognized at the date of initial application (no restatement). If the modified retrospective approach is applied, the ROU asset may be measured at an amount equal to the liability or at its carrying value as if the standard had applied at lease commencement. Under both options available using the modified retrospective approach, initial direct costs may be excluded when measuring the ROU asset. This option is available on a lease-by-lease basis.

If the modified retrospective approach is elected, a lessee may exclude initial direct costs from the measurement of the ROU asset at the date of initial application. This option is available on a lease-by-lease basis.

IAWG Views:

- 1. Initial costs included in the valuation of the lessee's ROU asset are limited to incremental costs directly attributable to negotiating and arranging the lease and that are incurred only if the lease is obtained.**
- 2. For existing operating leases, the initial direct costs are recognized in accordance with the new definition under IFRS 16 if the full retrospective treatment is applied. If the modified retrospective approach is applied, there is an option to exclude the initial direct costs from the measurement of the ROU asset. This option is available on a lease-by-lease basis.**

Use of the Low-Value Exemption and Materiality in Relation to Lease Agreements

Background:

The IASB included a low-value exception in IFRS 16 that applies to underlying assets. IFRS 16.B6 indicates that the assessment of low-value should be based on the value of the underlying asset when new. While the standard itself does not define “low-value”, the basis for conclusion does reference \$5,000 as the type of value intended. The FASB decided not to include such an exemption, instead leaving the matter to be addressed in terms of materiality.

IFRS 16.B3 further explains that a lessee shall assess the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset being leased. This may result in an asset where much or most of its useful life has been consumed exceeding the low-value threshold, but the impact of the lease being immaterial. This could also be the case for property leases where the underlying asset has substantial value, but the length of the lease and size of the portion leased is immaterial.

This raises a number of issues around the application of the low-value-exception and materiality in relation to leases.

Issues:

1. Is the low value asset exemption in IFRS 16 applied at the contract level or the item level?
2. Does IFRS 16 create a bright line value of \$5,000 or less for low value assets?
3. May an airline apply materiality rather than the low value exemption to some or all leases?

Analysis of Issues:

Low value asset exemption applied at the contract or item level

IFRS 16.5 states that a lessee may elect not to apply the recognition requirements of IFRS 16 to leases for which the *underlying asset* is of low value. The term “underlying asset” could be understood to be all assets covered by the contract (for example a group of laptops) or a specific item (a single laptop).

IFRS 16.B5 does indicate that an underlying asset can be of low value only if the lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee, and the underlying asset is not highly dependent on, or highly interrelated with, other assets. This does not directly address the unit of measure for the underlying asset but suggests that the appropriate unit of measure is the item and not the agreement.

Having discussed this matter with the standard-setter and international accounting firms, IAWG is of the view that the correct unit of measure is a specific item in the agreement that meets the criteria in IFRS 16.B5 and not the collection of assets covered by the agreement.

Does IFRS 16 create a bright-line value of \$5,000 or less for low value assets?

Paragraph 100 of the Basis for Conclusion of IFRS 16 states that at the time of reaching decisions about the exemption in 2015, the IASB had in mind leases of underlying assets with a value, when new, in the order of magnitude of US\$5,000 or less.

The IASB has consistently stated that they will not establish bright-line thresholds and that the basis for conclusion does not form part of the standard.

IFRS 16.B8 gives examples that suggest a wider latitude for setting the threshold. It indicates that low-value underlying assets can include tablet and personal computers, small items of office furniture and telephones and IFRS 16.B8 indicates that for example, leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value.

IAWG is of the view that the threshold suggested in the basis of conclusion of IFRS 16 is indicative and not prescriptive, and that it does not create a bright-line.

Can the low value exemption apply to some leases and materiality to others?

IFRS 16.B4 explains that the assessment of whether an underlying asset is of low value is performed on an absolute basis. Leases of low-value assets that qualify for the accounting treatment qualify regardless of whether those leases are material to the lessee.

IFRS 16.BC103 explains that the IASB decided that the recognition exemption for leases of low-value assets should be applied on a lease-by-lease basis. Therefore, an airline could apply the low-value exception to items below an established threshold for low-value and at the same time apply materiality to other agreements.

IFRS 16.6 states that if a lessee elects to apply low value exception, the lessee will record the lease payments as an expense on either a straight-line basis over the lease term or another systematic basis. IAWG is of the view that immaterial agreements would be treated in a similar manner.

Note that if this exception is applied, a lessee is required to disclose the amount of the expense recognized related to leases of low-value assets for which the lessee has elected to apply the recognition exemption. No such disclosure is required if these leases were treated as immaterial.

IAWG Views:

- 1. The low value asset exemption in IFRS 16 is applied at the distinct item level and not the contract level.**
- 2. IFRS 16 does not create a bright line value of \$5,000 or less for low value assets. It provides an indication of a value within an acceptable range of values.**
- 3. An airline may apply materiality along with the low value exemption to some or all leases.**

Variable Rates in Lease Agreements

Background:

IFRS 16 defines variable lease payments as the portion of payments made by a lessee to a lessor for the right to use an underlying asset during the lease term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

The measurement of the financial liability at commencement of a lease agreement includes a number of items and one of them is variable lease payments that depend on an index or a rate, for example, payments linked to a consumer price index, payments linked to a benchmark interest rate (such as LIBOR) or payments that vary to reflect changes in market rental rates. These payments are initially measured using the index or rate as at the commencement date in accordance with IFRS 16.27(b).

Rates such as LIBOR periodically reset and would require the lessee to remeasure the ROU Asset and Financial Liability in accordance with IFRS 16.42(b). Generally, this is done using the same incremental borrowing rate, but IFRS 16.43 states that there is an exception for floating interest rates, such as LIBOR. This should align the revised cash flows and discount rate resulting in no change in NPV and therefore no change in the Financial Liability and ROU Asset. This assumes that the incremental borrowing rate is based on the same floating rate and reset period, and that any "credit spread" remains constant.

Issues:

Should a change in a floating interest rate, such as LIBOR, result in a change in the value of the Financial Liability and ROU Asset?

Analysis of Issues:

IFRS 16.42(b) states that a lessee shall remeasure the lease liability by discounting the revised lease payments, if there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect). A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

IFRS 16.43 states that in applying paragraph 42, a lessee shall use an unchanged discount rate, unless the change in lease payments results from a change in floating interest rates. In that case, the lessee shall use a revised discount rate that reflects changes in the interest rate.

Based on these requirements, at the date when LIBOR rate changes, the lessee should revise the discount rate and the future lease payments linked to LIBOR. If the discount rate is based on LIBOR (that would be most common) it would appear that the cash flows and discount rate would adjust at the same time and result in no change in NPV.

Using the new rate, the lessee remeasures the Financial Liability, and it should not change because of the change in the LIBOR rate. Accordingly, the right-of-use asset should not be affected by the change in LIBOR. What does change is distribution of principal and interest components in future payments as the interest rate applied to the principal balance of the financial liability in computing the interest element of the payment will change.

This assumes that the discount rate (rate implicit in the lease or incremental borrowing rate) is linked to the variable rate. Generally variable borrowing rates include a "credit spread" that is fixed. While

this may change, IAWG is of the view that the implicit rate in the lease has only changed in relation to the variable component as only that portion is impacted. The incremental borrowing rate's "credit spread" may change, but as it was used as a proxy for the implicit rate in the lease, the implicit rate would not be impacted and therefore should not change the values of the Financial Liability and ROU Asset.

IAWG View:

A change in a floating interest rate, such as LIBOR, will result in no change in the value of the Financial Liability and ROU Asset if the discount rate has a variable rate component that matches the variable rate in the lease agreement.